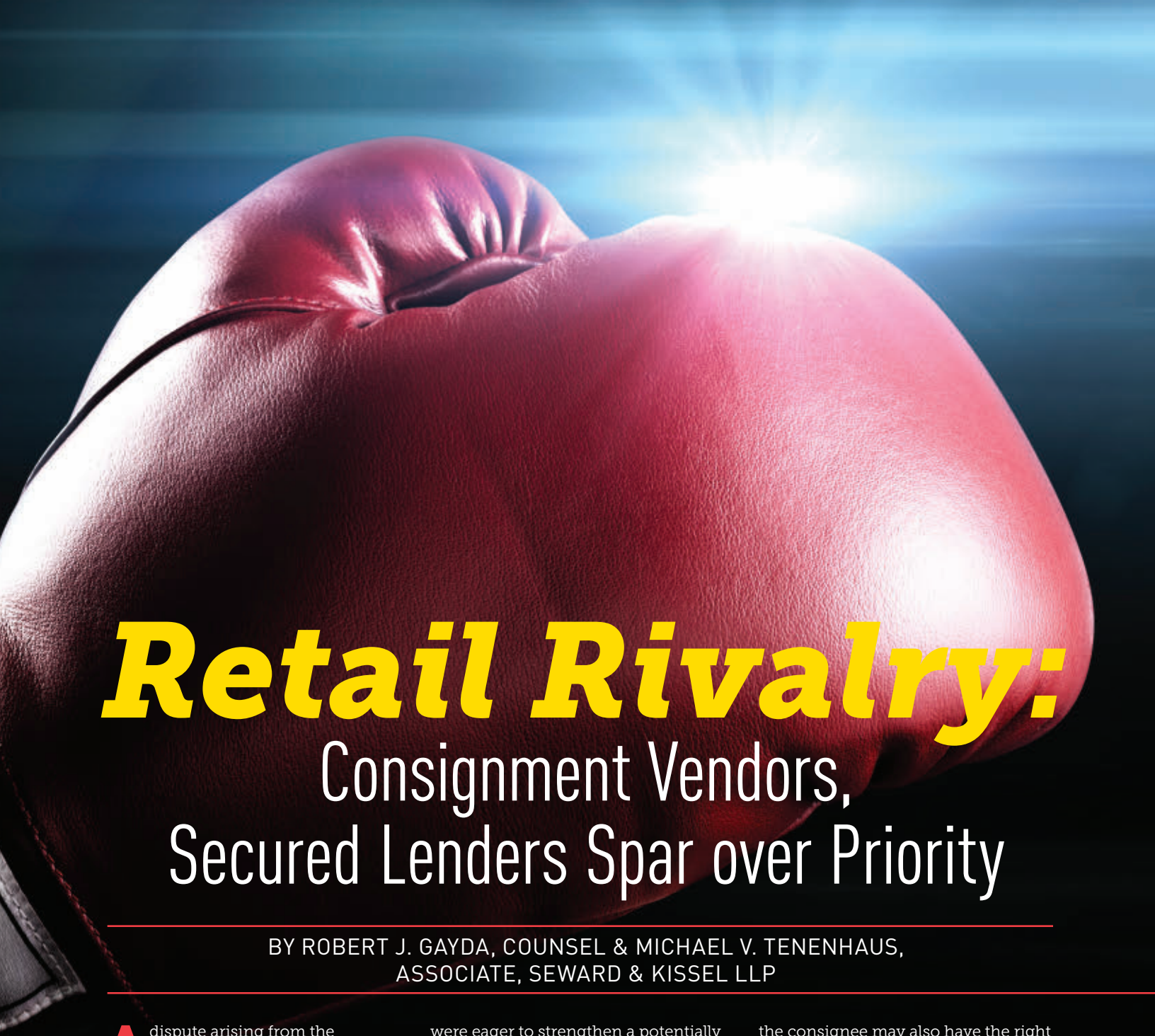

Retail Rivalry:
Consignment Vendors, Secured Lenders Spar over Priority

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A dispute arising from the bankruptcy cases of Sports Authority Holdings Inc. highlights an issue that could be at the forefront of upcoming retail bankruptcies and should always be considered by parties with credit exposure to distressed retailers. The dispute centered on the competing claims of Sports Authority's consignment vendors and its secured lenders in goods delivered prepetition, which had an aggregate invoice cost of approximately $85 million.

Both constituencies claimed priority in the goods and were willing to fight, given the high stakes—the consignment vendors faced relegation to the status of unsecured creditors, while the lenders were eager to strengthen a potentially deficient collateral position. Although ultimately settled, the vigorous dispute illustrates the arguments and considerations on both sides of the issue and is instructive for industry participants that may be involved in future bankruptcies in the sector.

Consignment Arrangements

Consignment is an arrangement in which the "seller," or consignor, delivers goods into the possession of the "purchaser," or consignee, for sale or use by the consignee. The consignor generally contracts to retain title to the goods and defers payment from the consignee until the consignee sells or uses the goods. In some situations, the consignee may also have the right to return the goods to the consignor. Upon a sale of the goods, title passes from the consignor to the ultimate purchaser, and the consignee remits an agreed-upon invoice price to the consignor. The relationship between the consignor and consignee is often governed by a written agreement and is specifically addressed by the Uniform Commercial Code (UCC).

Consignment arrangements are fairly common and often stress-free. Consignors generally have an expectation that they hold title to the goods in the possession of the consignee and have a priority interest in the proceeds of those

goods. However, as demonstrated by *Sports Authority* and other retail bankruptcies, this is a risky assumption. In fact, a consignor will only have priority in the consigned goods if the consignor carefully complies with the requirements of UCC Article 9.

The UCC has very specific conditions for a consignor's perfection of its interest in goods that have been delivered to the consignee. Consignors should be very mindful of these conditions, particularly when dealing with a distressed counterparty. UCC § 9-102(a)(20) defines consignment as a transaction in which a person delivers goods to a merchant for the purpose of sale and (a) the merchant deals in goods of that kind under a name other than the name of the person making delivery, is not an auctioneer, and 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; and (d) the transaction does not create a security interest that secures an obligation.

If a transaction qualifies as a consignment transaction under the UCC definition, the consignor essentially needs to take two steps to fully secure its interest in the consigned goods. First, it needs to perfect its interest vis-à-vis the consignee. This is significant because upon the filing of a bankruptcy petition, the debtor-consignee (or a trustee if one is appointed), acting as debtor-in-possession, is deemed to have the same interest in the goods that a hypothetical lien creditor would. This means that a consignment vendor with an unperfected interest in the goods would only have an unsecured claim in the bankruptcy, which would share pro rata with all other unsecured creditors. These claims often recover only cents on the dollar.

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If the consignment vendor were to perfect its claim against the consignee, it would have a priority interest in the goods, whereby, absent a senior secured interest in the goods, the consignor would likely recover its full contractual claim. To perfect its interest against the consignee, the consignor must simply file a UCC financing statement. The financing statement must be filed in the appropriate jurisdiction and must adequately describe the goods.

A consignor must meet additional requirements, however, to protect its interests in the goods against the consignee's existing secured creditors that have a security interest in the consignee's inventory. UCC § 9-103(d) provides that a consignor has a purchase-money security interest in goods that are the subject of a consignment, which, if perfected, has priority over conflicting security interests in the same inventory under UCC § 9-324(b). To obtain this priority, the consignor must have perfected its security interest (by filing a UCC financing statement) prior to the consignee's receipt of the goods.

Additionally, the consignor must send an authenticated notification (again describing the goods) to the holders of conflicting security interests (*e.g.*, a consignee's secured lender with a lien on inventory) that states that the consignor has, or expects to acquire, a purchase-money security interest in the inventory. The holder of the conflicting security interest must receive the notification within five years before the consignee receives possession of the inventory.

If the consignment vendor closely follows these procedures, the vendor should find itself in a strong position in any bankruptcy proceeding, as it will have a secured claim in the goods delivered to the consignee in accordance with its contract. However, as demonstrated by *Sports Authority*, many vendors fail to observe these requirements and can find themselves embroiled in litigation in a subsequent bankruptcy.

Sports Authority

Sports Authority filed for bankruptcy in Delaware on March 2, 2016. As of the petition date, the debtors' inventory included approximately 8.5 million units of goods supplied on consignment from approximately 170 vendors, with an invoice price of approximately $85 million. The consigned goods were delivered prior to the petition date pursuant to short-form agreements with Sports Authority that identified the arrangement as "a consignment as defined in Section 9-102" of the Colorado and Delaware UCCs, while also providing that the vendor shall retain title to all goods until the date of sale (when title would pass to the ultimate purchaser). These goods would prove to be the center of a four-month-long dispute between the debtors, their consignment vendors, and their secured lenders.

Along with a number of other first-day filings, Sports Authority filed a motion that sought authority to continue selling the consigned goods in the ordinary course of business. This motion proposed to grant the consignment vendors replacement liens on the proceeds of the sale of the consigned goods, but only to the extent that such vendors had valid, enforceable, non-avoidable, and perfected liens in the goods delivered to the debtors. A large number of consignment vendors objected to the requested relief.

These consignment vendors argued, among other things, that the consigned goods were not property of the Sports Authority estate and thus could not be sold. They further argued that a determination of whether the consigned goods were property of the estate could not be made in the context of a contested matter, but instead must be made in an adversary proceeding.

Sports Authority's secured term loan lenders also appeared. The secured lenders held a perfected lien on the debtors' inventory, which purportedly included the consigned goods. At the first-day hearing the secured lenders stressed that $85 million in value was at stake that could either be the secured lenders' collateral or the property of the consignors. The secured lenders stated that they could not consent to pay potentially unsecured creditors with what may be collateral, but that the idea of the debtors' motion was to put this issue off for another day.

After much discussion, the Bankruptcy Court allowed Sports Authority to sell the consigned goods on an interim basis while placing the proceeds of such sales in escrow. Subsequently, on March 10, certain of the consignment vendors and the debtors submitted competing forms of proposed interim orders. On March 11, in what proved to be a turning point in the dispute, the court entered the consignment vendors' form of order. Significantly, this form allowed the vendors to prohibit the sale of the consigned goods and required that Sports Authority segregate the goods and provide an accounting of the goods to the applicable vendors.

Segregation of the goods was not a practical possibility for the debtors. The debtors immediately made an oral motion for reconsideration, and the court conducted an emergency telephonic hearing. After that hearing, the court issued a revised order striking the vendors' right to prohibit the sale of the consigned goods from the order and scheduled another hearing for March 16, at which the court would consider what procedure would be followed if a consignor provided notice to Sports Authority to cease selling the consigned goods.

On March 15, Sports Authority filed approximately 160 adversary proceedings that generally alleged that the consignment vendors did not observe the UCC perfection protocol with respect to the consigned goods, by either failing to properly record their consignment interests and/or to notify the secured lenders of their interests. Based on these facts, Sports Authority sought orders declaring that the vendors held no more than general unsecured claims against the debtors.

Despite the existence of the adversary proceedings and the arguments advanced by Sports Authority and the secured lenders, at the March 16 hearing, the court ruled that Sports Authority was required to choose one of three options with respect to treatment of the consignment vendors. They had to (i) settle with the consignors, (ii) return their goods, or (iii) continue to sell the goods in accordance with the prepetition consignment agreements. Presented with that choice, Sports Authority chose to continue to sell the goods in the ordinary course of business and to pay the vendors as provided in their contracts (with those payments subject to claw-back) pending a final hearing. This ruling would remain the same through several different orders entered by the court through May 3, 2016.

The court also stated at the March 16 hearing that it would not expedite the

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adversary proceedings filed against the vendors. Both the entry of the vendors' proposed order on March 11 and the March 16 ruling were important and provided the consignment vendors with some leverage in the bankruptcy cases.

Legal maneuvering and argument continued through April, May, and June. First, on April 1, 2016, Sports Authority changed tack. The debtors filed a Bankruptcy Rule 9019 motion seeking approval of a settlement with certain vendors, under which the debtors would pay those vendors 60 percent of the invoice price upon the sale of the consigned goods, irrespective of their priority as to such goods. The debtors also sought to immunize these payments from claw-back. This was a substantial turn of events.

The secured lenders vehemently objected to this settlement, arguing that it effectively invalidated the secured lenders' liens and allowed the debtors to distribute the lenders' collateral without adequate protection. The proposal was ultimately withdrawn. The secured lenders also filed an independent motion seeking adequate protection, which was denied, as well as several appeals of the court's interim and final orders with respect to the consignment motion (all of which permitted the debtors to continue to sell the consigned goods and to remit the invoice price to the applicable vendor, while preserving the secured lenders' rights to seek claw-back of those funds at a later date). The secured lenders were also permitted to intervene in the debtors' adversary proceedings, which continued through June.

In late June, the vendors and the secured lenders struck a deal. On July 7, 2016, Bankruptcy Judge Mary F. Walrath approved a settlement agreement among Sports Authority, a substantial number of consignment vendors, and the secured lenders. The settlement, among other things, provided for a certain percentage of the sale proceeds of the consigned goods to be allocated to settling vendors under their respective consignment agreements. The particular percentage of the proceeds allocated to each settling vendor was set forth on a schedule to the settlement agreement, but generally resulted in between 25 and 49 percent of the proceeds being paid to the vendors, with the balance being retained by the secured lenders. According to Sports Authority, the percentage split of the proceeds between the settling vendors and the secured lenders generally recognized the strength of a specific vendor's arguments with respect to priority or the unique elements of the applicable consignment agreement.

Lessons for Consignors, Secured Creditors

The *Sports Authority* case holds lessons for consignment vendors and secured creditors alike. The case clearly illustrates the importance to consignment vendors of closely following the UCC's purchase-money security interest perfection requirements. If a consignment vendor complies with these requirements, it can sleep easy knowing that its interests will be protected in a bankruptcy, even against a secured lender with a lien on inventory. However, another, more subtle lesson for consignment vendors is that even if a vendor has not complied with the UCC, it still may be worthwhile to contest the matter to the bitter end. Even without an airtight legal right to the sale proceeds, the consignment

vendors in *Sports Authority* were able to extract value by putting up a significant fight. This will vary based on the facts, but it is a significant precedent to note.

Secured lenders dealing with retailers must fully understand a retailer's relationships with its vendors, as this may have a material impact on its credit/risk analysis. If a prospective borrower sells a significant portion of its goods on consignment, the lender must carefully investigate UCC filings and documentation to fully understand the value of the collateral it may be lending against. Moreover, the lender must consider the potential leverage that consignment vendors may wield in a bankruptcy, even if their interests are legally unprotected.

Sports Authority, a case in which the lenders asserted that only two of the debtors' 170 consignment vendors were properly perfected, demonstrates that secured lenders may be forced to undertake significant litigation to enforce their rights, despite strong legal support for their claims. This will be a significant consideration in evaluating a potential loan or a litigation strategy in defending a secured position.

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