



Young & New Members Committee

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[Due Process and 363 Sales of Consignment Goods](#)

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A recent decision of the Bankruptcy Court for the District of Delaware (court) halted a proposed §363 sale, and this decision could significantly impact future bankruptcy sales of retail businesses holding inventory on consignment. *In re Whitehall Jewelers Holdings Inc.*, 2008 WL 2951974 (Bankr. D. Del. July 28, 2008). Whitehall Jewelers is a nationwide specialty retailer of jewelry, operating 373 retail stores in 39 states as of June 23, 2008 (petition date). Whitehall Jewelers Holdings and its affiliated entities (debtors) had historically been engaged in selling jewelry and related products delivered to the debtors on consignment. The debtors experienced several years of financial difficulties and in April 2008 attempted to turn the company around with the purchase of Friedman's, a bankruptcy jewelry retailer. Unfortunately, these restructuring efforts were unsuccessful, and on June 23, 2008, Whitehall filed a petition for relief under chapter 11 of the Bankruptcy Code.

On the petition date, the debtors filed a motion seeking court approval of an expedited §363 sale of substantially all of its assets, including consigned goods in its possession. The debtors intended to sell

these assets at an auction, which would have resulted in significant losses to the consignment vendors. The consignment vendors filed various objections largely focused on the issue of whether the court could authorize a §363 sale of consignment goods prior to determining whether the goods are part of the bankruptcy estate. Due to the expedited nature of the issue, the court ordered briefings and scheduled oral arguments, solely on the legal issues.

The debtors argued that 11 U.S.C. §363(f)(4) permitted them to sell the consignment goods as part of the auction. Section 363(f) provides:

The trustee may sell property under subsection (b) of (c) of this section free and clear of any interest in such property of an entity other than the estate, only if - (4) such interest is in bona fide dispute. 11 U.S.C. §363(f)(4).

The debtors alleged that many of the consignment liens were in bona fide dispute because the liens were not properly perfected under Article 9 of the Uniform Commercial Code and that Article 2 of the UCC, if applicable, would allow such a sale. Thus, the debtors concluded that §363(f)(4) permitted sale of the consignment goods free and clear. Furthermore, the debtors proposed that any adequate-protection requirement was satisfied because the enforceable liens held by the consignment vendors would attach to the proceeds of the sale. In reality, these proceeds, estimated at \$0.53 on the dollar, would be insufficient to cover the value of the consigned goods.

The court, rather than proceeding with an analysis under §363(f) as the debtors urged, determined that the threshold issue was whether the consignment goods were "property of the estate." Section 363(f) permits sale of property under §363 (b) or (c). Section 363(b) provides that "[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, *property of the estate*...." 11 U.S.C. §363(b) (emphasis added). Thus, to be eligible for sale under §363(f), property must first be "property of the estate."

The definition of "property of the estate" is broad and encompasses "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. §541(a)(1). The debtors asserted that the consigned goods were property of the estate despite the consignment vendors' claimed ownership interests. The court did not address whether the property was, in fact, part of the debtors' estate. Instead, the court held that the determination of whether the consigned goods are part of the bankruptcy estate could not be resolved in a contested matter. The court stated that Federal Rule of Bankruptcy Procedure 7001(2) requires that the debtors commence an adversary proceeding to "determine the validity, priority, or extent of a lien or other interest in property." Fed. R. Bankr. P. 7001(2).

The Third Circuit Court of Appeals recently confirmed that a lien could only be invalidated by an adversary proceeding pursuant to Fed. R. Bankr. P. 7001(2). *SLW Capital LLC v. Mansaray-Ruffin (In re Mansaray-Ruffin)*, 530 F.3d 230, 232 (3d Cir. 2008). In *SLW Capital*, a chapter 13 debtor sought to invalidate a mortgage assignee's claim through a provision in her confirmed plan of reorganization. The Third Circuit stated that Rule 7001 of the Federal Rules of Bankruptcy Procedure sets forth the types of actions that must be resolved by the vehicle of an adversary proceeding. The court also noted that "[t]he [Federal] Rules [of Bankruptcy Procedure] are binding and courts must abide by them unless there is an irreconcilable conflict with the Bankruptcy Code."

The Third Circuit further stated that many of the 7000 series of Federal Rules of Bankruptcy Procedure "derive in whole or in part from the Federal Rules of Civil Procedure, giving an adversary proceeding all the trappings of traditional civil litigation." *Id.* at 234. For example, an adversary proceeding provides parties with the same discovery opportunities as traditional civil litigation, and the rules regarding

voluntary and involuntary dismissals, default judgments and summary judgment are also identical. The due process protections afforded by the Bankruptcy Rules were not in "irreconcilable conflict" with the Code, and thus, the Third Circuit held that the use of an adversary proceeding to invalidate a lien is mandatory. *Id.* at 235-38. Further, "[i]ts mandatory nature is grounded in principles of due process that trump 'finality' [of plan confirmation]." *Id.* at 238. As a result, the mortgage assignee's lien was unaffected by Mansaray-Ruffin's plan confirmation.

The court recognized that prior to the *SLW Capital* decision, courts have routinely disregarded Fed. R. Bankr. P. 7001(2) and allowed interests to be invalidated in contested matters. *In re Whitehall Jewelers Holdings Inc.*, 2008 WL 2951974, at *6. However, the court stated that "it is clear after *SLW Capital* that the law in [the Third] Circuit requires strict application of Rule 7001(2) in circumstances where, as here, a debtor seeks to invalidate a creditor's interest." *Id.* Thus, the court held, a debtor must commence an adversary proceeding when seeking to invalidate the interests of consignment vendors in consigned goods.

Subsequent to the court's decision, the debtors settled with the consignment vendors instead of proceeding with adversary cases to invalidate the consignors' interests in the consigned goods.

Hence, the debtors holding consignment goods will no longer be able to seek to invalidate consignors' interests in the goods via a contested matter. Rather, debtors will need to commence adversary proceedings against each vendor — potentially a time-consuming and expensive undertaking. Partly because of limited and stringent DIP financing in today's financial environment, many debtors seek to sell substantially all of their assets relatively early in the bankruptcy process. However, unless debtors plan ahead and commence adversary proceedings to invalidate liens and other interests, debtors holding consigned goods face significant limitations on what they may include as "property of the estate" in §363 sales.