

## Yeah, About That Consignment Agreement ... How You Can Lose Your Goods in a Retail Bankruptcy

You just heard a rumor that your largest retail customer is in financial distress and may file for bankruptcy. After a moment of panic, you review your consignment agreement with the retailer (this assumes that you have a written agreement) and you are relieved to see that it clearly provides that you still own the goods that you delivered to your customer and you are entitled to pick them up at any time. All good, right? Not necessarily. If you have not taken all of the necessary steps to properly perfect your consignment under the Uniform Commercial Code (UCC), your feeling of relief will be short lived. The failure to take these crucial steps could have devastating consequences in a bankruptcy case because creditors have a significant incentive to challenge the validity of your consignment arrangement in an effort to increase their own recoveries.

In a typical consignment transaction, a seller (you, the consignor) delivers goods to a reseller (your customer, the consignee) who holds the goods until they are sold to a buyer, and then a portion of the proceeds are transferred back to the seller. Article 9 of the UCC governs most typical consignment transactions and treats the consignee as having an ownership interest *even though the consignee doesn't really own the goods*. As a result, if a consignee files a bankruptcy case, any consigned goods then in its possession may become property of the bankruptcy estate unless the consignor has properly protected its interests in those consigned goods.

There are a number of steps a seller must take to protect its interests in consigned goods under the UCC. *First*, a consignor **must** have a written consignment agreement with the consignee that grants the consignor a purchase money security interest (PMSI) in the consigned goods. The consignment agreement should also provide that title to and ownership of the consigned goods remain with the consignor until the goods are sold, but the risk of loss remains with the consignee. To protect the value of the consignor's interests, the consignment agreement should also address other material terms such as inventory controls, sales and inventory reporting, insurance requirements, and payment terms. *Second*, the consignor must take a few additional actions to perfect its security interest in the consigned goods **prior** to their delivery to the consignee. These steps include: (1) filing a UCC-1 financing statement in the appropriate jurisdiction describing the consigned goods and (2) sending a written notice to all other parties with a liens in the consignee's inventory that describes the consignment arrangement (including the fact that you will take a PMSI security interest in the consigned goods), describes the consigned goods, and indicates when you will begin delivery of the consigned goods. *Third*, every five years, the consignor must also file a continuation UCC financing statement and provide new notices to each party with a lien in the consignee's inventory. Each of these steps is critical because the failure of the consignor to properly perfect its security interest prior to the bankruptcy filing may relegate the consignor to the status of a general unsecured creditor with no ownership interest in the consigned goods.

All hope may not be lost, however, if a consignor fails to properly perfect its consignment under the UCC. There are a number of transactions that are not deemed consignments under the UCC, but may still be deemed a "true consignment" under applicable state law. For example, goods consigned to a merchant that is generally known by its creditors to be "substantially engaged" in the selling of goods on consignment falls outside of the UCC and may still be entitled to protection. However, such arguments are fact intensive, generally require a significant legal expense, and are very risky to assess. The ultimate legal outcome is very uncertain — and unless a settlement is reached — may or may not result in a successful economic outcome. Therefore, even if you believe that your transaction falls outside of the UCC, you should still comply with all of the requirements of the UCC, just in case the particular consignment arrangement is challenged in court.



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- Retail

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**Cozen O'Connor's Bankruptcy, Insolvency & Restructuring and Retail Practice Groups stand ready to assist if you have any questions or concerns about your consignment arrangements.**