New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
JULY 31, 2019

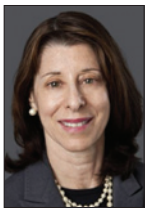
Consignments: The Sports Authority Cases, Article 9 and the PEB

In her Secured Transactions column, Barbara M. Goodstein discusses two recent decisions in the Sports Authority bankruptcy which underscore the continuing challenge to UCC commentators in guiding courts and practitioners effectively through the world of consignments.

In a typical consignment, a seller (the consignor) delivers goods to an intermediary or middleman (the consignee) which holds those goods for sale to a third party. The goods can be sold to the consignee, or they can be held by the consignee subject to sale (a bailment), in either case pursuant to an arrangement in which the consignee shares with the consignor, in whole or in part, the proceeds of the sale of those goods to the third party. Consignment sales can be a major part of a retailer's or distributor's business plan. However, goods in the possession of a bankrupt consignee can become property of its bankruptcy estate even if the property hasn't been sold to the consignee. Unfortunately, oftentimes this fact doesn't become apparent to creditors of a retailer or distributor until it files for bankruptcy protection.

The rules governing consignments can be somewhat baffling to lawyers, so much so that the UCC Permanent Editorial Board released its latest official commentary earlier this year (which includes amendments to the UCC Official Comments (PEB Commentary No. 20 Consignments (Jan. 24, 2019))) just on consignments. Two recent decisions in the Sports Authority bankruptcy, one issued prior to the recent PEB commentary but one after it as well, underscore the continuing challenge to UCC commentators in guiding courts and practitioners effectively through the world of consignments.

By **Barbara M. Goodstein**



Law of Consignments

A consignment for UCC purposes is understood to be a bailment, meaning the consignor (i.e., bailor) remains the owner of the consigned goods while they are held for sale by the consignee (i.e., the bailee). As discussed in the January 2019 PEB Commentary, consignments can be governed either by UCC Article 9 or common law. Under common law, the consignee's rights in the consigned goods are limited and its creditors cannot assert claims against those goods. Under Article 9, on the other hand, creditors of the consignee can assert claims against the consigned goods, in certain circumstances with priority over the rights of the consignor (and its creditors), notwithstanding that the consignor has legal title and the consignee does not.

UCC §9-102(a)(20) contains the Article 9 definition of a "consignment." That section contains an interesting mix of requirements. In order to constitute a consignment under Article 9, a transaction (regardless of form) must involve delivery of non-consumer goods with an aggregate value of at least $1,000 to a "merchant" (defined in UCC §2-104 as someone who deals in or is otherwise knowledgeable about the goods) who is not an auctioneer, provided the merchant (1) deals in those kinds of goods under a name other than that of the consignee and (2) is *not* generally known by its creditors to be "substantially engaged" in selling the goods of others, and provided further that the transaction itself does not create a security interest. As noted above, Article 9 grants significant rights to creditors of and purchasers from a consignee in comparison to non-Article 9 consignee creditors. Under UCC §9-319(a), while goods are in the

BARBARA M. GOODSTEIN *is a partner at Mayer Brown.*

possession of a consignee, it is deemed to have rights and title to such goods identical to those of the consignor. Thus, a consignor may unexpectedly find itself at risk should its consignment fall within Article 9, and must protect its interest in its goods in a way that does not apply to a consignor in a common law consignment.

The interest of the consignor in the goods is a "security interest" under UCC §1-201(b)(35) (notwithstanding that the consignor has title). Accordingly, the consignor must file a UCC financing statement to protect that interest from claims of creditors of the debtor/consignee. Perfection of course doesn't mean priority, and a perfected interest may defeat a judicial lien creditor, including a trustee in bankruptcy, but not other prior perfected creditors of the consignee. However, Article 9 provides a countervailing benefit to a consignor. Under UCC §9-103(d) a consignor's interest is deemed a purchase-money security interest in inventory. That means if the Article 9 consignor follows the strict rules of UCC §9-324(b) applicable to purchase-money inventory security interests, it will have priority over prior perfected liens. That also means, however, that the consignor must not only file a UCC financing statement against the consignee covering the consigned goods, but must as well notify creditors of the consignee of its interest in order to protect those goods from the claims of creditors of the consignee.

The policy behind all of this is obvious. Public notice of a consignor interest is warranted if the reasonable assumption is that the merchant (consignee) is selling its own goods and not goods belonging to someone else.

But too few consignors seem to be aware of this issue. Compounding this problem is that courts have difficulty providing proper guidance for when a consignment falls within the boundaries of Article 9. Both of these issues are illustrated by the recent battles among creditors in the Sports Authority cases of *TSA Stores, Inc. et al v. Performance Apparel Corp. a/k/a Hot Chilly's Inc. (In re TSAWD Holdings, Inc.*, 595 B.R. 676 (Bankr. D. Del. Nov. 26, 2018) (the PAC case) and *TSA Stores, Inc. et al v. Sport Dimension Inc. a/k/a Body Glove (In re TSAWD Holdings, Inc.)*, 601 B.R. 599 (Bankr. D. Del. April 12, 2019) (the Sport Dimension Case) before Judge Mary F. Walrath.

Sports Authority Cases

Sports Authority Holdings Inc. and its affiliates were national retailers of sporting goods and active apparel that filed for bankruptcy in Delaware on March 2, 2016. The debtors were parties at the date of filing to a 2006 syndicated secured term loan facility with Bank of America as Administrative Agent which had approximately $276 million of outstanding debt as of the petition date. That debt was secured by financing statements filed in 2006 and amended shortly before the bankruptcy to reflect Wilmington Savings Fund Society (WSFS) as successor agent to Bank of America.

The debtors had in place a program for the sale of goods on consignment that paid vendors (consignors) either a fixed amount for each item sold or a percentage of the retail sale price. Performance Apparel Corp. (PAC) and Sport Dimension Inc. were among those vendors. PAC filed a UCC financing statement but it had expired without continuation as of the date of bankruptcy. Sport Dimension filed a UCC financing statement approximately one month prior to the bankruptcy filing. In both cases, WSFS and the vendor filed competing claims against each other relating to the consigned goods (and their proceeds).

As expected, in each proceeding WFSF asserted that the interest of the vendor (consignor) was an Article 9 consignment, and so was required to be perfected by a UCC financing statement filing. In the PAC case, WSFS asserted priority over the vendor interest based on PAC's failure to continue its financing statement. In the Sport Dimension case, WSFS argued that it had priority because its financing statements were filed before the Sport Dimension UCC filing.

In each case, the vendors responded by arguing that the consignment at issue did not fall within the UCC definition of a consignment under UCC 9-102 and so no financing statement filing was required. The dispute in both cases as to whether the consignments were subject to Article 9 focused entirely on the condition under UCC 9-102(a)(20) that the merchant not be "generally known by its creditors to be substantially engaged in selling the goods of others."

The court in the Sport Dimension Case separately analyzed the two primary components of this requirement. First, what did it mean to be "substantially" engaged in selling the goods of others? Second, what did it mean to be "generally known by its creditors" to be engaged in selling the goods of others? The court in the PAC case analyzed solely the latter issue.

With respect to the first issue, WFSF argued in the Sport Dimension

case that consigned goods never exceeded 14% of the debtors' total inventory available for sale, citing a bright-line test in certain case law that consigned goods constitute at least 20% or more of the value of a debtor's inventory. Sport Dimension disagreed that the bright-test governed, referring to at least one case that did not insist on a 20% minimum.

The court flatly rejected the position of Sport Dimension, citing prior Delaware bankruptcy court decisions insisting on the 20% minimum, and distinguished the case cited by Sport Dimension, calling its reliance "misplaced."

The second issue is where, in the view of the PEB, Judge Walrath (and others) misconstrued UCC 9-102(a)(20), something the PEB was determined to fix with its January commentary.

In tackling this second issue, Judge Walrath noted correctly that the UCC will not apply to a consignee *generally known* by its creditors to be selling consigned goods. She also noted, again correctly, that there is case law precedent for an additional exception to UCC coverage, that being if a competing creditor *actually knew* that the consignee was engaged in selling consigned goods *or* sold the goods of the *specific* consignor. Judge Walrath explained the rationale behind this additional exception was that if a UCC financing statement can provide *constructive* notice to creditors as a group, why wouldn't actual knowledge of the competing creditor also suffice to support the UCC policy of protecting creditors from the "secret lien" of the consignor. The judge then went on to discuss at some length, in both opinions, whether the Sports Authority term loan lenders, either directly or through their agent or its successor agent, had actual knowledge of the particular consignment arrangement. Ultimately, the court reached opposite conclusions based on the facts in each of the two cases, ruling that the lenders (and agent) had specific knowledge of the PAC consignment arrangement (and so held for PAC) but did not have specific knowledge of the Sport Dimension arrangement (and so held for WSFS).

The problem is that while this specific knowledge exception may be appealing as a concept, it is not supportable by the terms of UCC 9-102(a)(20).

The PEB, in its commentary, comes out swinging on this issue. The commentary doesn't refer to the PAC opinion (the opinion was issued only 8 weeks before the commentary). It does, however, in observing that some authorities have "misconstrued" §9-102(a)(20), specifically cite a 2009 California state court appellate ruling relied on heavily by Judge Walrath in both opinions, namely *Fariba v. Dealer Services Corp.*, 178 Cal. App. 4th 156 (2009).

The commentary states categorically that 9-102(a)(20) "makes no reference to the knowledge of a particular competing claimant." It goes on to note that under this "misinterpretation" a consignment would be subject to Article 9 rules for creditors without knowledge of the debtor's consignment arrangements but not subject to those rules for creditors with specific knowledge. It concludes that "this anomalous result could lead to difficult priority disputes without promoting any Article 9 policy."

The point being emphasized by the PEB is that priority may be based on general notice, but not individual knowledge, and that priority disputes, whether between secured or unsecured creditors, are not and should not be resolved based on what a particular competing creditor knows.

Conclusion

It's surprising as well as disturbing to see this disconnect between recent court decisions on consignments and the views of the UCC Permanent Editorial Board. It will be interesting to see whether judicial support for the view that actual knowledge of a specific creditor is relevant to UCC 9-102(a)(20) is abandoned in light of the PEB commentary. Although Sport Dimension appealed its adverse ruling to the District Court, the matter was settled and the appeal withdrawn in late June 2019. Regardless, consignors need to be aware of the risks that Article 9 will govern their transactions and consider making it their business to routinely file (and maintain) financing statements on their consigned goods.