Protecting a Consignor's Interests in Retail Bankruptcy

Articles April 22, 2019

A recent decision from the United States Bankruptcy Court for the District of Delaware has a significant impact on both lenders and consignors in retail bankruptcy cases. On April 12, 2019, Judge Mary F. Walrath issued an opinion in the *Sports Authority* bankruptcy case (*In re TSAWD Holdings, Inc., et al.*, Case No. 16-10527-MFW, Adv. No. 16-5036-MFW, 2019 WL 1590531 (Bankr. D. Del. Apr. 12, 2019)) that requires a consignor of goods to disgorge payments received from the debtor after the commencement of its chapter 11 bankruptcy case, with the disgorged funds to be paid to the secured lender.

Judge Walrath ordered the consignor to turn over the proceeds of the sale of the consigned goods because Sports Authority's total inventory available for sale to its customers never included more than 14% of consigned merchandise. Under the Uniform Commercial Code ("UCC"), which governed the transactions, Judge Walrath held that Sports Authority was not "substantially engaged" in consignment sales because its sale of the consigned goods was below the 20% threshold recognized by courts as satisfying the UCC's requirement of substantial engagement for purposes of Section 9-102(a)(20)(A)(iii). Essentially, Section 9-102(a)(20)(A)(iii) operates as an exception to the definition of a "consignment", and, thus, the applicability of the UCC to such transaction, where creditors of the borrower/merchant generally know it to be substantially engaged in selling the goods of others (the "UCC Exception"). Here, because only 14% of Sports Authority's inventory constituted consigned goods, the Court found that the Debtor was not substantially engaged in the business of selling consigned goods; therefore, the UCC applied to the consignor for purposes of determining the priority of its security interest.

Based on this decision, and in light of the increase in retail bankruptcies, it is vital that consignors understand the provisions of the UCC that govern consignment sales to ensure full compliance with those rules. First it is important to note that Articles 2 and 2A of the UCC do not apply to a consignment.

Instead, a consignment is defined by Section 9-102(a)(20):

> "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;
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> (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.

If a consignment does not satisfy the requirements of Section 9-102(a)(20), the relationship between the consignor and consignee is governed by common law and the interest of the consignment seller would prevail over the interest of secured creditors. However, if the consignment falls within Section 9-102(a)(20) of the UCC, it is the UCC that applies to the relationship, and the consignor's rights are substantially different. Under the UCC, the consigned goods are

considered inventory of the consignee and the consignor needs to file a financing statement to perfect its security interest. In that instance, to prevail over a secured lender who perfected its security interest first, the consignor would need to demonstrate that the consignee (in this instance, Sports Authority) was “generally known by its creditors to be substantially engaged in selling the goods of others” in order to trigger the UCC Exception and take its interests outside the scope of the UCC.

Because of this distinction, before entering into a consignment relationship, a consignor must clearly understand the law governing the transaction with the consignee, know what secured financing is in place with its customer, and take the necessary steps to perfect its security interest. Furthermore, in the retail bankruptcy setting, a lender should fully understand the nature of the business of the retail borrower to determine at the outset whether it is substantially engaged in consignment sales.

Ultimately, the takeaway is that a consignor must ask the consignee about the scope and volume of its consignment business and its relationships with secured creditors to determine how to protect itself and/or whether to enter into the consignment relationship. In the event of confusion, please contact Mike Shiner or Maribeth Thomas to help navigate these rocky shoals.