Part 2: Consignment Issues in the Bankruptcy Court

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May 19, 2023
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Consignment Issues[1]

What qualifies as a consignment under Article 9?

a) Goods delivered to a "merchant **for the purpose of sale"**
b) The merchant **"deals in goods of that kind under a name" other than the consignor's name**
c) Whether it is **"not generally known"** by merchant's creditors that the merchant "is substantially engaged in selling the goods of others"
d) Not consumer goods (and value is more than $1,000)
e) Whether a security interest secures the transaction

Other relevant questions:

- Who bears the burden of proof under 9–102(a)(20)?
- How is a consignment different from other transactions (such as a "sale or return")?

1. Goods delivered to a merchant for the purpose of sale

a) Distinguished from bailment
   i. Bailment: goods remain the property of the bailor and are not for resale

b) Query whether raw materials to be processed are a bailment or a consignment
   i. The goods segregated until ready to process
   ii. No payment while sitting in the processor's yard
   iii. Invoicing occurs at the time the goods are moved for processing
   iv. Who is going to buy the finished goods?

c) *Georgetown Steel*, *Excalibur Machine*, and *Sensient Flavors*

   i. *In re Georgetown Steel Co., LLC*, 318 B.R. 352 (Bankr. D.S.C. 2004)
      - Background: Parties entered into "Consignment Agreement," under which the creditor retained title to raw materials; materials were stored in location segregated from other inventory. Debtor reported each week on amount of raw material that had been consumed. Creditor did not file UCC-1 financing statement. The day before debtor filed for bankruptcy, creditor sent letter terminating agreement and demanding reclamation of certain raw materials. After petition date, raw materials were sold.
      - Question: Which party—debtor or creditor who supplied raw materials—is entitled to proceeds of inventory that was in debtor's possession on

[1] Special thanks to Ms. Lauren Spungen, law clerk to Judge Deborah Thorne for the preparation of the materials.

petition date? Is the agreement a consignment under Article 9 (as debtor claims) or a sales transaction governed by Article 2 (as creditor claims)?

- Holding: Agreement is a consignment under Article 9.
    - Even though the raw material was incorporated in the final product, it was delivered "for the purpose of sale"
    - The debtor was dealings in "goods of that kind"
    - Whether the agreement created a security interest depends on whether it secures the obligation to pay for the unsold goods. Under the agreement, debtor was only obligated to pay for consumed materials
    - Court also looked at the transaction under Article 2. Because debtor did not become owner of raw materials upon delivery, question is whether this is a "sale or return," and court found that creditor retained title to unconsumed raw materials.
    - Is this case where creditor is asserting a hidden lien?

ii. *In re Excalibur Machine Co.*, 404 B.R. 834 (Bankr. W.D. Pa. 2009)

- Background: Creditor supplied raw steel for debtor to use in manufacture of goods. Under "consignment agreement," creditor was given a security interest in the raw material that it provided, and material would be kept segregated until used to produce final product. After petition, creditor moved to prohibit use of cash collateral or compel debtor to provide adequate protection.
- Holding:
    - Title to raw material passed from creditor to debtor when debtor moved materials out of segregated area
    - Creditor's security interest extended only to raw material that remained in segregated storage area and to proceeds of raw material but *not* goods that debtor produced using raw material
    - But creditor still entitled to unsecured claim for amounts invoiced for material purchased and used prepetition, as well as administrative expense claim.

iii. *Sensient Flavors, LLC v. Crossroads Debt, LLC*, No. 302323, 2013 WL 5857604 (Mich. Ct. App. Oct. 31, 2013)

- Background: Sensient purchased cherries and delivered them to Cherry Blossom. Under their agreement, Sensient would have a security interest in the cherries until Cherry Blossom processed them and sold the final product back to Sensient. After Sensient terminated UCC-1 financing statement—but Cherry Blossom still possessed cherries—Cherry Blossom entered into financing arrangement with Crossroads. Crossroads filed UCC-1 statement perfecting its security interest in inventory.
- Question: Who had a superior interest in the cherries, Sensient or Crossroads?

- Holding: The cherries were consignment goods subject to Crossroads's perfected security interest; Crossroads had a superior interest in the cherries.
    - Arrangement is similar to *Georgetown Steel*—the cherries were delivered "for the purpose of sale." Once removed from storage and processed, they became property of Cherry Blossom
    - Crossroads had perfected security interest in Cherry Blossom's inventory, including stored cherries and proceeds.

2. Merchant deals in good of that kind, under a name other than the consignor

a) *In re G.S. Distrib.*, 331 B.R. 552 (Bankr. S.D.N.Y. 2005)
- Background: Jewelry store debtor entered into exclusive distribution contract with jewelry designer Repossi. Contract specified that Repossi would provide jewelry to the debtor on a consignment basis, and Repossi would issue an invoice to debtor after each piece sold. Debtor was permitted to use Repossi trademark for promotion/sale.
- Question: Did debtor have rights in the jewelry it possessed? Was the arrangement a consignment?
- Holding: The arrangement was not a consignment under Article 9.
    - Debtor only sold Repossi goods and only sold under Repossi's name.
    - 9-102(a)(20)(A)(ii) is meant to ensure that consignee's general creditors are put on notice of consignor's interest in the consigned goods and protect them from hidden liens. When a consignee operates under the name of the consignor, the UCC assumes that creditors will be put on notice that merchant does not own inventory in its possession.
    - Outcome might have been different if debtor sold non-Repossi goods as well.

3. Whether it is not generally known by the merchant's creditors that the merchant is substantially engaged in selling the goods of others

a) Under former 2-326(3)(b), the statement was in the affirmative. But under 9-102(a)(20)(A)(iii), the statement is phrased in the negative and requires that the consignee's practices were ***not*** known by others.
b) *TSAWD Holdings, Inc.*, No. 16-10527 (MFW), 2018 WL 6885922 (Bankr. D. Del. Nov. 26, 2018)
- Background: Debtor had loan agreement with WSFS that was secured by a lien on all of debtor's inventory and proceeds. Debtor later entered into consignment agreement with Soffe, but Soffe did not file a UCC-1 financing statement until one month prepetition.
- Question: Can "generally known" requirement be met if there is no UCC-1 financing statement providing actual notice?
- Holding:
    - WSFS did not have actual knowledge of Soffe's consignment interest until after Soffe filed a UCC-1 financing statement
    - WSFS's security interest had priority over Soffe's interest in consigned goods that Soffe delivered *before* financing statement was filed; Soffe had priority

for consigned goods delivered *after* Soffe properly perfected its security interest.

4. Burden of proof

a) Split among courts

i. *In re Morgansen's Ltd.*, 302 B.R. 784 (Bankr. E.D.N.Y. 2003)

- Burden of proof falls on the party claiming to be protected by 9-102(a)(20). In this case, the burden was on the consignors, who claimed protected interest in goods they had delivered to the debtor and were asserting that there was no true consignment relationship between the parties.

ii. *In re Downey Creations, LLC*, 414 B.R. 463 (Bankr. S.D. Ind. 2009)

- Burden of proof falls on the party who bears the risk under 9–102(a)(20). In this case, the burden fell on the consignor. The court reasoned that this outcome incentivizes consignors to file a UCC-1 financing statement to protect their interests, discourages hidden liens, and increases predictability.

iii. *In re G.S. Distrib., Inc.*, 331 B.R. 552 (Bankr. S.D.N.Y. 2005)

- Burden of proof falls on the party claiming applicability of 9–102(a)(20). In this case, burden of proof was on the debtor, who asserted that the jewelry arrangement was a consignment.

iv. *In re Salander-O'Reilly Galleries, LLC*, 506 B.R. 600 (Bankr. S.D.N.Y. 2014), *rev'd on other grounds by* No. 14 CV 3544 VB, 2014 WL 7389901 (S.D.N.Y. Nov. 25, 2014)

- Burden of proof falls on the party claiming applicability of 9–102(a)(20). In this case—where owner of Botticelli painting loaned the painting to debtor's gallery and trustee asserted that arrangement was a consignment—the burden fell on the trustee to prove that Article 9's requirements were met.

5. Consignment versus other transactions

a) *In re Wolverine Fire,* 465 B.R. 808 (Bankr. E.D. Wisc. 2012)

- Background: Debtor obtained a truck from defendant and modified the truck to sell it. After debtor filed for bankruptcy, trustee brought adversary proceeding alleging that defendant willfully violated the automatic stay by retrieving truck from debtor and selling it postpetition. Trustee argued that the debtor acquired ownership of truck upon its delivery and that, because defendant failed to file a UCC-1 financing statement—the truck was part of the bankruptcy estate.
- Question: Was the defendant's transfer of the truck to debtor a consignment?
- Holding: The transfer was a consignment
  - The transfer was not a "sale on approval" – this applies when goods are delivered primarily for use, and the debtor was not the end user.
  - The transfer was not a "sale or return" – this applies if the goods are delivered primarily for resale

- But, because defendant did not perfect its security interest, the truck became property of the debtor's estate, and the transfer was subject to avoidance by the trustee.

b) *In re Valley Media*, 279 B.R. 105 (Bankr. D. Del. 2002)
   - Court discusses how a conclusive presumption arises that goods are held on a "sale or return" basis if: (1) the goods are delivered to a person for sale, (2) the person maintains a place of business at which he/she deals in goods of the kind involved, and (3) that place of business is under a name other than the person making a delivery. It is up to a consignor to rebut this presumption by filing a UCC-1 financing statement or proving that the consignee is generally known by creditors to be substantially in the business of selling consigned goods.

c) PEB commentary draft
   - Clarifies that consignment and bailment are mutually exclusive:
     - "A consignment is a bailment, and the consignor remains the owner of the consigned goods. A sale or return is, as the name suggests, a sale, pursuant to which the buyer becomes the owner of the goods. Absent an agreement otherwise, the seller does not retain any interest in goods delivered to the buyer. The buyer becomes the owner of the goods, even though it has a right to return the goods and to transfer ownership back to the seller."