

# Morgan Lewis

## INSIGHT

# UNDERSTANDING CONSIGNMENTS IN RETAIL BANKRUPTCIES

July 13, 2018

## AUTHORS AND CONTACTS

**Edwin E. Smith**

In retail bankruptcies, it is important for suppliers consigning goods to merchants to be aware of the commercial law rules governing consignments. Disputes among consignors, inventory lenders, and bankruptcy debtors have been arising frequently in retail bankruptcy cases. Disputes like these can be avoided if consignors consider the basics of commercial law rules governing consignments, particularly under the Uniform Commercial Code, and take steps to protect their rights and interests.

With the rise of retail store bankruptcies, it has become clear that many suppliers that consign goods to retail merchants are not fully knowledgeable of the commercial law rules governing consignments, especially those under the Uniform Commercial Code (UCC),<sup>[1]</sup> or the risks of not complying with those rules. The use of consignments by suppliers to retail merchants is more common than is widely thought. In bankruptcy cases such as those of The Sports Authority<sup>[2]</sup> and hhGregg,<sup>[3]</sup> consignors have clashed in litigation with inventory lenders of consignees and bankruptcy debtors on issues that, with proper planning, could have been avoided. This Insight will explain some of the basics of these commercial law rules by responding to a number of questions that, while perhaps not frequently asked, should be asked by consignors.

### ***What is a consignment?***

A consignment is at common law a bailment of goods by a supplier (the consignor) to a merchant (the consignee) for sale.<sup>[4]</sup> The consignor continues to own the consigned goods. The consignee acts in effect as a sale agent for the consignor in selling the goods. The consignee, when it sells the goods, sells them on behalf of the consignor, taking a commission on the sale and remitting the balance of the proceeds of the sale to the consignor. If the goods are not sold, the consignee has no responsibility to pay for the goods and instead returns them to the consignor.

A consignment should be distinguished from other commercial transactions. A consignment itself is not a sale by the consignor to the consignee.<sup>[5]</sup> No sale takes place until the consignee sells the goods on behalf of the consignor. The merchant's customer is then the buyer from the consignor. Likewise, since a consignment is not a sale, a consignment is not a "sale or return transaction" under Article 2 of the UCC.<sup>[6]</sup> A consignment is not a lease since the goods are delivered to the consignee for sale and not for the consignee's possession and use.<sup>[7]</sup> A consignment is not a "true" bailment since the goods, once again, are delivered to the consignee for sale and

not for storage or safekeeping. A consignment does not create a security interest to secure an obligation unless, contrary to what would be a "true" consignment, the consignee has the obligation to pay for the unsold consigned goods.[8]

***To what extent does the UCC affect consignments?***

The UCC does affect consignments, but only consignments that fall within the UCC's definition of the term "consignment" in Article 9 of the UCC, which deals with secured transactions. That definition, contained in UCC Section 9-102(a)(20), states the following:

"Consignment" means a transaction, regardless of its form, in which a person delivers goods to a merchant for the purpose of sale and:

(A) the merchant:

(i) deals in goods of that kind under a name other than the name of the person making delivery;

(ii) is not an auctioneer; and

(iii) is not generally known by its creditors to be substantially engaged in selling the goods of others;

(B) with respect to each delivery, the aggregate value of the goods is \$1,000 or more at the time of delivery;

(C) the goods are not consumer goods immediately before delivery; and

(D) the transaction does not create a security interest that secures an obligation.

Whether a particular consignment falls within the UCC definition of "consignment" is a critical issue. If a consignment falls outside of the UCC definition, the common law rules generally apply. At common law the interest of a consignor, as the owner of the goods, prevails as to the goods over the claims and interests of creditors or a bankruptcy trustee of the consignee. If the consignment falls within the UCC definition, the various rules of the UCC discussed below apply.

There are a number of consignment transactions that fall outside of the UCC definition. For example, I might take my bicycle to the consignment shop for sale by the shop. Since the bicycle is a consumer good[9] in my hands before delivery, the consignment falls outside of the UCC definition. Or I may take my office desk chair used in my business to the consignment shop for sale. The office chair is not a consumer good in my hands since I use it in my business. However, if the chair's value is less than \$1,000, the consignment would fall outside of the UCC definition. The shop may use the term "consignment" in its name and may advertise on its website that it deals with consigned goods. In that case, a consignment to the shop may fall outside of the UCC definition since the consignee may be "generally known by its creditors to be substantially engaged in selling the goods of others."

However, many consignment transactions in which a supplier delivers goods to a merchant for sale fall within the UCC definition. The goods in the hands of the supplier are not consumer goods; rather the goods are inventory[10] of the supplier. The value of the goods consigned may well exceed \$1,000. And it may be that the merchant to which the goods are delivered for sale is not "generally known by its creditors to be substantially engaged in selling the goods of others," especially if the consignment arrangements are not publicized by the merchant or only a small portion of the merchant's inventory consists of consigned goods.

*if a consignment falls within the Uniform Commercial Code, what steps does the consignor need to take to prevail over a lien creditor or bankruptcy trustee of the consignee?*

If the consignment falls within the UCC definition, the consignment transaction is considered to be a "security interest" governed by Article 9 of the UCC.[11] Even though the consignee has no obligation to pay for the consigned goods that remain unsold and therefore the consignor's interest does not secure an obligation, nevertheless the consignment is defined in the UCC within the term "security interest." [12] The consignor is the "secured party," [13] and the consignee is the "debtor." [14] Like any other secured party, the consignor will need to "perfect" the security interest, typically by filing a financing statement against the consignee and covering the consigned goods. [15]

The financing statement should be filed against the consignee in the state in which the consignee is located as determined under UCC Section 9-307. For example, if the consignee is a corporation, limited liability company, limited partnership, or statutory business trust organized in the United States, the state of the consignee's location would be the state under whose laws the consignee was organized. [16] The financing statement should provide

- > the name of the consignee as debtor (using the exact name of the consignee as evidenced in its publicly filed charter or other constituent document, a so-called "public organic record" [17]) and the mailing address of the consignee, [18]
- > the name and mailing address of the consignor as secured party, [19]
- > an indication of the collateral such as, "All goods consigned by consignor to consignee including, without limitation, [add general description of the type of goods]," [20] and
- > a checking-off of the alternative relationship as that of consignee/consignor. [21]

The financing statement should be tendered to the filing office with payment of the requisite filing fee. [22]

If the consignor does not file the financing statement, the consignee's interest in the consigned goods is subordinate to a lien obtained by a creditor of the consignee using the judicial process. [23] Article 9 refers to that creditor as a "lien creditor." [24] If the consignee became a debtor in a bankruptcy case, the consignee's bankruptcy trustee under Section 544(a) of the Bankruptcy Code has the status of a hypothetical lien creditor. The trustee may use that status to set aside an unperfected consignment interest [25] and treat the consignor's claim to the goods as a general unsecured claim.

*if the consignor has not filed the financing statement and the consignee is in financial distress, is there any advantage to the consignor filing the financing statement, even on the eve of the commencement of the consignee's bankruptcy case, for goods already delivered to the consignee?*

There is an advantage, at least with respect to goods delivered to the consignee during the 20-day period before the filing of the financing statement. To be sure, the filing of a financing statement to perfect a consignment interest in goods already delivered to the consignee generally raises a preference concern under Section 547 of the Bankruptcy Code. [26] However, Article 9 treats a consignment interest as a purchase-money security interest in the consigned goods. [27] As with any other purchase-money security interest, if the financing statement is filed before the end of the 20-day period after delivery of possession of the goods to the debtor, the purchase-money security interest will prevail over a lien of a lien creditor of the debtor arising at any time during the 20-day period. [28] If the debtor becomes subject to a bankruptcy case before the end of the 20-day period, the bankruptcy trustee—having the status, at the time of the commencement of the bankruptcy case, of a hypothetical lien creditor of the debtor under Section 544(a) of the Bankruptcy Code—is also subject to that purchase-money priority afforded to the consignment interest when a financing statement is filed before the end

of the 20-day period. Indeed, the financing statement may be filed before the end of the 20-day period even if the consignee's bankruptcy case has already commenced, notwithstanding the automatic stay that arises in the bankruptcy case.[29]

*If a consignment falls within the UCC, what steps does the consignor need to take to prevail over an earlier-filed inventory lender to the consignee?*

The consignor needs to take the same steps as an inventory purchase-money secured party would take for its consignment interest to prevail over the security interest of an inventory secured lender of the consignee if the secured lender has previously filed an effective financing statement against the consignee covering the consignee's inventory.[30] The consignor should perform a UCC search against the consignee in the state in which the consignee is located as determined under UCC Section 9-307. Once again, if the consignee is a corporation, limited liability company, limited partnership, or statutory business trust organized in the United States, the state of location would be the state under whose laws the consignee was organized.

If the UCC search discloses a financing statement covering inventory of the consignee, the consignor should send to the secured party on the financing statement a notification of the consignment at the address of the secured party provided in the financing statement. Below is a sample notification:

[Name and address of  
secured party provided on  
UCC search against Consignee]

Re: [Name of Consignee] (the "Debtor")

Ladies and Gentlemen:

We note the financing statement filed on \_\_\_\_\_, 20\_\_, with the Secretary of State for the State of \_\_\_\_\_ providing your name as secured party and the name of the Debtor as debtor. Based on the contents of the financing statement, it appears that you may be asserting a security interest in the Debtor's inventory, including after-acquired inventory.

We have or expect to acquire a purchase-money security interest in the inventory that we consign from time to time to the Debtor. The inventory may include, without limitation, [insert general description of the type of goods to be consigned].

Yours sincerely,

[CONSIGNOR]

By \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

cc: [Name of Debtor]

The financing statement should be filed, and the notification should be given, *before the goods are delivered to the consignee*.<sup>[31]</sup> The reason for taking these actions before the goods are delivered to the consignee is to make sure that the inventory secured lender does not advance funds in reliance upon the consigned goods being included in its inventory collateral.<sup>[32]</sup>

*if the consignment interest has senior priority over an earlier-filed security interest of an inventory secured lender to the consignee does the priority of the consignor's interest extend to the proceeds of the sale of the consigned goods?*

Usually no. Since the consignment is treated under Article 9 as a purchase-money security interest in inventory, the inventory purchase-money priority rules apply. As a general matter, only the consignor's security interest in identifiable cash proceeds received by the consignee on or before delivery of the goods to the buyer is entitled to the priority.<sup>[33]</sup> In most cases, the sale of the goods will generate accounts to which the priority will not extend. The rationale is that the consignee's existing secured lender will likely be lending against the accounts, providing the funds for the consignee to pay the consignor.<sup>[34]</sup> If the consignee requires a different result, an intercreditor agreement between the earlier-filed secured lender and the consignor would be required to reverse the priority in the proceeds.<sup>[35]</sup>

*if the consigned goods are returned to the consignor, is the return subject to the security interest of the inventory secured lender?*

That depends. If the consignor has taken all of the right steps for its consignment interest to obtain priority over the earlier-filed inventory secured lender, then the consignor owns the consigned goods, and there is no interest of the consignee in the goods in which the inventory lender's security interest can attach.<sup>[36]</sup> If the consignor has not taken those steps, then the goods will be returned to the consignor subject to the inventory secured lender's security interest unless the lender has authorized the return free of the security interest.<sup>[37]</sup>

*if the consignment interest is not perfected and the consignee becomes a debtor in a bankruptcy case, does the consignor have a reclamation right or, under Section 503(b)(9) of the Bankruptcy Code, an administrative claim for the value of the goods?*

No. Reclamation rights and Section 503(b)(9) administrative claims arise only when goods are sold to the debtor.<sup>[38]</sup> As indicated above, a consignment is not a sale of the consigned goods by the consignor to the debtor.

*if a consignor has not taken the steps to perfect its interest and for that interest to have priority over the consignee's inventory secured lender, what else can the consignor do to protect its interest in the consigned goods?*

The consignor can take the position that the consignment falls outside of the UCC definition of the term "consignment," usually because the consignee is "generally known by its creditors to be substantially engaged in selling the goods of others." If the consignor is successful in that argument, the consignor, as owner of the goods, will, as mentioned above, prevail as to the goods over the claims and interests of creditors and the bankruptcy trustee of the consignee. However, that position depends on facts that may or may not favor the consignor and will lead to expensive and time-consuming litigation. A consignor's understanding of the commercial law rules

applicable to consignments, including those of the UCC, and careful planning by the consignor should avoid these types of disputes.

## CONTACT

If you have any questions or would like more information on the issues discussed in this Insight, please contact the author, Edwin Smith.

---

[1] The UCC has been enacted in every state of the United States and the District of Columbia. All references in this article to the UCC are to the Official Text of the UCC promulgated by the American Law Institute and the Uniform Law Commission. Although many states have adopted nonuniform variations from the Official Text, the variations are not material to the issues discussed in this Insight. This Insight also refers from time to time to the Official Comments to the Official Text.

[2] *In re TSAWD Holdings, Inc.*, 565 B.R. 292 (Bankr. D. Del. 2017).

[3] *In re hgregg, Inc.*, 578 B.R. 814 (Bankr. S.D. Ind. 2017).

[4] See "consignment," consign, and "bailment for sale," *Black's Law Dictionary* (10th ed. 2014).

[5] See UCC § 2-106(1) ("A 'sale' consists in the passing of title from the seller to the buyer for a price . . .").

[6] UCC § 2-326.

[7] See UCC § 2A-103(1)(j) (defining the term "lease" in relation to goods).

[8] If the consignee has the obligation to pay for unsold goods, the transaction would be a sale of the goods to the consignee with a retention or reservation of title by the consignor until payment and, hence, a security interest securing an obligation. UCC §§ 1-201(b)(35), 2-401(1) and 9-109(a)(1).

[9] See UCC § 9-102(a)(23) (defining the term "consumer goods").

[10] See UCC § 9-102(a)(48) (defining the term "inventory").

[11] UCC § 9-109(a)(4).

[12] UCC § 1-201(b)(35) (defining the term "security interest" as including "any interest of a consignor").

[13] UCC § 9-102(a)(73) (defining the term "secured party" as including "a consignor").

[14] UCC § 9-102(a)(28) (defining the term "debtor" as including "a consignee").

[15] UCC § 9-310(a).

[16] See UCC §§ 9-307(e) and 9-102(a)(71) (defining the term "registered organization").

[17] See UCC §§ 9-503(a)(1) and 9-102(a)(68) (defining the term "public organic record").

[18] On the paper financing statement form in UCC § 9-521, blocks 1a and 1c.

[19] On the paper financing statement form in UCC § 9-521, blocks 3a and 3c.

[20] On the paper financing statement form in UCC § 9-521, block 4.

[21] On the paper financing statement form in UCC § 9-521, block 7.

[22] UCC § 9-516(a). A financing statement under the UCCs of most states has a five-year duration. See UCC § 9-515(a). The financing statement should be continued as needed before lapse. The continuation statement should be filed during the six-month period before lapse. UCC § 9-515(d). If there are other changes in the consignee's information, such as a change in the consignee's name, the consignor should determine whether the financing statement should be amended or a new financing statement should be filed to address the new information. See, e.g., UCC § 9-507(c).

[23] UCC § 9-317(a)(2).

[24] UCC § 9-102(a)(52) (defining the term "lien creditor").

[25] Bankruptcy Code § 550(a).

[26] Bankruptcy Code § 547(a); see Bankruptcy Code § 101(54) (defining the term "transfer").

[27] UCC § 9-103(d).

[28] UCC § 9-317(e).

[29] Bankruptcy Code §§ 362(b)(3) and 546(b).

[30] See generally UCC § 9-324(b) and cmt. 6 to UCC § 9-324. Under UCC Section 9-319(a), unless the consignee's interest has priority over the security interest of the earlier-filed inventory secured lender, the consignee has the power to grant a security interest in the consigned goods to the inventory secured lender while the goods are in the possession of the consignee. This is the case even though at common law the consignor is the owner of the goods.

[31] The notification needs to be renewed every five years, just like the financing statement needs to be continued. See UCC § 9-324(b)(3).

[32] Cmt. 4 to UCC § 9-324.

[33] UCC § 9-324(b). The interest of the consignor may also have priority in the proceeds if the proceeds consist of (a) cash proceeds constituting funds in a deposit account over which the consignor has control under UCC Section 9-104, (b) chattel paper over which the consignor has possession or control and is entitled to priority under UCC Section 9-330, or (c) instruments over which the consignor has possession and is entitled to priority under UCC Section 9-330(d).

[34] Cmt. 8 to UCC § 9-324.

[35] See UCC § 9-339.

[36] UCC § 9-319(b).

[37] UCC § 9-315(a)(1).

[38] See UCC § 2-702(2) and Bankruptcy Code §§ 546(c) and 503(b)(9). All of these sections are applicable only when goods have been sold to the debtor.