

Bankruptcy Law

Creditors Should Consider the Virtues of Selling Goods On Consignment

Offers protection against debtors

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As a result of the economic downturn, lenders and vendors are increasingly finding themselves becoming parties to bankruptcy proceedings involving a corporate liquidation or reorganization in the bankruptcy courts. The retail clothing and jewelry industries have been particularly hard hit over the last year, and we have seen various significant bankruptcies.

In *In re Whitehall Jewelers Holdings, Inc., et al*, 2008 WL 2951974 (Bankr. D. Del., July 28, 2008), the debtor and a group of consignment vendors engaged in motion practice concerning the status of consignment goods sold by the vendors to the debtor pursuant to consignment agreements and Uniform Commercial Code filings. The debtor claimed that it had the ability to sell consignment goods over the

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objections of the vendors/creditors pursuant to 11 U.S.C. Section 363 (b) and (f). The resulting decision by the court denying the debtor's motion to sell the consignment goods free and clear of liens highlights the benefits vendors should receive when selling goods pursuant to properly documented consignment arrangements, including written consignment agreements and Uniform Commercial Code financing statements.

A typical consignment arrangement consists of a consignee acting as an agent of the consignor for the purpose of delivering the goods to third-party customers. The consignee collects the sales proceeds of the goods for the benefit of the consignor, and keeps a portion of the sale as its profit. *Samuel Son & Co., Inc. v. Excalibur Machine Co., Inc.* 404 B.R. 834, 839 (Bankr. W.D. Pa. 2009). In such an arrangement, "there is no absolute obligation on the part of the consignee to pay for the goods because the consignee is not the buyer." Title to the goods remains with the consignor. Frequently, a consignment agreement will provide that a consignor owns a security interest in the goods as well as in the proceeds derived from any sale or other disposition of the goods.

The treatment property which consigned property is afforded in the bankruptcy proceedings is based primarily on

Article 9 of the U.C.C., and in some cases on Article 2 of the U.C.C. A consignment qualifies as an arrangement defined by Section 9-102(a)(20) of the code, when the following criteria are met:

a transaction ... 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; and 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.

The purpose of a consignor perfecting its secured interest by filing a U.C.C. financing statement is "to protect its interest in the property from the claims of a bankruptcy trustee or debtor in possession act-

ing on behalf of the estate's creditors...." *In re G.S. Distribution, Inc.*, 331 B.R. 552, 561 (Bankr. S.D.N.Y. 2005). In the event a consignment fails to meet the requirements of Section 9-102(a) (20), a consignor's arrangement may qualify for some recognition pursuant to U.C.C. Sections 2-102 and 2-326. The inquiry then becomes whether or not a transaction is properly characterized as "sale on approval" or "sale or return, with the latter being entitled to special treatment. If a consignment arrangement fails to comport with the provisions of U.C.C. Articles 9 or 2, a vendor will not be able to enjoy the protections offered by the U.C.C. and will be at risk of being treated as an unsecured creditor if the consignee seeks relief under the Bankruptcy Code. This can be particularly troublesome when the debtor-in-possession or trustee seeks to liquidate the goods for the benefit of the estate, since the proceeds of the sales will be used for the reorganization or liquidation of the estate, and the unsecured vendor will be treated as a low priority unsecured claimant.

On June 23, 2008, Whitehall Jewelers Holdings, Inc., filed a petition for relief under Chapter 11 of the Bankruptcy Code. Whitehall was a retailer of fine jewelry and operated 373 retail stores nationwide. As of the petition date, Whitehall held consignment goods of 124 consignment vendors with an approximate value of \$63 million in its inventory. The consignment vendors constituted Whitehall's largest group of creditors.

The standard Vendor Trading Agreement ("TVA") which defined the relationships between the vendors and Whitehall referenced various sections of Article 9 of the U.C.C. and specifically stated that the vendors "retained full title to each item of Consigned Merchandise Consignee shall acquire no right, title or interest in the Consigned Merchandise other than the right to possess the Consigned Merchandise as a Consignee and sell the Consigned Merchandise as provided under the Terms of Consignment." The TVA also stated that Consigned Goods were "sold to Whitehall by Vendor on a 'sale or return' basis." The consignment agreements at issue did not specify a minimum price to the goods to be sold or liquidated.

As part of their first-day motions,

Whitehall applied for an order pursuant to Sections 105, 363 and 365 of the Bankruptcy Code, seeking to obtain permission to conduct a liquidation auction of "substantially all of their assets," including the inventory of consigned goods. Whitehall proposed that the court could authorize a sale of the consigned goods pursuant to Section 363(f)(4) of the Bankruptcy Code, since a "bona fide dispute" existed as to whether the goods were property of the estate. Whitehall based its argument, in part, on the alleged failure of some consignment vendors to properly perfect their liens. Whitehall also claimed that under U.C.C. Section 2-326 some of the consignments "would be deemed a "sale or return" and subject to the claims of debtor's creditors. The consignment vendors opposed the sale and argued that their ownership in the consignment goods was sufficient to prevent Whitehall's proposed sale, and that a liquidation sale would result in large financial losses to them. In addition, the vendors also pointed to Third Circuit case law prohibiting a determination of the parties' rights in the consigned goods by way of motion practice. According to this body of case law, the respective ownership rights must be evaluated in an adversary proceeding, during which the parties would have an opportunity to develop discovery and in-court testimony.

The court ultimately ruled in favor of the consignment vendors and concluded that before a sale under Section 363(f) could be authorized, the ownership of the goods must be determined. The court held that it was not in a position to assess whether Whitehall's estate owned the goods and that Whitehall failed to sustain its burden to show the assets were property of the bankruptcy estate. The court stated that the burden of proof is particularly heavy where a sale of substantially all assets is proposed during the early stages of the case. Rather than filing adversary proceedings to determine the ownership and security interest issues, Whitehall agreed to return the goods at issue to the consignment vendors who did not wish to have their goods sold in the liquidation auction.

A validly perfected consignment agreement will be enforced. In *In re Excalibur Machine Co.*, a creditor which had supplied raw steel to a Chapter 11 debtor on a con-

signment basis opposed debtor's attempted use of cash collateral. The consignment agreement at issue specified a minimum price for the steel plates to be purchased and processed by debtor. The agreement was problematic in its effort to define the moment when the security interest ceased to exist or when the production stage had progressed to an extent where the arrangement's protection was extinguished. This problem was compounded by the financing statement which attempted to expand the security created by the security agreement. The court enforced the creditor's consignment agreement after it noted the U.C.C. financing statement had been filed, and ordered the debtor to pay the creditor for raw materials it purchased prepetition in the form of a priority administrative expense.

As these cases show, consignment arrangements have several benefits. The validity of consignment agreements and the security interests created by U.C.C. financing statements must be the subject of a court proceeding if a debtor or other party-in-interest attempts to challenge the consignment's effectiveness. The consignment agreement offers the consignor an opportunity to set a price floor, offering protection against debtors selling consignment goods at low prices during a liquidation sale. The consignment goods that remain unsold at the time of a debtor's bankruptcy filing can be reclaimed by filing a notice and seeking relief pursuant to 11 U.S.C. Section 546. In the event a debtor sells consigned goods prepetition but does not turn over the sales proceeds to the consignment vendor, the consignor may be entitled to a priority claim as an administrative expense. These benefits may be available provided that the consignment arrangement comports with U.C.C. Section 9-102(a) (20) and a U.C.C. financing statement has been filed.

A consignment agreement must clearly delineate the scope of the parties' agreement and the security interests envisioned, and a price floor should be set. The financing statement requires a detailed description of the security interest that is intended to be created. Only when these criteria are followed will a creditor enjoy the protections of a consignment arrangement. ■