

*Consignment Done Right:
Perfect and Notify for Enforceable Rights in
Bankruptcy*

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As originally published in the Credit Research Foundation 1Q 2020 Credit & Financial Management Review

Abstract

A vendor who fails to comply with UCC Article 9's strict requirements does so at the risk of forfeiting rights in its consigned inventory to the consignee's secured creditors with a perfected blanket security interest in the consignee's inventory, and being left with a low priority general unsecured claim.

Introduction

Consignment is a business arrangement between a vendor (known as the consignor) and a customer (known as the consignee). Consignees include retailers that specialize in a particular type of consumer product, such as clothing, shoes, athletic equipment and gear, as well as other customers in the business of selling consigned goods. Alternatively, customers can use the consigned goods in their possession in the production of finished goods and defer payment until after usage.

Customers that enter into consignment arrangements may benefit from the ability to offer a wider range of products, potentially drawing in new business and higher profits. The customer's operational financial risk is also greatly reduced compared to wholesalers and retailers that pre-purchase their entire inventory in the hopes of then selling the goods to retail consumers. Customers may also benefit from payment timing and cash flow because the purchase price of the consigned inventory is not paid for until the inventory is actually sold to the retail consumer.

Similarly, consignors may benefit from a consignment arrangement by obtaining higher visibility of their new product brands and gaining additional sales channels for proven products. The consignment arrangement may also significantly reduce the consignor's product storage costs by transferring the physical possession of the consigned goods to the consignee pending sale to consumers. Consignors may also enjoy the protections that Article 9 of the Uniform Commercial Code (UCC) provides to consignors that properly document, perfect and provide advance notice with respect to their consignment arrangements. So, what happens when a consignor does not "dot its Is" and "cross its Ts", by failing to comply with UCC Article 9's consignment requirements?

UCC Article 9 governs most consignment transactions and generally requires vendors to satisfy specific requirements in order to retain a superior interest in the consigned inventory. When vendors diligently complete the steps required by the UCC, they will gain priority over prior creditors with a blanket security interest in the customer's inventory and maintain priority over subsequent creditors with a security interest in the customer's inventory and unsecured creditors. However, vendors that fail to comply with the UCC Article 9's consignment requirements, including timely filing a UCC-1 financing statement in the appropriate jurisdiction, and providing the requisite advance notice of the consignment arrangement to all secured parties with a prior blanket security interest in the customer's inventory, risk forfeiting their superior rights in the consigned inventory and being relegated to holding a low priority general unsecured claim.

The enforceability of a vendor's consignment rights is often tested once a customer files for bankruptcy. The vendor's due diligence, preparation of the proper documentation for execution by the customer, perfection by filing a UCC-1 financing statement and advance notification of the consignment arrangement to existing creditors with a blanket inventory lien, as well as prompt actions the vendor should take to enforce its consignment rights following the filing of its customer's bankruptcy case, will often determine the extent of the consignor's recovery.

This article reviews three relatively recent decisions from the U.S. Bankruptcy Court for the District of Delaware arising from the Chapter 11 bankruptcy case of The Sports Authority

Holdings, Inc. (“Sports Authority”). These decisions provide insightful guidance concerning the consequences of failing to properly perfect a consignor’s rights and provide the required notice under the UCC, as well as some creative arguments consignors have raised in the absence of compliance with the UCC’s filing and notification requirements in seeking recovery of its consigned goods and recovery on its consignment claim.

UCC Consignment Overview

Consignment vendors deliver inventory to their customers pursuant to the terms of a written consignment agreement. The vendor typically retains title to the inventory and agrees to defer payment from the customer until the customer sells or otherwise uses the consigned goods. The vendor usually requires its customer to provide notice of the sale or use of the consigned goods. The vendor then, upon receipt of such notice, generally issues an invoice to its customer with the payment terms set forth in the consignment agreement, or a separate agreement between the vendor and customer. Alternatively, if the customer is unable to sell or use the inventory within a stated time period, the agreement can require that the customer return the consigned inventory to the vendor. Some consignment agreements provide that if the consigned goods are not sold or used within a specified time, title to the goods passes to the customer and the purchase price is payable according to the terms set forth in the consignment agreement or other agreement.

Many consignment transactions are governed by state law, usually the UCC. UCC Article 2-401 provides that a vendor’s retention of title to goods delivered to a customer is limited to the grant of a security interest in the goods. UCC Article 9-102(a)(2) defines a consignment as a transaction in which a vendor delivers inventory to a customer for purposes of sale, and the customer: (i) deals in inventory of that kind under a name other than the name of the vendor; (ii) is not an auctioneer; and (iii) *is not generally known to be substantially engaged* in selling the inventory of others. As part of any consignment arrangement, the aggregate value of the goods must be \$1,000 or more at the time of delivery, the goods must not be consumer goods immediately before delivery, and the transaction cannot create a security interest that secures an obligation.

UCC Article 9-103(4) also provides that a consignor’s interest in consigned goods is a purchase money security interest inventory. As such, a consignor must satisfy each of the following to obtain priority over other previously perfected creditors holding a valid security interest in the customer’s inventory and in the identifiable proceeds thereof:

1. The consignment interest must be perfected when the consignee receives possession of the inventory. The consignor perfects its interest by filing a UCC-1 financing statement describing the consigned inventory in the correct jurisdiction. A consignor may file a UCC-1 financing statement on its own, without the consignee’s signature, as long as the consignee executes or authenticates a consignment agreement describing the consigned inventory;

2. The consignor must send an authenticated notification to all holders of previously perfected security interests in the consignee's inventory. To do so, the consignor must conduct UCC and other lien searches in all applicable jurisdictions to identify all secured lenders that hold a prior perfected security interest in the customer's inventory. The notification must state that the consignor has, or expects to acquire, a consignment interest in inventory owned by the consignee and provide a description of the inventory; and
3. The holder of the previously perfected security interest must receive the notification within five years prior to the consignee's obtaining possession of the consigned inventory.

A consignor that fails to properly file a UCC-1 financing statement and timely provide the required notice to all holders of prior blanket security interests in the consignee's inventory risks losing any prior rights in the consigned inventory to creditors of the customer that obtain a judicial lien or security interest in the same inventory. This is especially significant where the consignee is a debtor in a bankruptcy case because the Bankruptcy Code provides that a trustee or debtor-in-possession can assert the rights of a hypothetical judicial lien creditor to avoid any unperfected consignment interests. A bankruptcy trustee or debtor in possession that avoids an unperfected consignment interest turns the consignor into a low priority general unsecured creditor.

Limited Exceptions to the UCC's Consignment Requirements

Consignors that fail to comply with UCC Article 9's requirements for perfecting their consignment interests and providing the requisite notice still may have a path to recovery on their consignment interests. There are exceptions to UCC Article 9's requirement that consignors file a UCC-1 financing statement describing the consigned inventory and provide timely advance notice of the consignment to the consignee's secured creditors with a prior perfected security interest in the consignee's inventory. However, these exceptions to the UCC's filing and notice requirements are limited in scope and often very difficult to prove.

Consignors that neglect to follow the UCC's filing and notice requirements may argue that their transactions are "true consignments" under state law that are subject to UCC Article 9. "True consignments" exist where the customer/consignee is generally known by its creditors to be substantially engaged in selling the goods of others. A consignor can demonstrate a "true consignment" exists by proving that *the consignee is generally known by its creditors to be substantially engaged in selling consigned goods*. Such "true consignments" need not comply with UCC Article 9's filing and notice requirements.

In addition to this "general knowledge" exception, UCC Article 9's filing and notice requirements do not apply to consignment transactions where the previously perfected creditor

had *actual knowledge* that inventory was held on consignment when the creditor obtained its security interest. To prevail, the consignor must prove that the consignee's other previously perfected secured creditors had *actual knowledge that* the consignee was engaged in a consignment transaction with the consignor.

The rationale for these exceptions to compliance with the UCC's filing and notice requirements is that Article 9 is intended to protect creditors from "hidden liens," such as the "secret liens" of unperfected vendors. The UCC's policy of protecting creditors against a non-compliant consignor's "secret lien" does not apply to secured creditors with actual knowledge of the consignor's interest when the creditors had made their secured loans to the customer. A consignment interest in such circumstances should not be extinguished for non-compliance with the UCC's filing and notice provisions because the unperfected consignor's interest is no secret to a secured creditor with actual knowledge of the consignor's interest in its consigned goods when the creditor had made its secured loan.

While this exception is easy to state, and has been recognized in certain circumstances, it is a very fact-dependent defense that is extremely difficult and costly to prove. First, it is difficult to show that a consignee is "generally known" by its creditors to be substantially engaged in selling consigned goods. Second, it is hard to prove that a previously perfected secured creditor had "actual knowledge" of a consignor's consignment interest. For these reasons, unperfected and otherwise noncompliant consignors have rarely succeeded in invoking these exceptions to recover their consigned goods or otherwise utilize their consignment rights to recover on their claims.

The Sports Authority Cases

On March 2, 2016 (the "Petition Date"), Sports Authority, a national retailer of sporting goods and active apparel, filed a voluntary Chapter 11 bankruptcy case. As part of its business, Sports Authority developed a "pay by scan" program for the sale of its vendors' inventory on consignment. Depending on the terms of the particular consignment agreement, when the consigned goods were sold, Sports Authority paid the vendor either a fixed amount or a percentage of the inventory's sale price. Performance Apparel Corp. ("Performance Apparel"), M J Soffe, LLC ("Soffe") and Sport Dimension Inc. ("Sport Dimension") had each entered into "pay by scan" consignment agreements with Sports Authority. Soffe and Sport Dimension failed to timely file the requisite UCC-1 financing statements in connection with their consignment arrangements. Performance Apparel did file a UCC-1 financing statement and provided proper notice, but then allowed its UCC-1 to lapse by failing to file a UCC continuation statement prior to the Petition Date.

Prior to filing for bankruptcy, Sports Authority borrowed approximately \$1.1 billion under a credit agreement with Bank of America (BOA), as administrative agent for a syndicate of term loan lenders. This included a \$300 million term loan, which was secured by a first-priority security interest in Sports Authority's hard assets, intellectual property, and general intangibles, as well as a second-priority security interest in Sports Authority's inventory. The term loan lenders obtained their security interest through Sports Authority's execution of a security

agreement. The lenders perfected their security interest by timely filing UCC-1 financing statements in all applicable jurisdictions. On December 31, 2015, Wilmington Savings Fund Society (WSFS) replaced BOA as the term loan lenders' agent.

At the outset of the Chapter 11 case, a dispute emerged over whether Sports Authority could pledge (as part of its Chapter 11 financing arrangement) or sell consigned inventory in Sports Authority's possession, where the consignors had failed to perfect their consignment interest or otherwise comply with UCC Article 9's consignment requirements, without the consignors' consent. The bankruptcy court allowed Sports Authority to sell the consigned inventory in the ordinary course of business but required that Sports Authority pay for the consigned goods in accordance with the terms of each respective consignment agreement. However, the bankruptcy court's order specifically preserved WSFS' rights to recover any payments Sports Authority made to a consignor from the sale of inventory in the event the bankruptcy court subsequently ruled that WSFS had a superior interest in the consigned goods.

Approximately two weeks after the Petition Date, Sports Authority commenced over 160 separate adversary proceedings against consignment vendors, including Performance Apparel, Soffe and Sport Dimension. In each litigation, Sports Authority asked the bankruptcy court to determine whether WSFS or the respective consignor had a superior interest in the consigned goods. WSFS subsequently intervened as a plaintiff in the adversary proceedings and sought a declaration by the bankruptcy court that WSFS had a senior perfected security interest in the consigned inventory. While substantially all of the other defendant consignment vendors had settled with Sports Authority in the early stages of the litigation, Performance Apparel, Soffe, and Sport Dimension each filed answers and counterclaims to the complaint, seeking a declaration that WSFS' security interest did not attach to their consigned inventory and that WSFS' lien was subordinate to their consignment rights. A summary of key facts, legal arguments, and the bankruptcy court's rulings in each of these litigations is provided below. These case studies provide an insightful overview of the myriad of legal and factual disputes that may arise from contested consignment arrangements that do not comply with UCC Article 9's requirements for a UCC-1 financing statement filing and advance notification.

Soffe

In 2010, Soffe entered into a "pay by scan" consignment arrangement with Sports Authority. Soffe neglected to file a UCC-1 financing statement or otherwise notify WSFS of Soffe's consignment arrangement with Sports Authority until February 4, 2016, less than one month before the Petition Date. At that time Soffe filed a UCC-1 financing statement and notified WSFS of Soffe's UCC filing and consignment arrangement.

Soffe asserted a claim of approximately \$5,421,528 on account of consigned goods that were in Sports Authority's possession on the Petition Date. WSFS argued that Article 9 of the UCC governed the priority of interests in Soffe's consigned goods, and contended that WSFS' interest was superior to Soffe's interest in the inventory because WSFS had filed its UCC-1 financing statement first and Soffe had failed to comply with UCC Article 9's consignment requirements. In response, Soffe argued that Article 9 did not apply to its interest in the consigned goods

because BOA had actual knowledge of Soffe's consignment arrangement and that such knowledge was imputed to the term loan lenders, including WSFS.

Soffe attempted to prove the actual knowledge exception to UCC Article 9's consignment requirements by arguing that the term loan lenders, including WSFS, knew that the inventory was sold on consignment to Sports Authority based on documents BOA had received as a lender to Soffe and its parent company, Delta Apparel, Inc. (Delta) under a completely separate credit facility. As part of that loan arrangement, Delta prepared and submitted monthly borrowing base reports to BOA, which included a list of specific assets excluded under the Delta loan, including a line item titled "TSA Pay By Scan." A BOA representative reviewed the monthly borrowing base reports in connection with Delta's loan. However, the BOA representative testified that he did not specifically know that Soffe had sold inventory on consignment to Sports Authority, but only that he was generally aware that Soffe had sold certain inventory on consignment terms.

The bankruptcy court ruled that UCC Article 9 governed the respective interests of Soffe and the term loan lenders in the consigned goods. The bankruptcy court concluded that Soffe had failed to satisfy the exceptions to the UCC filing requirements because Soffe did not prove that BOA had "actual knowledge" of Soffe's consignment arrangement with Sports Authority. The bankruptcy court held that the reference to Sports Authority in Delta's borrowing base reports was ambiguous, and that BOA's representative did not know that Soffe was selling consigned inventory to Sports Authority.

Alternatively, the bankruptcy court found that even if BOA had actual knowledge of Soffe's consignment arrangement with Sports Authority, Soffe did not prove BOA's knowledge could be imputed to WSFS or the other term loan lenders. The bankruptcy court held that BOA had no duty under its agreements with the term lenders to provide notice to the lenders of Soffe's consignment arrangement with Sports Authority.

Accordingly, the bankruptcy court ruled that WSFS' security interest had priority over Soffe's interest in the consigned goods that Soffe delivered to Sports Authority prior to Soffe's filing of its UCC-1 financing statement and the provision of notice to WSFS. The bankruptcy court relied on WSFS' perfection of its blanket security interest in Sports Authority's inventory (by filing its UCC-1 financing statement) before Soffe had perfected its interest.

WSFS conceded that Soffe had satisfied its UCC Article 9 filing and notification obligations when it finally filed its UCC-1 financing statement and sent a notification letter to WSFS on February 4, 2016. Accordingly, the bankruptcy court granted Soffe priority status in its consigned goods, valued at \$580,207.53, that were in Sports Authority's possession on the Petition Date and that Soffe had delivered between February 4, 2016 and the Petition Date.

Sport Dimension

Sport Dimension, a manufacturer of athletic apparel, began selling inventory to Sports Authority in the 1990s. In 2011, Sport Dimension and Sports Authority entered into a consignment arrangement. Similar to Soffe, Sport Dimension neglected to file a UCC-1 financing statement

and provide notice to BOA, until January 25, 2016, just a little over one month before the Petition Date.

WSFS argued that Article 9 of the UCC governed the priority of interests in the disputed consigned goods and contended that its interest was superior to Sport Dimension's interest because WSFS was first to file a UCC-1 financing statement. In response, Sport Dimension made three arguments for why UCC Article 9 did not apply to its interest in the consigned goods. First, Sports Authority's creditors generally knew Sports Authority was *substantially engaged* in selling the inventory of others. Second, WSFS had *actual knowledge* of Sports Authority's consignment arrangement with Sport Dimension. Third, Sport Dimension had satisfied Article 9's requirements by sending notice of the filing of its UCC-1 financing statement to BOA prior to the Petition Date. The bankruptcy court rejected each of Sport Dimension's arguments.

The bankruptcy court held that a consignee is "substantially engaged" in selling the goods of others, such as consigned goods, where consigned inventory comprises 20% or more of the value of all of the consignee's inventory. Sport Dimension could not show that Sports Authority met this threshold because the value of Sports Authority's consigned goods, either before or after the Petition Date, never exceeded 14% of the value of all of Sports Authority's inventory.

The bankruptcy court also held that Sport Dimension failed to prove that WSFS or the term loan lenders had actual knowledge of Sport Dimension's consignment arrangement with Sports Authority. The bankruptcy court ruled that UCC Article 9 governed Sport Dimension's arrangement with Sports Authority because Sport Dimension could not prevail on its substantial engagement in selling consigned goods and actual knowledge arguments.

The bankruptcy court also rejected Sport Dimension's argument that it had satisfied Article 9's requirements by sending notice of its UCC filing/consignment interest to BOA, the term lenders' predecessor agent. The bankruptcy court found that Sport Dimension never sent notice to WSFS, the term lenders' then current agent, and that there was no evidence that BOA had forwarded Sport Dimension's notice to WSFS or had any obligation to do so. Consequently, WSFS's security interest in the inventory had priority over Sport Dimension's consignment rights. The bankruptcy court directed Sport Dimension to disgorge all proceeds of the consigned inventory Sport Dimension had received post-petition.

Performance Apparel

In 2009, Performance Apparel entered into a consignment arrangement with Sports Authority. Unlike Softe and Sport Dimension, Performance Apparel did timely file a UCC-1 financing statement and gave proper notice to BOA. However, Performance Apparel's UCC-1 financing statement and security interest lapsed in 2014, when Performance Apparel had failed to timely file a continuation statement to extend the effectiveness its UCC-1 financing statement. This left Performance Apparel with an unperfected interest in its consigned goods in Sports Authority's possession with an estimated "extended cost" of \$1,586,446 as of the Petition Date.

WSFS argued that UCC Article 9 governed the priority of interests in the consigned goods and that WSFS' security interest in the consigned goods had priority over Performance Apparel's

consignment rights in the goods. WSFS relied on its security agreement that included, as collateral, all of Sports Authority's inventory and WSFS's properly filed UCC-1 financing statement. WSFS argued that the lapse of Performance Apparel's UCC-1 financing statement resulted in Performance Apparel losing its perfected interest and prior rights in the consigned inventory.

In response, Performance Apparel argued that the term loan lenders were unable to assert superior rights in the consigned goods because Performance Apparel's consignment rights were not subject to UCC Article 9. Performance Apparel attempted to prove that the term loan lenders had *actual knowledge* of Performance Apparel's consignment arrangement with Sports Authority before the lenders extended their secured term loan.

The bankruptcy court sided with Performance Apparel, holding that the term loan lenders had actual knowledge of Performance Apparel's consignment arrangement with Sports Authority and of Performance Apparel's prior rights in its consigned goods when the term lenders had extended their secured loans. As a result, Performance Apparel did not lose its consignment rights when its UCC-1 financing statement had lapsed. Consequently, the bankruptcy court held that Performance Apparel's interest in its goods consigned to Sports Authority was superior to the term lenders' blanket security interest in the goods.

Disposition of Consignment Appeals

The procedural history of each of the adversary proceedings summarized above is perhaps the best indicator of the time, energy, and litigation costs that may result when consignors do not comply with their UCC Article 9 obligations and are forced to litigate the exceptions to compliance with the UCC. In March 2016, the adversary proceedings were commenced in the bankruptcy court against Performance Apparel, Soffe, and Sport Dimension. The bankruptcy court issued its decisions in the Performance Apparel and Soffe adversary proceedings in November, 2018. The opinion in the Sport Dimension adversary proceeding was issued in April, 2019. Each of the consignors then appealed the bankruptcy court's ruling to the U.S. District Court for the District of Delaware. Ultimately, all of the appeals were dismissed after each of the consignors entered into settlement agreements with WSFS and the Debtors in late 2018 and 2019.

Conclusion

As the trio of Sports Authority cases illustrate, a vendor who fails to comply with UCC Article 9's strict requirements does so at the risk of forfeiting rights in its consigned inventory to the consignee's secured creditors with a perfected blanket security interest in the consignee's inventory, and being left with a low priority general unsecured claim. While consignors that fail to comply with the UCC may have some basis to argue that they have a true consignment that is not subject to UCC Article 9, the reality is that this defense is very difficult and costly to prove. Best practices warrant that a consignor follow UCC Article 9's perfection and advance

notification requirements to obtain prior rights in its consigned goods. That is the preferred way to avoid costly litigation risk and the loss of rights in the consigned goods.

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