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Consignment Agreements: Delaware Bankruptcy Court Denies Consignment Seller's Secured Position Due To Insufficient Notice

Business Information for Clients and Friends of Shumaker, Loop & Kendrick, LLP

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Manufacturing • Customers • Vendors • Supply Chain • Financial
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An April 12, 2019 Delaware Bankruptcy Court decision in the Sports Authority Chapter 11 case (*In re TSAWD Holdings, Inc.)* is an important reminder for sellers of goods on properly obtaining security in the goods they sell, to insure payment from the customer.

Manufacturing companies constantly evaluate the credit risk of selling goods to their customers. The business goal of increasing sales and revenue is tempered by the reality that not all customers will pay as agreed. Companies utilize a number of tools to hedge this risk including terms of sale, credit limits, credit insurance, and some form of security. Particularly when sales volume is significant, companies often sell goods to customers on a secured basis by obtaining a security interest in the goods sold.

Article 9 of the Uniform Commercial Code (UCC) (regarding secured interests and transactions) defines this arrangement as a purchase money security interest, or a PMSI. Consignment agreements may be deemed to be a PMSI, such that consignment sellers must comply with the Article 9 PMSI requirements for the consignment agreement to create a valid first priority security interest.[1] The security interest should include inventory as well as products and proceeds.

[1] Under UCC 9-324(b), a PMSI has priority over a blanket lien on all assets including inventory if (1) the purchase-money security interest is perfected when the debtor receives possession of the inventory; (2) the purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest; (3) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and (4) the notification states that the person sending the notification has or expects to acquire a purchase-money security interest in inventory of the debtor and describes the inventory.

In the event the customer becomes insolvent or files a Chapter 11 petition, whether or not the seller of goods has a valid first priority security interest is critical. If it does, the seller will be a secured creditor to the extent of the value of the collateral (including consigned inventory) in the customer's possession at the time of the Chapter 11 filing.

If the collateral value equals or exceeds the amount owed, the seller should realize a 100% recovery. If the seller does not have a perfected security interest in the goods sold, the customer's secured lender with a blanket lien on all assets will assert that its lien attaches to the goods sold as a first priority security interest. Moreover, the customer's Chapter 11 estate will assert its priority as a hypothetical judgment lien creditor over an unperfected security interest. In this case, the seller will be a general unsecured creditor, a class of creditors that often receives little or no value in Chapter 11 cases.

The recent Sports Authority ruling denied the seller a valid security interest in goods sold under a consignment agreement because it did not meet the Article 9 requirement regarding notice to creditors with competing security interests in inventory. In Sports Authority, the seller in fact provided proper notice to Bank of America as the administrative agent for a syndicate of lenders under a 2006 term loan with Sports Authority. However, in 2015, Wilmington Saving Fund Society, FSB (WSFS) became the administrative agent under the term loan, pursuant to an assignment from Bank of America to WSFS.

The parties amended and filed a UCC-3 financing statement assignment reflecting the change in December, 2015. The seller filed a UCC-1 financing statement to perfect its PMSI on goods sold in January, 2016. The seller provided notice to Bank of America, not to WSFS. The seller argued that the actual knowledge of Bank of America should be imputed to WSFS based on principals of agency law. However, the Delaware Bankruptcy Court rejected this argument and ruled that the lenders' liens had priority because the seller failed to properly notify WSFS of its PMSI.

If the consignment transaction was initiated prior to the December, 2015 assignment from Bank of America to WSFS, the seller may have relied on a UCC records search prior to December, 2015 that would not have disclosed the WSFS assignment. The lesson learned is the seller should update the UCC search at the time of its own UCC-1 filing. If the assignment to WSFS had occurred after the seller's UCC-1 was filed, the seller's notice to Bank of America would have been sufficient. However, best practices for sellers should include periodically updating UCC searches, particularly for substantial exposures, and consider supplementing PMSI notices to competing holders of security interest in inventory and accounts receivable. Sellers often utilize third-party vendors to manage UCC filings and notices to competing holders. For customers with large exposures, it is worthwhile to independently verify that the PMSI requirements have been met.

We hope you found this useful and informative. Please contact us if you have any questions about this or any other matter.

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