

## Corporate Restructuring & Bankruptcy

An ALM Publication

WWW.NYLJ.COM

MONDAY, JUNE 22, 2015

# Protecting Consignors' Interests And Rights to Recover Property

BY CARREN B. SHULMAN

Consignment is an arrangement between two parties for one to sell the goods of another. If the goods are sold, a discounted sales price is paid to the original seller with the balance to the buyer/consignee. Many retail industries have used consignment for years, but many are moving towards consignment. Other industries have used consignment and consignment-like relationships, such as "conditional sales."<sup>1</sup> In this uncertain economy, consignment is realizing a resurgence and may be an effective cost saving measure for vendors/consignees. This article addresses the law on consignment and how consignors protect themselves.

Consignment is governed by Article 9 of the Uniform Commercial Code (UCC), §9-109(a)(4). Consignment is defined in UCC §9-102 as:

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.

If seller is "not generally known [to be] ... selling the goods of others," the person delivering the goods (consignor) must file a lien as notice to the world of its owner-

ship rights. To the extent the consignment relationship fails sections (B) or (C) above, there may be a consignment relationship, but it may not be governed by Article 9. See Official Comment to §9-102, No. 14. In such case, the relationship could be governed by Article 2 (Sale of Goods, §2-326) or common law, yet nothing prohibits the parties to such arrangement from filing a lien as a protective measure (in fact such filing should be considered to protect the seller/consignor's

CARREN B. SHULMAN, a finance and bankruptcy partner at Sheppard, Mullin, Richter & Hampton in New York, has advised manufacturers and suppliers on supply chain issues for more than 20 years.

rights). And to the extent consignment is solely to create a security interest, and therefore fails §9-102(D), it would be a secured transaction and governed in any event by Article 9, requiring the filing of a lien. See, e.g., *In re Morgansen's LTD*, 302 B.R. 784 (Bankr. E.D.N.Y. 2003) (bankruptcy trustee authorized to sell consigned property where property was not subject to Article 9); Livingston on Consignments Under UCC Article 9, by Margit Livingston, 3/10/2009, 2009 Emerging Issues 3413, Matthew Bender & Company.

Let's examine consignment in the retail industry. Countless articles describe the increase and preference for Internet shopping over visiting a retail store. What does this mean for retailers? They need less space, less stock, and frequent turnover of product to keep things "fresh." A byproduct of the Internet consumer is the growing trend towards consignment arrangements, which places less risk on and requires less capital outlay by the storefront seller.

The hallmarks of a consignment relationship are:

- Title to the goods never vests or passes to consignee, consignor retains ownership.
- A minimum price for the sale of goods, allowing consignor to retain some control over price.
- Consignee usually pays a discounted price for the goods and retains the balance.
- The agreement is short-lived and terminable on notice.

Form consignment agreements are often very short and uncomplicated. Sounds easy right? In fact, there are many pitfalls of consignment arrangements for consignors in failing to follow the statutes.

### Title/Ownership Rights

Why is it important to put others on notice of consignor's ownership rights? Because anyone with a lien on consignee's inventory or a claim against its assets may acquire consignor's goods and dispose of them before consignor's rights may be asserted. Most lenders require a lien on collateral. While consigned goods should not be subject to encumbrance by lenders' liens because consignee lacks title, an unknowing lender (like a good faith buyer), may be unaware of consignor's ownership rights. The same is true of a landlord who may seize leased store property and unknowingly dispose of

consignor's goods. Rather than risking a race to the finish line, notice of ownership of consigned property is preferred and essential.<sup>2</sup>

How does consignor ensure others are on notice of its ownership rights?

- File a lien before or simultaneously with the delivery of consigned goods.

The lien should state that the relationship is a consignment relationship and that title has not passed to consignee (since a lien is typically filed to denote a security interest in goods for which title has passed). Moreover, the lien should be filed before the goods are delivered to avoid any confusion as to ownership. See §9-317, §9-319 (governing the rights of consignee vis-à-vis its creditors/pur-

---

Once consignor has ensured that its ownership rights are protected, ensuring that consignee provides **accurate and updated records** of sales and receipts is essential.

chasers). *This is particularly critical where the consignee has another lender with a perfected security interest over the assets and inventory of the consignee.* See §9-324(b) (purchase money security interests over inventory). If the consignee has an existing lender/lienor, consignor should notify that lender/lienor in compliance with UCC §9-324(b):

- Send consignor's filed lien to the other lienholders.
- Deliver the goods to consignee within five years of delivery of the filed lien, or, said another way, update the delivery of the filed lien to the competing lienor every five years.
- Describe for the other lienholder the goods consignor is delivering and over which it will have a lien.

Existing or competing lienholders should be identifiable when consignor searches for competing liens, however, requiring the consignee to notify its lienholders is also recommended. Additionally, consignor should periodically confirm whether other liens have been filed against consignee that may cover the same goods.

### Payment/Pricing

Once consignor has ensured that its ownership rights are protected, ensuring that

consignee provides accurate and updated records of sales and receipts is essential. In this age of electronics, consignee should be sophisticated enough to transmit reports of sales records timely in electronic format and funds due should be transferred quickly.

- Monitor reports and payment for timeliness and discrepancies.

A typical consignment relationship will require at least monthly reporting of sales of consignor's goods and a statement as to the amounts due to consignor, which should also be paid monthly. Thus, there is a constant cycling of reports, sales and payments such that consignor can identify quickly whether there have been any price changes, fall off in sales, or other issues requiring immediate attention.

Notably, consignment arrangements will not require consignee to maintain a separate bank account for sales. Indeed, for most retailers that would be impossible. Therefore funds due to consignor may be comingled with other funds of consignee. Such comingling should not present a problem as long as consignee timely pays when due; another reason to ensure payments are received monthly. Otherwise, in a liquidity crisis, consignor will need to trace the cash from the sale in order to ensure full payment of amounts due. It is, therefore, also important that consignor's lien document specifically state that consignor has *a security interest in the proceeds of any sales of the goods.* See §9-315 (Secured Party's Rights on Disposition of Collateral and in Proceeds).<sup>3</sup>

Since consignor must rely on reports from consignee to confirm sales of goods, consignor should maintain its own records and methods of ensuring compliance by consignee. For instance, consignor should run periodic checks on inventory, storage/sale methods and accuracy of reporting. If its goods are sold by consignee in hundreds of stores, spot checks at key stores or a periodic review of the consignee's business records of remaining inventory should allow consignor to at least confirm that consignee's systems are in place and running appropriately. Consignee should be a well-run machine if it has many consignment relationships, and slippage could be indicative of liquidity issues or failures of management that should lead to a review of the relationship.

Additionally, consistently checking reports will confirm that consignee is meeting the minimum sales price agreed to in the

contract. A fire sale at consignee's stores should not result in a below contract discount on consignor's product. In addition to raising a red flag as to consignee's finances, deep discounts on consignor's product can hurt the market for its product with consignor's other consignees. Since the relationship involves potentially fast turnover and comingling of cash, quick identification of a problem will be key to recovery and limit consignor's losses.

### Termination

Consignor must have the right to terminate the relationship for convenience with short notice to recover its property. Since the goods belong to the consignor, this should not be a controversial requirement. Nonetheless, actual recovery may take some time. If goods have been spread out to different locations, they will need to be amassed to return them to consignor. A time limit for return should be placed on consignee after which consignee should be liable for paying consignor for the goods as if the goods had been sold. Further, while consignee should be required to collect all of consignor's goods to the facility where they were initially delivered, consignor should be prepared to collect the goods from that point to ensure they are quickly and safely returned. See §9-609 (Secured Party's Right to Take Possession after Default). Similarly, consignee can terminate the relationship on short notice as long as it returns the goods to consignor and accounts for and pays for goods sold.

### Other Important Concerns

Of course, ensuring that consignee is properly insured and maintaining insurance is important. Consignor should require consignee to confirm each year that the insurance is being maintained and, if possible, that consignor is a beneficiary of such insurance in the event of fire or other damage or loss. Consignor should also confirm that consignee's insurance extends to transfer of consignor's goods between stores, as inventory must be shipped from consignor to consignee and then transferred between facilities.

Indemnification by consignee for any sales and marketing practices and procedures and for payment of taxes in the jurisdiction in which the goods are sold is recommended. If the consignee's sales and marketing practices

did not comply with local law in or outside of the United States, the consignor may have bigger issues than just nonpayment. Best practice also will be to ensure that the consignee discloses precisely where the product will be dispersed and sold and to have consignee confirm that it is compliant with all laws in each and every one of those jurisdictions.

And, in the event consignee confirms there are liquidity issues or if a bankruptcy or similar proceeding in or outside of the United States ensues, consignor should ensure it is familiar with the laws of the relevant jurisdiction and that its rights to the goods and its agreement have been disclosed to all relevant parties so that it can recover its goods or limit or eliminate exposure.

### Bankruptcy

If the consignee seeks protection of the Bankruptcy Code or the laws of insolvency or administration in a foreign jurisdiction, recovery of cash and product will be more difficult. Because title has not passed to consignee, the consignment relationship should be respected and consignor should at least be able to recover its unsold property. Consignor should have consignee obtain a comfort order from the relevant court or administrator to collect its goods. In *In re Radio Shack*, Case No. 15-10197-bls (Bankr. D. Del.) the court entered an order protecting consignment rights by ensuring, inter alia, that consignor would receive its full contract payment upon the sale of any consigned goods during the course of the bankruptcy. See D.N. 455. Additionally, Radio Shack began the process of returning goods to those consignors who requested it. Cf. *In re Family Christian*, Case No. 15-00643-jtg (Bankr. W.D. Mich.), wherein the bankruptcy court authorized the debtor to sell to a related party all inventory, including consigned inventory regardless of the existence of a consignment agreement, over the objection of consignors.<sup>4</sup>

Returning product will take time and in a liquidation, recovery may take longer because there may be less control by the trustee or insolvency administrator over inventory. Of course, the ease of recovery depends upon how well documented the relationship was before the bankruptcy occurred. Recovery of cash may be more difficult where the cash was comingled and not segregated before the filing, however, consignor should

be a secured creditor of consignee if all necessary filings were made. Alternatively, an earmarking claim may be appropriate since sales of consignor's product would automatically have generated the obligation to pay consignor its agreed upon revenue under the consignment agreement.

### Conclusion

In short, there is no reason to fear a changing environment with increased reliance on consignment. Just be sure if you're the consignor you're protecting your rights in your product and your payment stream. Of course, if consignees continue to demand consignment relationships, query at which point consignors may simply sell their product on their own direct to the customers.

.....●●●.....

1. This article does not address "conditional sales" where goods are delivered to the ultimate user of the goods and held separate from other inventory of the buyer until needed, at which point buyer notes the "sale" on its books and records. This relationship is common in industries where "forward provisioning" is necessary, e.g., parts for installation on trucks, trains, aircraft or heavy equipment or machinery where the delay in obtaining parts would result in significant strain or losses on a business. Conditional sales can be protected relationships and are common with aircraft, e.g., 49 USC §40102; 11 U.S.C. §1110. As with consignment arrangements, conditional sales should be protected with the filing of a lien and any related filings.

2. Consigned goods may be warehoused. In a warehouse, consignor should ensure that consigned goods are properly identified and separated, from other inventory: "Owned by ABC Corp."

3. Consignor should be aware that its security interest in proceeds may be lost, as set forth in §9-315, if the cash proceeds from the sale of consignor's goods are used to purchase other property in which consignor does not have a security interest, or property in which another lienor has a pre-existing security interest.

4. In bankruptcy, a contract must be assumed or rejected in its entirety (11 U.S.C. §365(a)); a debtor cannot decide which provisions of a contract to assume or reject. Thus, consignors should receive all amounts due under their contracts for the sale of inventory and if their contracts require it, should have the right to recover inventory from the debtor or any purchaser of the debtor's assets with knowledge of consignor's rights. Notably, in *Family Christian*, many consignors formed an ad hoc committee and filed a complaint for turnover of their assets.