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Retail Relief:

Amend the UCC to End the Filing Requirement to Perfect Consignment Interests

BY STEPHEN B. SELBST

Placing goods on consignment is a common occurrence in retail, but to perfect those goods, consignors are required to file with the UCC and give notice to other secured parties. Many consignors fail to follow this procedure and end up as unsecured creditors if the retailer files for Chapter 11. Stephen Selbst argues it is time to change the law.

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The retail sector's troubles are well known. Since 2016, many retailers have sought Chapter 11 protection, including Toys "R" Us, The Limited, Radio Shack and Sports Authority. Industry experts predict more bankruptcy filings are likely. A surprising discovery from these bankruptcies is the extent to which many retailers have relied on consignments to reduce inventory costs and, by failing to follow proper procedure, have risked forfeiting possession of the very assets they are acquiring.

In a consignment, the consignor delivers goods to the consignee for resale, but the consignor holds title over the goods until they are sold, at which point the consignee pays for them.

Under the Uniform Commercial Code, a consignor has a purchase money security interest, but must file a UCC financing statement to protect that interest and give notice to other secured parties which may have competing interests in the goods.

If the consignee fails to file a UCC financing statement or give notice, the consignor's claims are considered *unperfected* and subject to avoidance in bankruptcy. When this happens, the debtor receives title to the goods free from consignor rights. This means the debtor can sell the goods without paying sale proceeds to the consignor.

Consignors can prevent this scenario by satisfying the UCC's requirements, but consignors have an established track record of failing to either file a UCC financing statement or give notice. Consignors' failures to comply with the UCC have led to disputes about whether the consignors may reclaim their consigned goods, whether a debtor may sell the consigned goods and who is entitled to the proceeds of sale.

A Disastrous Situation

Being an unsecured creditor in a retail case is often disastrous: unsecured creditors frequently receive pennies on the dollar or no distribution. Many consignors are also small businesses which sold to large retailers. Often the retailer pushed to transform the relationship from a straight sale to a consignment model.

For example, in the Sports Authority bankruptcy, disputes arose regarding $85 million of consigned inventory shipped by approximately 170 vendors, most of which had not filed financing statements. The average value of the consigned inventory was $500,000, which suggests the consignees were significantly smaller businesses than Sports Authority. Other cases involving consignment disputes based on failures to file financing statements include Valley Media (records and CDs), Whitehall Jewelers (jewelry) and Hancock Fabrics (plush goods and sewing patterns).

The current retail turmoil provides an opportunity to examine the policies underlying the UCC's filing rules for consignments, which are based on long-outmoded views of the commercial marketplace and should be amended given the harsh consequences unperfected consignors experience.

Small Vendors Trapped

Recent retail bankruptcies have demonstrated many consignors are not complying with the UCC's filing rules. The cases also suggest small vendors, selling to much larger retailers, are being trapped with

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unperfected consignment interests. This was the pattern in the *Sports Authority*, *Whitehall Jewelers* and *Valley Media* bankruptcies. It may be, as smaller concerns, these vendors are not receiving proper advice on how to perfect consignment interests or they view compliance as overly difficult or expensive. In light of these failures, it's worth considering who benefits from the consignment rules and whether the rationale for requiring consignors to file UCC statements still holds water in modern commerce.

The UCC's filing requirements for consignments were intended to bring clarity to an unsettled body of law. Prior to the UCC, some courts treated consignments as valid, where the consignor was not required to make a public filing to protect its interest in the goods. If the consignee became insolvent, title was still vested in the consignor, which could reclaim its goods. Meanwhile, other courts ruled some transactions were *false consignments*. In these cases, the consignor had to comply with chattel mortgage or conditional sales laws, and its goods were subject to the claims of the consignee's creditors if it failed to do so.

The UCC was supposed to end the dichotomy between true and false consignments by requiring all consignors to file financing statements. The policy for requiring the filing of financing statements was enacted because a consignment created a *secret lien* upon inventory, which other creditors could not ascertain because the retailer seemed to be the owner of the consigned goods, which the courts called *ostensible ownership*. The argument was a merchant's other vendors would rely on the presence of the consigned goods as proof of the merchant's creditworthiness, and the merchant's inventory could be sold to pay creditors if it became insolvent.

Reflects a Bygone Age

Those arguments reflected the market of the times, when few retailers operated at more than one location and generally did not obtain financing secured by inventories, and when vendors could inspect a retailer's store to verify inventory levels.[1]

Today's retail marketplace is vastly different than it was in the early 20th century. Inventory-based secured financing is now the norm. In the 15 largest U.S. retail bankruptcy cases, the size of the debtors, measured by asset size, ranged from a low of $1.7 billion to a high of $14 billion.[2] These retailers typically operated in hundreds of locations and each of those debtors had secured inventory financings. Even if the ostensible ownership rationale had force 60 years ago, its underlying basis disappeared long ago.

The lenders making loans to retailers today are not relying on visual assessments of inventory. They receive financial statements and detailed information regarding inventories, cash sales and accounts receivable from their borrowers. These lenders know consigned inventory cannot be carried as an asset on their borrowers' balance sheets because the borrowers don't have title to these assets. Accordingly, lenders do not rely on consigned inventory in making loans. So the idea of individual vendors visiting a merchant's store to physically assess the level of inventory present when deciding whether to ship to the merchant is a relic of a bygone age.

But because these lenders typically have blanket liens on all their borrowers' assets, they comply with the UCC's filing procedures, which provide actual notice to all creditors that the debtor's inventory is subject to a lien. Given their level of knowledge of their borrowers, the ostensible ownership theory does not support protecting these lenders from a consignor's "secret liens." The ostensible ownership theory similarly fails to make a persuasive case for why a merchant's general unsecured creditors should benefit from the avoidance of a consignor's unperfected security interest. If the inventory lenders have made UCC filings, the entire creditor body is on notice of their interest, which means that no other creditor has a legitimate expectation that the debtor's inventory is unencumbered.

If a consignor's unperfected security interest is avoided, the consequences depend on the debtor's capital structure and the value of its other assets. For the unperfected consignor, the consequences are its claim is unsecured, which is clearly different — and worse — treatment than it and the debtor agreed to. And if the rationale for requiring consignors to file financing statements has been eroded by change, there is no reason why they should continue to suffer the disastrous consequences of being treated as unsecured creditors.

But if the fundamental premise beneath treating a consignment as a secured transaction is no longer valid, and if this treatment harms innocent consignors, a simple and common-sense solution exists. When the law is no longer in line with commercial practice, change the law.

If the inventory lenders have a typical after-acquired property clause, their lien attaches to the consigned goods. If the debtor's assets are sufficient to repay the inventory lenders without the consigned inventory, the consigned goods become unencumbered assets available to pay other claims.

Windfall for Debtors

But if the assets backing the inventory loan are not sufficient, the consigned goods become additional collateral for the secured lender. In that event, the secured creditors receive a windfall because they did not lend against or rely on these assets. The same argument applies to other creditors; allowing them to receive the benefit of the consigned goods similarly gives them a windfall.

Many scholars have argued, in today's market, credit is no longer granted based on ostensible ownership.[3] But if the fundamental premise beneath treating a consignment as a secured transaction is no longer valid, and if this treatment harms innocent consignors, a simple and common-sense solution exists. When the law is no longer in line with commercial practice, change the law. That could easily be accomplished by letting the purchase money security interest of a consignor be perfected upon delivery of the goods to the merchant for resale, without requiring the filing of a UCC financing statement. Such a change would protect the legitimate interests of consignors without unfairly harming the interests of other creditors, which would no longer have a principled argument about being the unintended beneficiaries of avoided liens on consigned goods. As Supreme Court Justice Oliver Wendell Holmes observed more than a century ago:

> When we find that in large and important branches of the law the various grounds of policy on which the various rules have been justified are later inventions to account for what are in fact survivors from more primitive times, we have a right to reconsider the popular reasons, and take a broader view of the field, to decide anew whether those reasons are satisfactory.[4] abfj

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1 See, Dolan. *The UCC's Consignment Rule Needs an Exception for Consumers*. 44 Ohio St. L, J. 21 (1983) at 29-33.

2 Fortune. *Here's Another Reason Why Toys 'R' Us Bankruptcy Is a Big Deal*. September 19, 2017.

3 Questions about the validity of the ostensible ownership theory and the treatment of consignments as secured transactions are not new. Criticism of the ostensible ownership theory can be found in Helman. *Ostensible Ownership and the Uniform Commercial Code*. 83 Comm. L. J. 25 (1978) (arguing modern credit practices have supplanted visual assessments of a debtor's assets); Dolan. *The UCC's Consignment Rule Needs an Exception for Consumers*. 44 Ohio. St. L. J. 21 (1983) (same); Mooney. *The Mystery and Myth of "Ostensible Ownership"* and *Article 9 Filing: A Critique of Proposals to Extend Filing Requirements to Leases*. 39 Ala. L. Rev. 683 (1988) (generally criticizing ostensible ownership theory) and Schroeder. *Some Realism About Legal Surrealism*. 37 Wm. & Mary L. Rev. 455 (1966) (broadly criticizing ostensible ownership theory).

4 Holmes. *The Common Law*. 37 (M. Howe ed. 1963).