

CREDITOR'S RIGHTS TOOLKIT

How Can a Consignor Perfect Consignment Rights Before a Bankruptcy Is Filed?

Consignments may be governed by either common law or Article 9 of the Uniform Commercial Code (UCC), the latter of which requires the consignor to comply with various procedures in order to perfect its security interest in the consigned good.

A consignor who properly perfects its security interest in consigned goods elevates its status from a general unsecured creditor to a secured creditor with respect to the consigned goods should its customer file for bankruptcy.

Absent compliance with such procedures, the consignor risks other creditors of the consignee obtaining liens and security interests with priority over its own unperfected interest, as well as avoidance of that unperfected interest by the debtor-consignee or other estate representative in the debtor's bankruptcy case.

Key Issues

- **WHAT IS A CONSIGNMENT?**

Under a typical consignment, the vendor (consignor) delivers goods to its customer (consignee) for that customer to hold for use or sale to third parties. The consignor agrees to defer payment until the goods are used or sold by the consignee and retains title in the interim. Any goods not used or sold will normally be returned to the consignor by the consignee.

- **UCC DEFINITION OF CONSIGNMENT**

UCC Article 9 governs many consignment transactions and requires vendors to satisfy specific requirements in order to retain a superior interest in the consigned inventory. UCC Section 9-102(a) (20) defines consignment as a transaction in which a person delivers goods to a merchant for purposes of sale, and (i) the merchant 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. As part of any consignment arrangement, the aggregate value of the goods must be \$1,000 or more at the time of delivery, the goods must not be consumer goods immediately before delivery, and the transaction cannot create a security interest that secures an obligation.

- **CONSIGNOR MUST PERFECT ITS CONSIGNMENT INTEREST TO DEFEAT CONSIGNEE'S CREDITORS**

To prevail over the debtor-consignee's creditors or a bankruptcy trustee, the consignor must perfect its interest in the consigned goods by:

- **Filing a Financing Statement.** A consignor can perfect its interest in its consigned goods by filing a UCC financing statement describing the goods in the correct jurisdiction. A consignor that fails to properly file a UCC financing statement risks losing its prior rights in the consigned goods to those creditors of the consignee that obtain judicial liens and security interests in the goods. Since a bankruptcy trustee and debtor-in-possession have the rights of a judicial lien creditor, they would similarly enjoy priority over an unperfected consignor.
- **Giving a Purchase Money Security Interest Notice.** A consignor must do more than merely file a UCC financing statement to obtain a priority in its consigned goods over the rights of the consignee's creditor that perfected a blanket security interest in the consignee's inventory prior to the consignment arrangement. UCC Section 9-103(d) provides that a consignor's interest in consigned goods is a purchase money security interest (PMSI) in inventory. As such, to prevail over the debtor-consignee's creditors or a bankruptcy trustee, the consignor must perfect its interest in the consigned goods by satisfying all of the requirements for a valid PMSI contained in UCC Section 9-324: (a) perfection of the consignment interest prior to the consignee's possession of the goods; (b) delivery of a notice to the holders of conflicting security interests in the consignee's inventory stating that the consignor has, or expects to, acquire a consignment interest in the goods and describing the goods; and (c) receipt of the notice by the holders of conflicting security interests in the goods. The conflicting interest secured party must receive a notice that the consignor has a PMSI in the consignee's inventory (PMSI notice) within five years before delivery of the consigned goods to the consignee.

While there may be some very limited common law exceptions to the UCC's filing and notice requirements for "true consignments," reliance on any exceptions are fraught with risk, likely to result in litigation in the event of a bankruptcy, and not recommended for consignment vendors.

Takeaway

Consignors should be aware that consigned goods held by a debtor for resale are generally property of the debtor's bankruptcy estate and will be subject to the potentially superior claims of the debtor's bankruptcy trustee and/or the debtor's inventory-secured parties. Absent perfection of its purchase-money security interest in the consigned goods and, in appropriate cases, the sending of notices to the consignee's other inventory secured parties, the consignor can expect to be relegated to the position of a general unsecured creditor. The vendor's due diligence, preparation of the proper documentation for execution by the customer, perfection by filing a UCC-1 financing statement, and advance notification of the consignment arrangement to existing creditors with a blanket inventory lien, are crucial to safeguard the vendor's consignment rights and maximize recovery following the filing of its customer's bankruptcy. As always, it is important to consult with experienced counsel to ensure that a consignor's rights are fully protected.