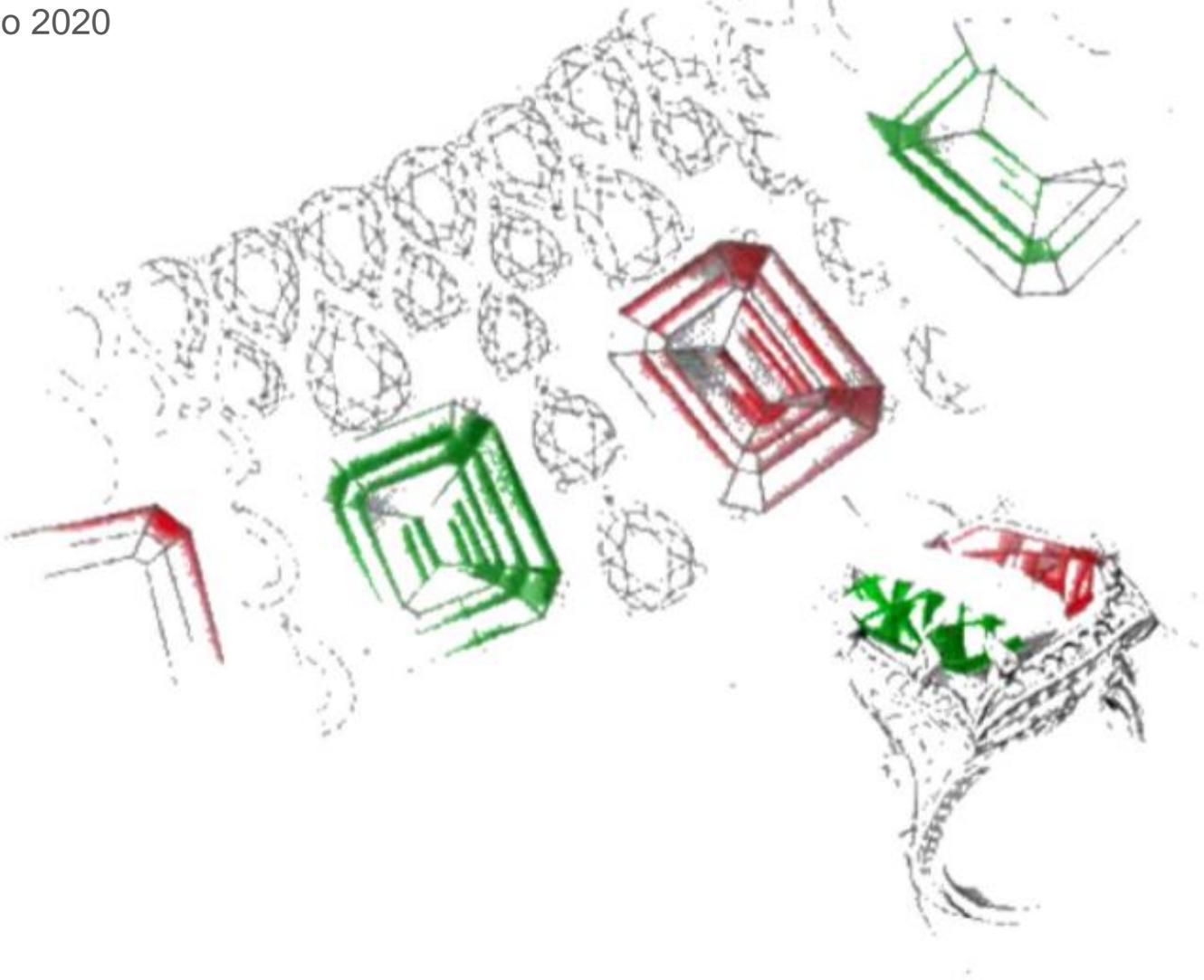


# UNDERSTANDING CHAPTER 11 AND ITS EFFECTS ON SUPPLIERS AND CONSIGNMENT AGREEMENTS

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## INTRODUCTION

This paper is intended to provide Italian companies with a basic understanding of the United States chapter 11 bankruptcy process, focusing in particular on suppliers and suppliers that have consignment agreements with U.S. bankruptcy debtors. It is important not to assume anything based on a European understanding of insolvency, which is very different from the American bankruptcy system.

## OVERVIEW OF THE CHAPTER 11 PROCESS

### **The petition.**

Chapter 11 of the United States Bankruptcy Code generally provides for a reorganization, usually of a corporation or partnership, in order to keep the business alive and pay creditors over time. The bankruptcy case begins when a company or individual (the “debtor”) files a petition with the bankruptcy court. The petition may be voluntarily filed by the debtor, or it may be an involuntary petition filed by creditors.<sup>1</sup>

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<sup>1</sup> 11 U.S.C. §§ 301, 303. Citations to “U.S.C.” refer to the United States Code. Chapter 11 bankruptcy proceedings are governed by title 11, chapter 11 of the U.S. Code.

### Bankruptcy jurisdiction.

U.S. bankruptcy courts are federal courts under the supervision of U.S. district courts. The district courts generally refer all bankruptcy cases to bankruptcy courts.<sup>2</sup> Unlike federal district courts, which are created under Article III of the United States Constitution, bankruptcy courts are Article I courts, and their jurisdiction is accordingly more limited and sometimes subject to challenge.<sup>3</sup> While district judges have lifetime appointments, bankruptcy judges are appointed for terms of fourteen years.<sup>4</sup> Their decisions may be reviewed and appealed first to the U.S. district courts, and then to the U.S. courts of appeals and the Supreme Court. In some cases, a party may seek to “withdraw the reference,” or remove a matter from the bankruptcy court, and have it heard by the district court instead.<sup>5</sup>

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<sup>2</sup> 28 U.S.C. § 157(a).

<sup>3</sup> See U.S. CONST. art. III; 28 U.S.C. §§ 157, 1334; see, e.g., *Stern v. Marshall*, 564 U.S. 462 (2011).

<sup>4</sup> 28 U.S.C. § 152(a)(1).

<sup>5</sup> 28 U.S.C. § 157(d).

**The debtor in possession.**

The filing of a chapter 11 bankruptcy creates a new entity, known as the “debtor in possession” or “debtor.” Unlike a chapter 7 bankruptcy and many non-U.S. insolvency systems, in a chapter 11 bankruptcy, the debtor in possession continues to manage its assets and operations, although it must obtain approval by the bankruptcy court for transactions that are outside of the ordinary course of business. The debtor must also obtain the consent of its lender or the bankruptcy court to use its cash reserves if a lender has a lien on assets of the debtor that includes cash.

Generally, a debtor may not pay debts that arose prior to the commencement of the bankruptcy until after the confirmation of a plan of reorganization by the bankruptcy court. A debtor generally must pay post-bankruptcy debts in full so long as they benefit the estate.

The debtor may be able to obtain financing to pay for its ongoing expenses as it continues to operate. For example, the Neiman Marcus debtors have obtained such financing, as discussed further below.

### **The bankruptcy estate.**

The filing of a chapter 11 petition also creates a bankruptcy “estate,” which consists of all of the debtor’s legal and equitable interests in property as of the commencement of the bankruptcy.<sup>6</sup> State law governs whether a debtor has legal or equitable interests in certain property. For example, a vendor contract may state that is governed by Texas law. That is the law that the bankruptcy court must apply to determine a party’s rights under the contract. The goal of the debtor’s estate in a chapter 11 case is to eventually pay the claims of creditors and reorganize the business so it may continue operating after the bankruptcy is over.

### **The automatic stay.**

The filing of a bankruptcy petition triggers an important protection for debtors called the “automatic stay.”<sup>7</sup> The purpose of the automatic stay is to give the debtor “breathing room” from its creditors so that it may successfully reorganize its business.<sup>8</sup> The automatic stay prohibits certain actions from being taken against the debtor, including:

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<sup>6</sup> 11 U.S.C. § 541(a)(1).

<sup>7</sup> 11 U.S.C. § 362.

<sup>8</sup> *In re United Health Care Org.*, 210 B.R. 228, 233 (S.D.N.Y. 1997).

- enforcing judgments;
- attempting to obtain possession of the property of the bankruptcy estate;
- creating, perfecting, or enforcing liens against the property of the estate;
- attempting to collect on a claim against the debtor that arose before the bankruptcy; and
- setting off debts owing to the debtor that arose before the bankruptcy against any claim against the debtor.<sup>9</sup>

There are some important exceptions to the automatic stay that will be discussed in further detail below. A party may also file a motion to ask the bankruptcy court to lift the automatic stay so that it can take an otherwise prohibited action. Unless one of the exceptions clearly applies, a party should not take a prohibited action without first seeking court approval.

### **The creditors' committee.**

The United States Trustee, who is charged with protecting creditors, appoints a creditors' committee, usually consisting of the seven largest unsecured creditors willing to serve.<sup>10</sup> The creditors' committee serves an important role in consulting with the trustee and debtor and in investigating

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<sup>9</sup> 11 U.S.C. § 362(a).

<sup>10</sup> 11 U.S.C. §§ 1102, 1103.

matters relating to the debtor's financial condition and the operation of its business.<sup>11</sup> The trustee appointed a creditors' committee in the Neiman Marcus case on May 19, 2020.

### **Executory contracts.**

The debtor has the ability to assume (*i.e.*, accept) or reject unperformed contracts, known as "executory contracts" and unexpired leases.<sup>12</sup> In other words, the debtor can decide whether it wishes to continue performing a contract or lease. If the debtor assumes a contract, it must cure all of its defaults and must fully pay for its future obligations under the contract.<sup>13</sup> If a debtor rejects a contract, then the counterparty has a claim for damages, which will be paid at the conclusion of the bankruptcy along with the other claims of creditors.

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<sup>11</sup> See 11 U.S.C. § 1103(c).

<sup>12</sup> 11 U.S.C. § 365(a).

<sup>13</sup> 11 U.S.C. § 365(b).

## Claims.

Generally speaking, a “claim” in a bankruptcy is the right to receive payment.<sup>14</sup> Claims may be liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.<sup>15</sup> State law governs property rights in a bankruptcy proceeding, including whether a claim is “secured” or not. Secured claims take precedence over unsecured claims in the bankruptcy. For example, a lender typically will provide funds to a party only if it takes a security interest in collateral (*i.e.*, property) that the debtor owns, such as the debtor’s building or its accounts receivable. If the party later files for bankruptcy, the lender will have a “secured claim” and will receive priority of payment before other unsecured creditors. In some bankruptcies, such as Neiman Marcus, it is expected that the secured claims will be paid 100 percent of their claim, while unsecured claims will be paid an unknown percentage of what is owed. The Creditors’ Committee in Neiman Marcus has objected to the debtors’ disclosure statement because it does not disclose the percentage that

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<sup>14</sup> 11 U.S.C. § 101(5)(A), (B).

<sup>15</sup> 11 U.S.C. § 101(5)(A).

unsecured claims will be paid. The debtors will have to provide this information before the disclosure statement and plan can be approved.

How much creditors can recover depends on how much the debtor can collect from anyone that owes money to the debtor. For example, the debtor may file lawsuits against parties in order to recover funds owed to the debtor. Any money the debtor recovers in the lawsuit will go to pay its creditors.

A creditor may file a proof of claim form to assert its interest in a debtor's bankruptcy.<sup>16</sup> The court sets a deadline to file the proof of claim, called a "claims bar date."<sup>17</sup> The claims bar date in Neiman Marcus is July 20, 2020 by 5:00 p.m. Central Time.

In a chapter 11 bankruptcy, the debtor files schedules of its creditors, assets, and liabilities, which will list the claims of creditors.<sup>18</sup> In large bankruptcies, such as Neiman Marcus, the bankruptcy filings, including the schedules, are available for free on a public website.<sup>19</sup> Note that the Neiman

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<sup>16</sup> 11 U.S.C. §§ 501, 1111; FED. R. BANKR. P. 3001.

<sup>17</sup> FED. R. BANKR. P. 3003(c)(3).

<sup>18</sup> 11 U.S.C. § 521(a)(1); FED. R. BANKR. P. 3003(b).

<sup>19</sup> See <https://cases.stretto.com/NMG>. The Neiman Marcus schedules are available at <https://cases.stretto.com/NMG/court-docket/schedule-statements/>. They are listed by the individual debtor's name, such as Bergdorf Goodman or The Neiman Marcus

Marcus schedules do not list goods that it has in its possession for sale by consignment because such goods belong to the consignor, and are not an asset of the bankruptcy estate.<sup>20</sup> The schedules should list the amounts owed to a consignor, however.

If the creditor's claim is already listed in the schedules in the correct amount, it is not necessary for the creditor to file a proof of claim.<sup>21</sup> The claim is "allowed" and thus paid unless another party in interest objects, in which case the court decides the amount of the claim or whether it is to be disallowed for some reason.<sup>22</sup>

### **Administrative claim for post-bankruptcy sales.**

As noted above, a chapter 11 debtor may generally continue to pay for post-petition (*i.e.*, post-bankruptcy) purchases of goods and services in the ordinary course of business. These amounts are given administrative claim

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Group LLC. Please note that many consignors had contracts with The Neiman Marcus Group, Inc., which changed its name to The Neiman Marcus Group LLC. Its schedule may be found at <https://cases.stretto.com/public/X064/10251/PLEADINGS/1025106202080000000073.pdf>.

<sup>20</sup> See Schedules of Assets and Liabilities of Debtor the Neiman Marcus Group LLC at 18; see note 19 for link to website.

<sup>21</sup> FED. R. BANKR. P. 3003(b)(1).

<sup>22</sup> 11 U.S.C. § 502(a), (b).

status, and have priority over unsecured and other claims. To have administrative claim status, the goods or services must be necessary and beneficial to the debtor's estate.<sup>23</sup> For example, if one of the Neiman Marcus debtors decides that it is beneficial to continue selling goods on consignment after the bankruptcy, the consignor will have an administrative claim and will be paid 100 percent of what it is owed. If there is any question about whether a transaction meets this administrative claim standard, it may be advisable to discuss this with debtor's counsel. If the purchase is unusually large or has questionable terms, bankruptcy court approval may be required.

### **The disclosure statement and plan of reorganization.**

The debtor will file a disclosure statement giving creditors relevant information about the plan of reorganization. The plan is the debtor's proposal of how it will reorganize and pay the claims of its creditors. Creditors whose claims to repayment are "impaired" (*i.e.*, are not paid 100 percent of their claim) are entitled to vote on the plan. Unimpaired creditors cannot vote on the plan because they will be paid in full.

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<sup>23</sup> 11 U.S.C. § 503.

To be “confirmed,” or approved by the bankruptcy court, a plan must:

(1) be accepted by all impaired classes of claims or interests, or if rejected, may not discriminate unfairly and be fair and equitable as to the rejecting impaired class; (2) be feasible; and (3) be in the best interests of holders of claims and interests.<sup>24</sup> The bankruptcy court will hold a confirmation hearing to determine if the plan satisfies these requirements. If the plan is not confirmed, the debtor may not be able to reorganize its business, the case could be converted to a chapter 7 liquidation, and the debtor could go out of business.

Once the bankruptcy court confirms (*i.e.*, approves) the plan, the debtor must satisfy certain conditions for the plan to be effective. Once the “effective date” occurs (*i.e.*, the plan goes into effect), then creditors will receive distributions on their claims. Claims are paid in the order specified in the Bankruptcy Code and as detailed in the plan, generally: (1) to secured creditors, (2) to timely filed unsecured claims, and (3) to untimely filed unsecured claims.<sup>25</sup> Creditors typically receive a percentage of the full amount owed to them, although secured claims and even unsecured claims

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<sup>24</sup> 11 U.S.C. § 1129.

<sup>25</sup> 11 U.S.C. § 726(a).

may be paid in full if there are sufficient funds in the bankruptcy estate to do so.

In Neiman Marcus, the debtors have filed their disclosure statement and proposed plan. Neither specifically mentions the treatment of consignors because their rights and are addressed in the Final DIP Order and will be addressed in future court orders if their consignments are objected to in the procedures discussed below. *See* Section C.3 below. However, if the consignor has a secured claim under the UCC, it will receive priority of payment over other creditors. Under the Neiman Marcus plan, secured claims generally will receive either a 100 percent payment or delivery of the collateral that secured the claim. As noted above, consignors that have a general unsecured claim will be paid a percentage of their claims depending on how much cash the debtors can collect in the bankruptcy. The plan anticipates that the debtors will be operating as usual after the plan is confirmed, meaning that consignors may continue to do business with the reorganized Neiman Marcus as they did prior to the bankruptcy. The Neiman debtors have sought court approval to close several stores, however.

## EFFECTS ON SUPPLIERS

As discussed above, suppliers that have sold goods to a chapter 11 debtor prior to the bankruptcy generally will have to wait until the plan is confirmed to receive payment on those pre-petition debts. As noted above, the debtor will decide whether to assume the contract and continue performing it, or whether it wishes to reject the contract.

Depending on the type of contract the supplier has, it may be able to stop supplying the debtor after the bankruptcy. If the supplier used separate purchase orders without any ongoing contractual obligation, it may simply choose not to supply goods to the debtor in the future. However, if the contract is “executory,” meaning that both the supplier and debtor have ongoing, material obligations to perform, then the supplier cannot stop performing until the debtor has rejected the contract.

A supplier considering whether to continue engaging in new business with the debtor should consider the debtor’s creditworthiness and whether it has obtained debtor-in-possession (“DIP”) financing to pay for administrative claims.

For example, the bankruptcy court has approved the Neiman Marcus debtors' proposal to obtain DIP financing, which will ensure that the debtors can continue to pay their suppliers. If the supplier wishes to continue supplying the debtor post-petition, it should contact the debtor to confirm the terms and payment arrangements. The supplier may also file a motion to seek "adequate protection" to require the debtor to make periodic cash payments to the supplier.<sup>26</sup> For example, if the debtor failed to pay the supplier's administrative claim for new goods provided on consignment to the debtor, the supplier could file a motion to ask the bankruptcy court to protect its interest in getting paid.

Suppliers with consignment contracts may be able to terminate the contract and set off amounts owed, as detailed below. *See* Section B.2. Given that every contract and factual situation is different, however, suppliers should proceed cautiously and consult counsel to determine their options. It is important that suppliers not take any steps that violate the automatic stay.

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<sup>26</sup> 11 U.S.C. § 361.

**Ipsso facto clauses.**

Many contracts, including consignment agreements, contain “*ipso facto*” clauses that allow a party to terminate the contract or modify other contractual rights upon the counterparty’s insolvency or commencement of a Chapter 11 bankruptcy case. For example, a party cannot rely on a bankruptcy filing to increase or modify the payment terms under the contract. Such provisions violate the Bankruptcy Code and its automatic stay by improperly modifying the debtor’s interest in a contract solely because of the bankruptcy filing.<sup>27</sup>

For example, the standard consignment contract Neiman Marcus used contains an *ipso facto* clause that provides that if either party files a bankruptcy petition under the United States Bankruptcy Code, that is an “Event of Default” that allows the other party to terminate the contract and require the return of all consigned merchandise.<sup>28</sup>

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<sup>27</sup> See 11 U.S.C. §§ 365(e)(1), 541(c)(1)(B).

<sup>28</sup> See Neiman Marcus Consignment Agreement §§ 12, 13.

### Safe harbors for forward contracts.

There are limited “safe harbors” to allow *ipso facto* clauses to operate in certain contracts, including swap agreements, repurchase agreements, master netting agreements, securities contracts, and, importantly for those with consignment agreements, “forward contracts.”<sup>29</sup> Forward contracts are defined to include a contract for the purchase, sale, or transfer of a commodity or similar good with a maturity date more than two days after the contract is entered into, including consignment agreements.<sup>30</sup> A consignment contract may qualify as a forward contract. For example, the standard Neiman Marcus consignment agreement appears to be a forward contract because it provides for the purchase or sale of goods on consignment more than two days after the contract is signed. Note that a debtor, such as Neiman Marcus, may contest this, however.

If the consignor has a forward contract with the debtor, and the consignor also qualifies as a “forward contract merchant,” meaning it is in the business of entering into such contracts,<sup>31</sup> it may exercise its contractual

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<sup>29</sup> See 11 U.S.C. §§ 555, 559, 560, 561, 362(b)(17).

<sup>30</sup> 11 U.S.C. § 101(25); *In re Olympic Nat. Gas Co.*, 294 F.3d 737, 740 (5th Cir. 2002).

<sup>31</sup> A “forward contract merchant” is defined by the Bankruptcy Code to mean:

right to terminate, liquidate, and accelerate (or close out) the contract without violating the Bankruptcy Code.<sup>32</sup>

**Setoff rights for forward contract merchants.**

A forward contract merchant may also exercise its right to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with a forward contract.<sup>33</sup> In other words, a consignor that qualifies as a forward contract merchant may set off the termination payment owed by the debtor under the consignment agreement against amounts the consignor owes the debtor, without violating the automatic stay or seeking prior court approval.<sup>34</sup>

**Setoff rights for other suppliers.**

A supplier that is not a forward contract merchant may be able to exercise rights that may arise under applicable state law to set off mutual

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a Federal reserve bank, or an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity (as defined in section 761) or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade.

11 U.S.C. § 101(26).

<sup>32</sup> 11 U.S.C. § 556.

<sup>33</sup> 11 U.S.C. § 362(b)(6).

<sup>34</sup> 11 U.S.C. § 362(b)(6).

debts between the debtor and creditor that arose prior to the bankruptcy.<sup>35</sup>

“Mutual” means that the debts must be between the exact same debtor entity and creditor entity. A creditor may not set off a debt owed by an affiliate of the debtor or its own affiliate. The creditor must seek approval by the bankruptcy court prior to exercising these setoff rights.<sup>36</sup>

### **Reclaiming goods sold before the bankruptcy.**

A supplier may also request in writing to reclaim the goods it sold (not consigned) to the debtor that the debtor *received* while insolvent, within 45 days before the commencement of the bankruptcy case, but it must do so either 45 days after receipt by the debtor, or no later than 20 days after the bankruptcy was filed.<sup>37</sup> The supplier may request leave of court to file such a request late.<sup>38</sup> The supplier’s rights to reclaim goods is subordinate to the superior rights of the lenders.<sup>39</sup> For this reason, the Neiman Marcus debtors have objected to claims to reclaim goods.

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<sup>35</sup> 11 U.S.C. § 553.

<sup>36</sup> 11 U.S.C. § 362(a)(7).

<sup>37</sup> 11 U.S.C. §§ 546(c), 503(b)(9); *see also* TEX. BUS. & COM. CODE § 2.702.

<sup>38</sup> 11 U.S.C. § 503(a).

<sup>39</sup> 11 U.S.C. § 546(c)(1).

Claims for amounts owed for goods sold and received within this timeframe are “allowed administrative expenses.”<sup>40</sup> The debtor will set a deadline to file requests for payment of administrative expense. For example, in *Neiman Marcus*, the deadline for filing requests for administrative claims and expenses (the “Administrative Claims Bar Date”) is 30 days after the plan becomes effective, after approval by the bankruptcy court.

### TREATMENT OF CONSIGNMENT AGREEMENTS

As noted, state law governs a party’s rights in property. Consignments in the United States are generally governed either by the common law – the body of law in English and American systems that develops through judicial decisions, rather than legislative enactments – or by the Uniform Commercial Code (the “UCC”), which is uniform legislation enacted by most states, including Texas.<sup>41</sup>

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<sup>40</sup> 11 U.S.C. § 503(b).

<sup>41</sup> BLACK’S LAW DICTIONARY 276 (6th ed. 1990); *see* TEX. BUS. & COM. CODE § 1.101.

### Common-law “true consignments.”

Under common law, a consignment contract is one in which a party (the “consignor”) agrees to send goods to a merchant (the “consignee”) to sell, and the consignee agrees to either pay for the goods after they are sold or return any unsold goods to the consignor.<sup>42</sup> The consignor retains title to the goods until the consignee actually sells the goods.<sup>43</sup> A consignment under the common law is considered a “true consignment.” The Neiman Marcus standard consignment contract states that it is a true consignment.<sup>44</sup>

### UCC consignments.

Consignments that meet the UCC definition of consignments create security interests in the consigned goods.<sup>45</sup> The UCC defines a “consignment” to mean:

a transaction, regardless of its form, in which a person delivers goods to a merchant for the purpose of sale and:

(A) the merchant:

(i) deals in goods of that kind under a name other than the name of the person making delivery;

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<sup>42</sup> BLACK’S LAW DICTIONARY 307.

<sup>43</sup> *Id.* at 307.

<sup>44</sup> See Neiman Marcus Consignment Agreement § 3.

<sup>45</sup> TEX. BUS. & COM. CODE §§ 9.102(a)(20), (73)(C), (F), 9.109(a)(4), 2.401(a).

- (ii) is not an auctioneer; and
- (iii) is not generally known by its creditors to be substantially engaged in selling the goods of others;
- (B) with respect to each delivery, the aggregate value of the goods is \$1,000 or more at the time of delivery;
- (C) the goods are not consumer goods immediately before delivery;
- (D) the transaction does not create a security interest that secures an obligation; and
- (E) the transaction does not involve delivery of a work of art to an art dealer or delivery of a sound recording to a distributor if Chapter 2101, Occupations Code, applies to the delivery.<sup>46</sup>

Whether a contract meets the definition of a UCC consignment depends on the circumstances. For example, in the Neiman Marcus bankruptcy, some consignors have contended they have true consignments, rather than UCC consignments, because Neiman Marcus was known for selling the goods of others. But the standard consignment contract Neiman uses states both that the contract is a true consignment and that Neiman will execute and deliver all necessary UCC financing statements to the consignor.<sup>47</sup> Therefore, a consignment agreement with Neiman Marcus

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<sup>46</sup> TEX. BUS. & COM. CODE § 9.102(20).

<sup>47</sup> See Neiman Marcus Consignment Agreement §§ 3, 4.

could be either a true consignment or a UCC assignment depending on whether the arrangement meets the UCC definition and whether the consignor “perfected” its security interest in the consigned goods.

To protect its security interests and ensure favorable treatment in a subsequent bankruptcy, the consignor must take certain steps outlined in the UCC. Under the UCC, a consignor has a “purchase-money security interest” in inventory with regard to consigned goods.<sup>48</sup> A consignor can perfect its security interest by satisfying the UCC’s requirements for a perfected priority consignment interest, and thereby obtain priority over a conflicting security interest in the same inventory.<sup>49</sup> These requirements include (1) filing a UCC financing statement with the Texas Secretary of State describing the goods *prior to* the consignee’s receipt of the goods; (2) sending an authenticated notification to the holders of conflicting prior perfected security interests in the consignee’s inventory that the consignor has or expects to acquire a consignment interest in the goods and describes the goods; and (3) receipt of such notice by the holders of conflicting inventory security interests within five years before the consignee’s receipt of the

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<sup>48</sup> TEX. BUS. & COM. CODE § 9.103(d).

<sup>49</sup> TEX. BUS. & COM. CODE § 9.324(b).

goods.<sup>50</sup> The latter two steps only apply if the holder of the conflicting security interest has filed a financing statement covering the same types of inventory and other conditions apply.<sup>51</sup>

The standard consignment contract used by Neiman Marcus provides that the consignee, Neiman Marcus, will execute and deliver to the consignor the required UCC financing statements. It appears to be up to the consignor to file the statement, however. If the consignor did not file the UCC financing statement prior to the bankruptcy, the contract would not be “secured” and therefore would receive a lower priority in the bankruptcy. The contract would be treated as a common-law true consignment unless it is challenged in the bankruptcy court.

If a consignor fails to timely perfect its security interest, other creditors, such as the debtor’s lender, may claim a superior interest in the consigned goods.<sup>52</sup>

In addition, while the consignee has possession of the goods, the consignee is deemed to have the rights and title to the goods identical to

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<sup>50</sup> TEX. BUS. & COM. CODE § 9.324(b)(1)-(4).

<sup>51</sup> TEX. BUS. & COM. CODE § 9.324(c).

<sup>52</sup> See *TSA Stores, Inc. v. M J Soffe, LLC (In re TSAWD Holdings, Inc.)*, 565 B.R. 292, 299 (Bankr. D. Del. 2017).

those of the consignor and may grant a security interest in the goods to another creditor that is superior to that of the consignor.<sup>53</sup> That means the consignee can grant a lender a security interest in the goods, and can successfully have the goods sold to pay back the lender.<sup>54</sup>

Thus, in some cases, it may be preferable for a consignor to assert a true consignment. Although a consignment contract may state that it is a true consignment, such as standard Neiman Marcus contract, the consignor has the burden to prove that is the case, and a court may disagree.<sup>55</sup>

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<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *See id.*

### Procedures for consignments in the Neiman Marcus case.

In Neiman Marcus, the debtors' initial request for DIP financing provided that its DIP lenders would have priority claims over all of the debtors' assets. After several consignors objected that debtors could be granting the lenders a lien on or claims against their consigned goods, the debtors requested and the bankruptcy court approved a final DIP order that provides that "Valid Consigned Merchandise" shall not be deemed to be the property of the debtors' estate and shall not be subject to liens, claims, or encumbrances. As long as the merchandise is deemed "valid," this protects the merchandise from being used to pay the claims of the DIP lenders and other creditors. The DIP order provides that a "Valid Consignor" is any vendor that consigned and delivered merchandise prior to the bankruptcy petition and also:

1. filed a UCC financing statement,
2. obtains a court order that the merchandise was a valid consignment,
3. is deemed to have a valid consignment because no one objected to their consignment interest by July 30, 2020, or

4. consigned and delivered merchandise after the bankruptcy petition was filed on May 7, 2020.<sup>56</sup>

Thus, if a consignor has not filed a UCC financing statement, it would either be deemed a Valid Consignor after July 30, 2020, provided no one objects to their consignment interest, or it must seek a court order to determine that the consignment is valid.

For consignors whose interests are objected to by July 30, 2020, the DIP order provides that the bankruptcy court will hold a hearing on August 26, 2020 to establish procedures to determine the consignors' interests.<sup>57</sup>

For consignors that choose to continue consigning merchandise after the bankruptcy petition, the DIP order provides that they may, but are not required to file a UCC financing statement to protect their interest in the property.<sup>58</sup>

A consignor that is a Valid Consignor under the definition above may request the Debtor to return the consigned property, but it must give notice

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<sup>56</sup> Final Order (I) Authorizing The Debtors To (A) Obtain Postpetition Financing And (B) Utilize Cash Collateral, (II) Granting Adequate Protection To Prepetition Secured Parties, (III) Modifying The Automatic Stay, and (IV) Granting Related Relief 90-91, ¶ 39 (Dkt. 850).

<sup>57</sup> *Id.* at 93, ¶ 39 (g).

<sup>58</sup> *Id.* at 92, ¶ 39(d).

to the debtors and to the agents for the DIP and pre-petition lenders.<sup>59</sup> The Valid Consignor must pay the cost and expense of the return, but may file a claim in the bankruptcy to recover that money.<sup>60</sup>

### Issues with consignments in bankruptcy.

In general, several issues can arise in chapter 11 bankruptcy proceedings with regard to consigned goods, including:

- The debtor may attempt to sell the consigned goods below cost and keep the proceeds free and clear of the consignors' interests.
- The debtor's lenders may have superior interests in the consigned inventory and proceeds given that consignors failed to file UCC financing statements.
- The debtor may need to file lawsuits against each consignor to determine their rights under the agreements and state law.
- The debtor could seek to "avoid" and therefore recover transfers of the debtor's property made within 90 days before the filing of the chapter 11 petition, during which time the debtor is presumed to be insolvent.<sup>61</sup>
- The debtor could seek to avoid and recover "fraudulent transfers" made within two years before the filing of the petition if the debtor was insolvent at that time or became insolvent as a result of the transfer.<sup>62</sup>

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<sup>59</sup> *Id.* at 94, ¶ 39(h).

<sup>60</sup> *Id.*

<sup>61</sup> 11 U.S.C. §§ 547(b), 550.

<sup>62</sup> 11 U.S.C. §§ 548, 549.

When issues like these arise, it may be necessary for creditors with consignment agreements to file objections and motions in the bankruptcy court to assert and protect their rights. For example, in *Neiman Marcus*, consignors whose interests have been objected to will receive notice of the objection and will need to file a motion in the bankruptcy court to ask the court to determine that they have a valid consignment.

## WHAT SUPPLIERS CAN DO TO PROTECT THEMSELVES

Once a bankruptcy has been filed, a supplier must be careful not to violate the automatic stay, but can take several steps to protect itself, including:

- locate and review all contracts, agreements, documents, invoices, and communications regarding the supplier's dealings with the debtor;
- seek the advice of counsel regarding the supplier's rights, if any, to terminate contracts, set off amounts owed, and reclaim goods;
- either stop providing new goods to the debtor or continue providing new goods for consignment or sale and payment in full;
- monitor the filings in the bankruptcy to determine if issues arise that could affect the supplier;
- talk to other similarly situated creditors and determine whether it makes sense to join forces on a particular issue;
- contact the debtor's counsel to discuss concerns and perhaps negotiate a resolution of disputes;
- review the debtor's disclosure statement and schedules to determine if the supplier agrees with the debtor's calculation of amounts due, and if not, file a proof of claim before the deadline (the claims bar date);
- file a motion to lift the automatic stay to exercise otherwise prohibited rights;
- file objections when necessary to protect the supplier's interests;

- file an “adversary proceeding” –a lawsuit filed in the bankruptcy case – to protect the supplier’s rights;
- vote for or against the bankruptcy plan;
- be patient – bankruptcies can take time;
- review future contracts closely to understand the consignor’s rights before signing the agreement and ask to clarify any unclear language;<sup>63</sup>
- file UCC financing statements to ensure that the consignor’s interest is secured and receives priority treatment in any future bankruptcy;
- investigate the financial health of the companies you are dealing with; and
- consider diversifying your client base to spread your risk.

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<sup>63</sup> Note that large companies such as Neiman Marcus will often insist on using a standard form contract as a condition of doing business.

## CONCLUSION

The filing of a chapter 11 petition can present many questions and challenges for creditors, including suppliers and consignors. In general, however, chapter 11 provides an orderly means for a debtor to reorganize and continue operating its business. Suppliers and consignors may wish to continue to supply the debtor with goods after the bankruptcy filing, or they may be able to terminate their relationship with the debtor if the circumstances and the law permit them to do so. It is important to stay informed and be prepared to assert one's rights if and when it becomes necessary. Fortunately, debtors often prefer to resolve potential disputes amicably rather than engaging in time-consuming litigation.

