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In re Whitehall Jewelers Holdings, Inc.

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Introduction

In *In re* Whitehall Jewelers Holdings, Inc., No. 08-11261(KG), 2008 WL 2951974 (Bankr. D. Del. July 28, 2008), the court held against Whitehall Jewelers Holdings, Inc. ("Debtors"), in favor of approximately 124 consignment vendors ("Consignment Vendors"), where Debtors sought an order permitting the "free and clear" sale of all of their assets and inventory, including consigned goods from Consignment Vendors. *See id.* at *1–2. In order to develop a full understanding of the court's holding, it is necessary to understand its statutory context, specifically sections 363 and 541 of the Bankruptcy Code, as well as Federal Rule of Bankrtupcy Procedure 7001(2), and portions of the UCC pertaining to consignment goods. After a review of the relevant statutes, a discussion of the court's reasoning will follow with a particular focus on the court's analysis of the various arguments presented by Debtors, and the interesting way in which the court construed the applicable law, ultimately to the benefit of the consignment vendors.

Discussion

Section 363. Use, Sale, or Lease of Property

"It has long been recognized that the bankruptcy court has the power to authorize the sale of property free of liens with the liens attaching to the proceeds, without the consent of the

lienholder." Collier on Bankruptcy 363.06, 363–46; *Ray v. Norseworthy*, 90 U.S. (23 Wall.) 128 (128) (1875); *Van Huffel v. Harkelrode*, 284 U.S. 225 (1931). Section 363(f)(4) of the Bankruptcy Code reiterates this longstanding right, and permits the sale of property free and clear of the interests of non-debtors in the property, if those interests are subject to *bona fide* dispute. A bona fide dispute "weighs the equities in favor of the sale because a disputed interest should not prevent a sale that would be beneficial to the estate and with respect to which adequate protection may be provided." Norton Bankruptcy Law and Practice 3d, chapter 44 (§§ 44:16 et seq.); *See In re Bedford Square Associates, L.P.*, 247 B.R. 140 (Bankr. E.D. Pa. 2000).

The trustee has the burden of demonstrating that a *bona fide* dispute exists by establishing an objective basis for a dispute as to the validity of the debt. *See* Collier on Bankruptcy 363.06[5]; *In re* Octagon Roofing, 123 B.R. 583, 590 (Bankr. N.D. Ill. 1991); *In re* Collins, 180 B.R. 447 (Bankr. E.D. Va 1995). However, the court need not resolve the underlying dispute, nor even determine its probable outcome, but rather must determine whether the dispute merely exists. *Id.*; *In re* Taylor, 1908 B.R. 142 (Bankr. D. S.C. 1996).

Section 541. Property of the Estate

Section 541(a) defines the property comprising the estate. Under section 541(a)(1), the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case," subject to the exceptions in section 541(b) and (c)(2). 11 U.S.C. § 541. Paragraph (1) is considered to be broad, encompassing tangible and intangible property, causes of action, and other forms of property. ¶541.04 COLLIER ON BANKRUPTCY. The trustee may not assert greater rights than the debtor had on the commencement of the case. *See id.*; *see also* Norton Bankruptcy Law and Practice 3d, chapter 61 (§§ 61.4 et seq.) ("Inclusion in the estate does not

change the nature of property in the debtor; a limited interest in the hands of the debtor remains the same in the estate.).

Regarding property held by the debtor as a bailee, agent, or consignee, "[i]tems in the possession of the debtor may become property of the estate only to the extent of the debtor's property interest in those items." ¶541.06[1][a] COLLIER ON BANKRUPTCY. Thus, the nature and relationship between the debtor and property is a "critical component of determining what interests in the property will comprise property of the estate." *Id.*; *See* Missouri v. U.S. Bankruptcy Court for E.D. of Arkansas, 647 F.2d 768 (8th Cir. 1981).

Consignments, pre-UCC

In a consignment scenario, the consignment goods belong to another, the consignor, subject to the debtor/consignee's right to possession. "[A] consignment is equivalent to a bailment for care or sale, wherein there is no obligation of purchase in the consignee." ¶541.06[1][b] COLLIER ON BANKRUPTCY. Prior to the adoption and use of the Uniform Commercial Code ("UCC"), the consignee bankruptcy estate would have no claim on consigned goods, because title to the property considered to be in the consignor. *See* ¶541.06[1][b] COLLIER ON BANKRUPTCY; *see also Ludvigh v. American Woolen Co.*, 231 U.S. 522 (1913); *Thomas v. Field-Brundage Co.*, 215 F. 891 (8th Cir. 1914). In order to determine whether there was an actual consignment, courts looked to the existence of an obligation to purchase or pay for the goods under the contract between the parties, or the parties' actions. *See* ¶541.06[1][b] COLLIER ON BANKRUPTCY; *see also In re* Flanders, 134 F. 560 (7th Cir. 1905).

Consignments under the UCC

Under the UCC, consignments are divided into two categories: "true" consignments and consignments intended as security interest. If a consignment is intended as a security interest, it

will fall within the scope of Article 9 (section 9-102). *See* ¶541.06[1][b] COLLIER ON BANKRUPTCY; *see also* NORTON BANKRUPTCY LAW AND PRACTICE 3d, chapter 61 (61:6 et seq.). In order to protect the "secured interest," a financing statement must be filed to perfect the "consignor's" rights. Otherwise, the "consignor's" claim will be "subordinate to the rights of an intervening judicial lien creditor (section 9-301(1)(b)) and, therefore, render it void as against the trustee asserting such rights under section 544(a)." ¶541.06[1][b] COLLIER ON BANKRUPTCY. Consequently, the "consignor" will essentially be reduced to the status of a general unsecured creditor. *See id.*

In a "true" consignment," a consignment not intended as a security interest will be treated like a sale-or-return contract. *See* UCC § 2-326. Pursuant to UCC section 2-326, "if delivered goods may be returned by the buyer even if they conform to the contract, the transaction is . . . (b) a "sale or return" if the goods are delivered primarily for resale." This is significant because Section 2-326(2) considers goods held on "sale or return" subject to the claims of the buyer's creditor while in the buyers possession. UCC § 2-326(2). Thus, consignors are only protected where the possessing party "is known by his creditors to be dealing in the goods of others or the consignor complies with the filing provisions of Article 9." ¶541.06[1][b] COLLIER ON BANKRUPTCY.

Federal Rule of Bankruptcy Procedure 7001(2)

Rule 7001(2) of the Federal Rules of Bankruptcy Procedure provides that "a proceeding to determine the validity, priority, or extent of a lien or other interest in property," is an adversary proceeding. Prior to *SLW Capital, LLC v. Mansaray-Ruffin* (*In re* Mansaray-Ruffin), 530 F.3d 230 (3rd Cir. June 24, 2008), "courts had routinely disregarded Rule 7001(2) in matters similar to the one at issue [in *In re* Whitehall]." *Whitehall*, at *6–7. For instance, in *In re*

Collins, 180 B.R. 447, 452 n. 8 (Bankr. E.D. Vir. 1995) (*citing In re* Oneida Lake Dev., Inc. 114 B.R. 352, 358 (Bankr. N.D.N.Y. 1990)), the court noted that section 363(f)(4) was satisfied despite the debtor not filing an adversary proceeding to avoid the creditor's lien. *See Whitehall*, at *6.

Significantly, following *SLW Capital*, the *Whitehall* court held that a lien can only be invalidated in the Third Circuit "by an adversary proceeding commenced pursuant to Rule 7001(2) and not by motion." *See Whitehall*, at *6 (*citing SLW Capital*, at *1). The *SLW Capital* court held that invalidation could only occur through litigation in an adversary proceeding in order to "provide greater procedural protection." *SLW Capital*, at *6. Additionally, the court held that the adversary proceeding Rule at issue was "mandatory," and that the mandatory nature stemmed from "principles of due process that trump 'finality'." *SLW Capital*, at *6.

Debtors' Arguments in Support of Sale

In *Whitehall*, the Debtors argued that the Consignment Vendors' interests in the consigned goods were in dispute due to the failure of many vendors to properly perfect their consignment interests under UCC Article 9 and UCC section 2-326, which makes goods sold in a "sale or return" transaction subject to creditor claims. *See Whitehall.* at *3. Further, Debtors argued that as a result of the Vendor Trading Agreements ("VTA") between the parties, which specifically incorporated provisions of the UCC relating to consignment ("The Parties intend that the transfer and delivery of goods by Consignor to Consignee . . . shall be characterized . . . within the respective meanings . . . under the Uniform Commercial Code"), that the rights of the Consignment Vendors were subordinate to the rights of Debtors' creditors. *See id.* at *1–3. Therefore, because the goods were in *bona fide* dispute, as contemplated by section 363(f)(4), the court should allow the consigned goods to be sold as part of the proposed section 363 sale.

The Decision

In rendering its decision, the court turned its attention to the largely "ignored or avoided threshold issue" of whether the consigned goods were even property of the Debtors' estate under section 541. *See Whitehall* at *3. The court held that Debtors utilized "the wrong procedural tool, i.e., a contested matter," instead of the required adversarial proceeding under Federal Rule of Bankruptcy Procedure 7001(2), in order to "determine the validity, priority, or extent of [an] interest in property." *See id.* at *6–7. As was previously discussed, the court considered itself to be bound by the authoritative recent 3rd Circuit decision in *SLW Capital* to consider Rule 7001(2) mandatory. *See id.* at *6. Because a sale motion is considered to be a contested matter, and not an adversarial proceeding, the Debtors used the "wrong procedural tool." *See id.*

The Court also emphasized the apparent "heavy" burden to demonstrate that the consigned good were property of the estate. *See id.* (*citing In re* Summit Global Logistics, Inc., 2008 WL 819934 at *9 (Bankr. D.N.J. March 26, 2008) ("When a pre-confirmation . . . sale is of all, or substantially all, of the Debtor's property . . .the sale transaction should be 'closely scrutinized,' and the proponent bears a heightened burden [ ]."). Thus, Debtors did not meet the initial burden of establishing that the consigned goods were property of the estate, and could not proceed with the sale of the consigned goods. *See id.* at *7

Significantly, the applied "property of the estate" threshold test allowed the court to avoid ruling on the section 363(f)(4) *bona fide* dispute issue. If the relevant UCC provisions had instead been applied, it seems likely that the consignment goods would be considered in *bona fide* dispute. *See id.* at *1. For example, as argued by Debtors, UCC section 2-326 provides that goods held on sale or return "are subject to [the claims of the buyer's creditors] while in the buyer's possession." Since the consigned goods were in the buyer's possession, and according to

the VTA, the goods were "sold to Whitehall by Vendor on a 'sale or return' basis," it seems reasonable for Debtors to believe that section 2-326 would subject the goods to the claims of the Debtors creditors, which would in turn make the goods in *bona fide* dispute. *See id.* at *2. Similarly, since UCC section 9-103(d) treats most consignments as purchase money security interests, the failure to perfect would allow those interest to be avoided under the section 544 "strong arm" power.

Notably, the court seemed to minimize the effect of the VTA, referring to it as a "generic," when the terms of the VTA benefited Debtors, but cited terms of the VTA when it was to the Consignment Vendors benefit. *See id.* at *6 ("Given the terms of the VTA that the Consignment Vendors remain owners of their goods . . . the delineated purported interests are simply not sufficient to demonstrate that the Consigned Goods are property of the estate."). Additionally, the Court also suggested that a reading of the VTA could in fact support the conclusion that the consigned goods were the property of the Consignment Vendors, again remarking on the "absence of evidence" preventing a "definitive ruling" for either party. *See id.* at *4.

Assessment of the Court's Decision

Given the apparent validity of Debtors' arguments, the court's decision may have been influenced by other case-specific factors, such as the significant amount of undetermined factual issues, and that an inclusion of consignment goods as part of the proposed 363 sale would be a final disposition of the property. *See Whitehall* at *7. Nonetheless, the effect of the decision is significant since it effectively prevented a prompt free and clear sale. As the court noted, the Debtors' would have to file and resolve more than 120 adversary proceedings prior to conducting a sale. *See id.* The reasoning of the opinion is not limited to consignment cases, but extends to

any situation where the debtor's interest in the property is in dispute. The potential impact of the case is made more extensive by the court's rejection of the debtor's argument that the broad section 541 definition of property of the estate meant that consigned and "sale or return" goods were property of the estate, even if the Debtors' rights were less than full title. *See id.* at *5–6. However, given the court's fact-specific concerns, the persuasive force of the court's holding in the future may be limited.