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The Benefits of Properly Documenting a Consignment Transaction and the Potential For Recovery By Creditors that Don't!

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Vendors sometimes enter into consignment arrangements with their financially distressed customers as an alternative means of selling their goods. In a consignment, the seller, known as a consignor, delivers goods to its customer, known as the consignee. The consignor retains title to the goods and agrees to defer payment by the consignee until the consignee sells or otherwise uses the goods. The consignee also usually has the right to return the consigned goods to the consignor in the event the consignee is unable to sell or use the goods.

A consignor can obtain enhanced rights in the consigned goods by satisfying all of the requirements governing consignment transactions contained in Article 9 of the Uniform Commercial Code (UCC). Consignors that fail to satisfy all of these requirements risk losing their rights in the consigned goods and being treated as general unsecured creditors when a financially distressed consignee files bankruptcy.

However, the plight of consignors that fail to dot their i's and cross their t's according to UCC Article 9's consignment requirements is not hopeless. Several court rulings have conferred leverage on consignment creditors that did not satisfy UCC Article 9's requirements, enabling them to obtain more favorable treatment of their claims than they would have otherwise enjoyed as unsecured creditors.

Most recently in the Sports Authority Chapter 11 case, the United States Bankruptcy Court in Delaware refused to approve Sports Authority's sale of consigned goods free and clear of the consignors' interests where there was no prior court determination that the consigned goods were property of Sports Authority's bankruptcy estate. The court ordered Sports Authority to pay the consignors in accordance with their consignment agreements, including those consignors that did not satisfy UCC Article 9's consignment requirements, for consigned goods that Sports Authority sold after the bankruptcy filing. Sports Authority commenced separate lawsuits against each consignor, which are currently pending, seeking the bankruptcy court's determination of the rights of Sports Authority, its consignors and its secured lenders (that claim a security interest in all of Sports Authority's inventory, including the consigned goods).

Does this suggest a shift in the balance of power in favor of consignment creditors that do not dot their i's or cross their t's? Well folks, there is more to this story and it is still unfolding.

Bottom line, whether or not a Chapter 11 debtor can sell consigned goods without the consignment vendor's consent, and whether the debtor's secured lender with a blanket security interest in the debtor's inventory has a superior right to the consigned goods, are hotly contested issues. Best practices dictate that a consignment creditor take all the necessary steps under UCC Article

9 to protect its interest in the consigned goods delivered to the consignee. However, consignors that fail to follow UCC Article 9's consignment requirements still have cards to play to obtain at least some recovery on their consignment claims.

Obtaining Rights in Consigned Goods

In certain industries, it is common practice for vendors to enter into consignment arrangements to facilitate their sale of goods, and improve the likelihood of their customer's payment for the goods sold or used, or the customer's return of unsold or unused goods. In a typical consignment arrangement, a consignor delivers goods to the consignee but retains title to the goods until the consignee sells or uses them. The consignor issues an invoice after the consignee reports its sale or use of the goods, and the consignee can return unsold or unused goods to the consignor.

UCC Article 9 governs most consignment transactions. UCC Section 9-102(a)(20) defines a consignment as a transaction in which a person delivers goods to a merchant for purposes 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) the goods must have a total value of at least \$1,000.00 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.

Consignment terms are frequently governed by a written agreement between the consignor and consignee. A consignor has enhanced rights to the goods delivered to the consignee if the consignor satisfies UCC Article 9's requirements for a perfected priority consignment interest. The consignor must file a UCC financing statement describing the goods in the correct jurisdiction in order to maintain a protected interest in the goods. Otherwise, the consignee's creditors can obtain judicial liens and security interests in the goods with priority over the consignor's unperfected consignment interest. According to UCC Section 9-317(a), a judicial lien creditor, including a bankruptcy trustee or debtor-in-possession, has priority over an unperfected consignor. UCC Article 9 also allows a consignor to file a UCC financing statement on its own, without the consignee's signature, as long as there is a consignment agreement executed or otherwise authenticated by the consignee that describes the consigned goods. The consignor uses the same UCC form that a secured creditor uses in perfecting a security interest in personal property collateral.

In addition to perfecting its consignment interest, a consignor must take additional steps to obtain priority over the rights of the consignee's secured lender, or other creditor, with a prior blanket security interest in the consignee's inventory. UCC Section 9-103(d) states that a consignor has a purchase money security interest in its consigned goods. As such, a consignor would have priority over creditors holding prior floating liens in the consignee's inventory, including the consigned goods, if the consignor satisfies all of the requirements for a purchase money security interest in the debtor's inventory contained in UCC Section 9-324. These

requirements include (a) filing a UCC financing statement describing the goods prior to the consignee's receipt of the goods; (b) sending an authenticated notification to the holders of conflicting prior perfected security interests in the consignee's inventory that states that the consignor has acquired, or expects to acquire, a consignment interest in the goods and describes the goods; and (c) receipt of such notice by the holders of conflicting inventory security interests within five years before the consignee's receipt of the goods.

Some consignment transactions are excepted from the requirement that a consignor file a UCC-1 financing statement and provide notice of its consignment interest to secured lenders with prior perfected security interests in the debtor's inventory. These consignments are considered "true consignments" where a consignor delivers goods to a merchant that is generally known by its creditors to engage in the sale of consigned goods. However, this exception is difficult to prove and is rarely successfully invoked. Accordingly, even if a consignor does not recognize the necessity of filing a UCC financing statement and following all of the other UCC Article 9 requirements for obtaining a priority consignment interest, it should do so anyway to protect against any challenge of its consignment rights.

A consignor frequently runs into trouble recovering its consigned goods when it fails to dot its "i's" and cross its "t's" in the documentation that creates and secures payment of its consignment claim. This occurred in the Whitehall Jewelers, Family Christian Stores and, most recently, Sports Authority Chapter 11 cases.

The Whitehall Jewelers Case

Whitehall Jewelers was a nationwide specialty retailer of fine jewelry, operating 373 retail stores in 39 states. Whitehall acquired most of its inventory pursuant to consignment arrangements (usually confirmed in written consignment agreements) with its vendors. The consignment agreements were governed by the UCC and provided that each consignor owned and had full title to the consigned goods and Whitehall had no right, title or interest in the goods until their resale.

On June 23, 2008, Whitehall filed its Chapter 11 petition in the United States Bankruptcy Court in Delaware. At the time of its bankruptcy filing, Whitehall was in possession of approximately \$63 million of consigned goods received from approximately 124 consignors. The same day as its Chapter 11 filing, Whitehall filed a motion seeking court approval of the sale of substantially all of its assets, including consigned goods, free and clear of all liens and interests. The proposed purchasers were a group of liquidators that intended to conduct going-out-of-business sales at Whitehall's stores. The proposed purchase price was approximately 50% of the cost value of the consigned goods.

Whitehall argued that the bankruptcy court had the power to approve the sale of the consigned goods free and clear of all consignment interests because Whitehall had challenged the consignment interests of all consignors. Whitehall

disputed the consignors' interests in the consigned goods and claimed they were unsecured creditors on several alternative grounds. Certain consignors had failed to file UCC financing statements or had filed UCC financing statements that were defective, thereby rendering their consignment interests unperfected.

Certain consignors objected to the sale of the consigned goods free and clear of their consignment interests on the ground that they, not Whitehall, owned the goods. As a result of this dispute, the bankruptcy court refused to authorize the sale of any consigned goods until it determined the ownership of the consigned goods. The court reasoned that Section 363(b) of the Bankruptcy Code allows a debtor to sell only property of the debtor's bankruptcy estate (and not the consignment vendors' property).

The bankruptcy court also ruled that it could not determine whether the consigned goods were property of Whitehall's bankruptcy estate in the context of Whitehall's Section 363 sale motion. The court could only invalidate a lien or other interest, such as a consignment interest, as part of the relief requested in a lawsuit. The court, therefore, required Whitehall to first commence lawsuits against each of its 124 consignment vendors prior to any determination of Whitehall's and its consignors' interests in the consigned goods. The court also directed Whitehall to segregate in an escrow account proceeds from the sale to the liquidators in an amount equal to the cost of the consigned goods sold after the bankruptcy filing and prohibited any sale of consigned goods at prices below cost.

Due to the bankruptcy court's ruling, Whitehall faced the prospect of a substantial delay of the sale process and limitations on the sale and disposition of the proceeds of its consigned goods while it litigated 124 separate lawsuits over whether the consigned goods were property of its bankruptcy estate. That shifted the balance of power in the case in favor of the consignors, including the unperfected consignors, which they successfully used to negotiate a favorable global settlement of their claims. As part of the settlement, Whitehall agreed to return the consigned goods to those consignors participating in the settlement and pay them from the escrow account for the consigned goods Whitehall had sold after its bankruptcy filing.

The Family Christian Case

The issue of consignment rights arose again in the Family Christian Stores Chapter 11 case. Family Christian operated a national chain of more than 250 retail stores that sold Christian religious merchandise such as books, music and movies. Family Christian had filed for Chapter 11 on February 11, 2015 in the United States Bankruptcy Court for the Western District of Michigan. Family Christian sought approval of a sale of substantially all of its assets, including goods it had acquired under various consignment arrangements, free and clear of all liens and interests in the assets. At the time of the bankruptcy filing, Family Christian held more than \$20 million of book value of inventory under consignment arrangements with 150 to 200 consignment vendors.

A group of 27 publishers and other vendors that delivered a majority of the consigned goods commenced a lawsuit against Family Christian, requesting a judgment prohibiting Family Christian from selling their consigned goods and determining that these goods were not property of Family Christian's bankruptcy estate. The consignors argued that Family Christian must either pay for the consigned goods once they were sold or return the goods to the consignors. The consignors asserted that although most of them had failed to file UCC financing statements, the consignment transactions were "true consignments" not governed by the UCC. As a result, the consignors did not have to comply with the consignment requirements of UCC Article 9 because Family Christian was generally known by its creditors to be engaged in selling the goods of others, and according to the consignment agreements, the consignors retained ownership of the consigned goods after delivering them to Family Christian.

Family Christian disputed the consignors' allegations that the consignment transactions were true consignments outside the scope of UCC Article 9. Instead, Family Christian asserted that all the consignment transactions fell squarely within the UCC's definition of consignment and, therefore, the consignors were required to file UCC financing statements and follow all of the other UCC Article 9 requirements for obtaining priority status in their consigned goods. However, most of the consignors had failed to do so. Family Christian, therefore, requested that the bankruptcy court determine that the consignors did not have any interests in the consigned goods and that Family Christian was authorized to sell the goods free and clear of their consignment interests.

These consignors reached a settlement with Family Christian. The settling consignors agreed to Family Christian's sale of their consigned goods in exchange for sharing in a cash payment of \$500,000, plus one of two payment options: (1) payment of each consignor's Bankruptcy Code Section 503(b)(9) claim for the value of goods sold and delivered to a debtor within 20 days prior to the bankruptcy filing, which is entitled to administrative priority status—plus 10% of the book value of the consignor's goods sold after June 15, 2015, or (2) payment of 35% of the book value of the consignor's goods sold after June 15, 2015. Either way, the settling consignors received far more favorable treatment than general unsecured creditors who were expected to receive a de minimis recovery on their claims.

Other consignors who were not part of the group of settling consignors were offered the same two payment options if they accepted Family Christian's Chapter 11 Plan, which Family Christian had filed as the vehicle for selling its business. Those consignors opting to reject the Chapter 11 Plan retained their claims, and Family Christian was required to either return the consigned goods or continue to litigate over the consignors' rights in their consigned goods. These consignors risked being relegated to the status of general unsecured creditors if they did not prevail in their litigations with Family Christian.

The Sports Authority Case

Sports Authority Holding, Inc. and its affiliated entities, are one of the nation's largest sporting goods retailers. Prior to their Chapter 11 filing, Sports Authority operated 464 stores and 5 distribution centers throughout the United States. On March 2, 2016, Sports Authority filed Chapter 11 in the United States Bankruptcy Court in Delaware.

At the time of its bankruptcy filing, Sports Authority reported that it was in possession of 8.5 million units of consigned goods, at a cost of \$84.8 million, from 170 consignors. Sports Authority typically entered into its standard form of consignment agreement with each of its consignors. The agreement contemplated a consignment with the consignor retaining title to the consigned goods until the goods were sold, at which time title passed to the purchaser of the goods. Under the agreements, Sports Authority was required to remit the agreed-upon invoice price to the consignor within a specified timeframe following the sale of the consigned goods.

On the first day of its Chapter 11 case, Sports Authority filed a motion requesting authority to continue selling consigned goods it had received prior to the bankruptcy filing free and clear of all liens and interests (including the consignors' interests), and to grant the consignors that satisfied all of the UCC Article 9 consignment requirements prior to the bankruptcy filing a "replacement lien" in the sales proceeds of the consigned goods. Soon thereafter, in response to a flood of objections to the sale by multiple consignment vendors, including consignors that had failed to satisfy UCC Article 9's consignment requirements, Sports Authority filed approximately 160 lawsuits against nearly every consignor, seeking a determination that the consignors did not have valid interests in the consigned goods.

The consignors objected to Sports Authority's motion, arguing that Sports Authority could not sell the consigned goods because they were not property of Sports Authority's bankruptcy estate. The consignors asserted that they had retained title to the goods following their delivery to Sports Authority under the consignment agreements, and could demand the return of the goods. They also asserted that Sports Authority could not sell their consigned goods until the bankruptcy court had determined that the consignors did not have valid consignment interests in the goods, which the court could only do through the lawsuits against the consignors (not merely based upon a motion like the one Sports Authority filed).

Sports Authority responded that the consignors did not retain title to their consigned goods in Sports Authority's possession, and at best, the consignors had security interests in the goods under the UCC. Nearly all of the consignors had failed to file UCC financing statements that were necessary to perfect their security interests in the consigned goods. As a result, Sports Authority's secured term lenders, with blanket security interests in Sports Authority's inventory, had superior rights to the consigned goods and the proceeds of their sale.

Sports Authority further argued that it could continue selling the consigned goods in the ordinary course of business,

without the consignors' consent, because UCC Section 9-319 states that while goods are in the possession of the consignee, the consignee is deemed to have rights and title to the goods identical to those of the consignor. Sports Authority then relied on Section 365(d)(4) of the Bankruptcy Code, which permits a debtor to sell assets subject to *bona fide* dispute, free and clear of liens and interests, to continue to sell the consigned goods because the consignors' interests in the goods were subject to *bona fide* dispute due to the pending lawsuits against the consignors.

Certain of Sports Authority's secured term lenders, allegedly owed \$276 million, put significant pressure on the Debtors to take a hard line against and not settle with the consignment vendors. The term lenders supported Sports Authority's motion and the 160 lawsuits, reiterating many of Sports Authority's same arguments. The term lenders also argued that they had a superior interest in the consigned goods because they had a senior security interest in all of Sports Authority's inventory, including all consigned goods, and the consignors did not have valid perfected and prior interests in their goods. The term lenders then requested that all proceeds from the sale of consigned goods be held in escrow, pending the bankruptcy court's determination in each of the lawsuits of whether the consignors or the term lenders had a valid prior interest in the consigned goods.

Following numerous motions, objections, and hearings, the bankruptcy court ultimately ruled that, pending adjudication of the lawsuits, Sports Authority had three options regarding the consigned goods: it could stop selling the goods, settle with the consignors, or continue to sell the goods in accordance with the terms of the consignment agreements, which included paying the agreed-upon invoice price to the consignors upon the sale of any consigned goods. Sports Authority chose the third option, continuing to sell the consigned goods and remitting the invoice price of the goods to the consignors in accordance with the terms of the consignment agreements.

The bankruptcy court also denied the term lenders' request for the escrowing of the proceeds from the sale of consigned goods pending the adjudication of the pending lawsuits. The court instead ruled that the term lenders could seek recovery of the sale proceeds from the consignors if the court ultimately decides that the lenders had prior rights to the consigned goods.

The bankruptcy court's ruling undoubtedly favored the consignors. The term lenders warned that they would have difficulty collecting sale proceeds from consignors in the event the court ultimately determines that the lenders had a superior interest in the goods.

The term lenders appealed from the bankruptcy court's ruling, which appeal is currently pending. The lenders also joined in the pending lawsuits against each of the consignors, requesting that the bankruptcy court determine that the lenders have a superior interest in the consigned goods (and all sale proceeds) and requiring the consignors to pay all proceeds they received to the term lenders in the event the court rules in the lenders' favor. The term lenders and many of the

consignors are currently negotiating the terms of a potential settlement regarding the treatment of their respective interests in the consigned goods. So this story is far from over!

Conclusion

A consignor's rights in consigned goods after its customer files bankruptcy will likely continue to raise hotly contested issues in bankruptcy cases. Indeed, in the Sports Authority case, the helplessly underwater secured term lenders have an \$85 million reason to fight. The lesson learned from the Sports Authority, Whitehall Jewelers and Family Christian Stores bankruptcy cases is that a consignor should take all necessary steps to comply with all of UCC Article 9's requirements for a valid, perfected and superior interest in its consigned goods. However, a consignor that messes up and fails to dot its i's and cross its t's can take solace from the courts' holdings in these cases that encourage them to invoke their consignment rights to throw a monkey wrench into a debtor's efforts to sell their consigned goods. Consignors that mess up now can use their leverage to obtain at least some recovery on their consignment claims. Not a bad outcome!

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