

## Steps to perfecting a security interest in consigned goods



Jason M. Smith, Alec Davidson | Tuesday, July 30, 2019

A recent Ninth Circuit Court of Appeals case provides a new wrinkle and clarification to well-settled law affecting security interests in consigned goods. Lenders, businesses with consigned goods inventory, and businesses selling goods on consignment must heed the Ninth Circuit Court of Appeals' holding in *In re Pettit Oil Company*, No. 17-60081 (9th Cir. Mar. 11, 2019).

### **What is a consignment arrangement?**

In a consignment arrangement, a seller of goods (a consignor) delivers goods to a middleman (a consignee), who retains possession of the goods until they are sold to a buyer or eventually used by the consignee. Once sold to a buyer or used by the consignee, the sale proceeds (except for any applicable fees payable to the consignee) are transferred back to the consignor. The consignor retains title to the consigned goods until they are sold or used.

What is often overlooked is that the consignor and any lenders of the consignor can take a security interest in the consigned goods under the Uniform Commercial Code (UCC). This creates a dilemma for the consignor and/or the lender. If the consignee files for bankruptcy, then, unless the consignor's or lender's security interest in the goods is perfected by filing a financing statement, the consignor or lender will have only an unsecured security interest subordinate to the bankruptcy estate.

**The case in question: *In Re Pettit Oil Company***

## Steps to perfecting a security interest in consigned goods

---

*In Re Pettit Oil Company* explored the issue of whether a security interest in consigned goods applies to the proceeds and accounts receivable of consigned goods sold.

Pettit Oil Company distributes bulk petroleum products and operates “card lock” sites where commercial customers use access cards to purchase fuel products. Pettit was a party to a consignment agreement with IPC (USA), Inc., whereby IPC delivered fuel to Pettit’s card lock sites and Pettit would sell the fuel to its customers. IPC paid Pettit a monthly commission in exchange for Pettit selling IPC’s fuel at Pettit’s stations. Pursuant to the terms of the consignment agreement between Pettit and IPC, Pettit prepared invoices and directed customers to remit payments directly to IPC every time a customer purchased consigned fuel. Notwithstanding this process, some customers continued to pay Pettit instead of IPC. Anticipating that payments to Pettit were likely to occur, the consignment agreement required Pettit promptly to forward such payments to IPC.

Pettit filed for bankruptcy, and it still had IPC fuel and the proceeds from previously sold fuel (both in cash and accounts receivable) in its possession. But IPC never filed a financing statement or otherwise perfected its security interest in the consigned fuel, the accounts receivable, or the cash proceeds.

In the bankruptcy proceedings, the bankruptcy trustee sought the value of the fuel, the cash proceeds, and the accounts receivable as part of the bankruptcy estate. The bankruptcy trustee relied upon UCC § 9-319(a), which provides in pertinent part:

“for purpose of determining the rights of creditors of....a consignee, while the goods are in the possession of the consignee, the consignee is deemed to have rights and title to the goods identical to those the consignor had.”

Based on this provision, the trustee maintained that IPC’s interest in the fuel, cash proceeds and accounts receivable were subordinate to the trustee’s because IPC failed to file a financing statement or otherwise perfect its security interest. IPC conceded that UCC § 9-319(a) precluded its rights to the goods (i.e., fuel) held by Pettit at the time of its bankruptcy filing. But IPC claimed that because the plain language of UCC § 9-319(a) is silent on the issue of whether the consignee is deemed the owner of the proceeds of the consigned goods, IPC’s rights in the proceeds are not subordinate to the bankruptcy estate. Rather, IPC contended that under general property law principles, the proceeds were the product of a bailment (i.e. a transfer of possession with a transfer of ownership). IPC argued that, therefore, such proceeds were rightfully the property of IPC because the UCC contains no explicit provisions giving Pettit an ownership interest in the proceeds.

### **Consignor loses priority in proceeds when it fails to perfect its security interest in the goods**

The Bankruptcy Court and the Ninth Circuit Court of Appeals disagreed with IPC’s claims. Although UCC § 9-319(a) is silent on the allocation of proceeds of consigned goods, the Ninth Circuit looked to the policy rationale behind Article 9 and concluded that the term “goods” in UCC § 9-319(a) includes the proceeds of those goods. The court held that a ruling that “proceeds” are outside the scope of the perfection rules would “disrupt the delicate balance of the U.C.C. drafters struck between the interest of consignors and the interests of the consignee’s other creditors.”

In short, IPC would have had priority over the bankruptcy trustee’s judicial lien extending to both the fuel and proceeds if it had perfected its security interest in the fuel. The Ninth Circuit held that a consignor loses priority in the proceeds when it fails to perfect its security interest in the goods.

## Steps to perfecting a security interest in consigned goods

---

### Practical Implications for Lenders

The Ninth Circuit Court of Appeals' decision in *In re Pettit* underscores the importance for secured lenders of properly perfecting a security interest in a borrower's consigned goods if it makes sense under the circumstances.

Lenders have two options when they discover through due diligence that a borrower is a consignor that owns consigned goods delivered to a consignee for sale. First, a lender may perfect a security interest in consigned goods by taking the following steps:

1. Obtain a consignee waiver executed by the consignee holding the borrower's goods for sale. A consignee waiver is similar to a bailee waiver, except for a few differences because of the nature of consigned goods compared to goods held in bailment.
2. Obtain copies of the executed consignment agreement, if any, between the consignor (i.e., the borrower) and the consignee.
3. File a separate UCC-1 financing statement naming the consignor/borrower as the secured party and the consignee as the debtor. This financing statement must subsequently be assigned from the borrower to the lender as secured party. It is important to note that this financing statement is different and separate from the financing statement a lender would file against a borrower's assets in a secured lending transaction.
4. Conduct a lien search on the consignee to confirm whether any third parties have a conflicting security interest in the consigned goods.
5. If the lien search reveals that a third party has a perfected security interest in the consigned goods, then send a notice letter to the third party indicating that the borrower has put these goods in the possession of the consignee on consignment and that the lender is perfecting a security interest in such goods.

Lenders are only protected in consigned goods delivered after the filing of a UCC-1 financing statement and giving notice to conflicting holders of security interests. To the extent a lender makes consigned goods eligible, the lender should consider making consigned goods already delivered to the consignee ineligible and excluded from the borrowing base, if applicable.

The foregoing steps to perfect a security interest in consigned goods can add extra time and costs to a loan transaction. Fortunately, lenders have the second option of making the consigned goods ineligible and excluding them from the borrowing base.

If you have questions regarding this case, please contact the McDonald Hopkins attorneys listed below.

---



**Jason M. Smith**



**Alec Davidson**

