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When Vendors Are Consigned to a Lower Authority

*By Michael G. Parisi, C. Jordan Myers, and David A. Wender**

The Sports Authority bankruptcy highlights one of the key aspects of its business—its use of consignment arrangements with various vendors. In this article, the authors explain the issue presented in the case and delve the consignment dispute, the outcome of which will serve as precedent for future retail bankruptcy cases and will impact relations among vendors, retailers, and secured lenders.

The latest in a long line of troubled retailers, Sports Authority Holdings, Inc., and certain affiliated entities, filed for bankruptcy protection on March 2, 2016. The bankruptcy case highlights one of the key aspects of Sports Authority's business—its use of consignment arrangements with various vendors. Unlike other recent retailer bankruptcies, Sports Authority, its secured lenders, and its consignment vendors have clashed over Sports Authority's ability to sell consigned goods and its ability to use and/or grant a lien in the proceeds from the sale of consigned goods. The dispute has affected the course of the bankruptcy case, and the outcome may serve as precedent for future retail bankruptcy cases and impact retailer/vendor relationships and transactions involving secured loans to retailers.

THE ISSUE

The issue presented in *Sports Authority* is the priority between the existing senior lenders and the consignment vendors. The Uniform Commercial Code ("UCC") provides that any retention or reservation of title by the seller of property (such as a reservation contained in a consignment agreement) in goods delivered to the buyer is limited in effect to a reservation of a security interest. Thus, at a minimum, a consignor must file a UCC financing statement to protect its security interest. This action will safeguard the consignor against subsequent lienholders and the claims of a bankruptcy trustee or debtor-in-

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possession. However, in order to obtain priority over a consignee's existing secured lender, the vendor must satisfy the UCC's purchase money security interest requirements, which include perfection of the security interest by filing a UCC financing statement prior to the consignee receiving possession of the inventory and sending a notification to the consignee's secured lender identifying the consignor's anticipated purchase money security interest in specified inventory. A consignor's failure to satisfy the UCC purchase money security interest requirements will leave the vendor vulnerable to competing claims from a consignee's secured lender to the proceeds following sale of the consigned goods.

SPORTS AUTHORITY CONSIGNMENT DISPUTE

On the petition date, Sports Authority filed a motion seeking authority to continue selling consigned goods in the ordinary course of business free and clear of liens, claims and encumbrances. Sports Authority proposed to grant the applicable consignment vendor a replacement lien on the proceeds of its consigned goods in the amount of the agreed-upon consignment sale price, which would be subject to any other liens (e.g., secured lender liens) that may exist on such proceeds. Such proceeds would then be deposited in a segregated account and remitted to the consignment vendor upon consent from Sports Authority's secured lenders, provided that Sports Authority could later seek to claw back such proceeds from the consignment vendor if it was determined that the consignment vendor did not have a valid, enforceable, unavoidable and perfected lien on the consigned goods (i.e., the consignment vendor did not satisfy the applicable purchase money security interest requirements under the UCC).

Following objections by various consignment vendors, the bankruptcy court entered an interim order providing that, subject to entry of a final order and the applicable consignment agreement as modified by the interim order, (1) Sports Authority may continue to sell consigned goods received prior to the petition date with the applicable consignment vendor's lien attaching to the proceeds in the same validity and priority existing as of the petition date; (2) Sports Authority shall deposit the sale proceeds in an escrow account; and (3) Sports Authority may file adversary proceedings against any consignment vendors it believes, based on reasonable due diligence, do not have a valid, perfected, unavoidable and senior lien or ownership right in the prepetition consigned goods held by Sports Authority.

The amounts involved are significant. As of the petition date, Sports Authority was selling consigned goods from approximately 170 consignment vendors in its stores and online, possessing approximately 8.5 million units of

consigned goods with an aggregate invoice cost of approximately \$85 million. The contribution margin or gross margin represented by the amount that retail sale proceeds exceed the consignment sale price for the most recent fiscal year was \$128 million.

Following the entry of the interim order, Sports Authority filed more than 160 adversary proceedings against its consignment vendors, seeking orders declaring that (1) the consignment vendors' reservation of title in the consigned goods was ineffective;¹ (2) the consignment vendors do not have perfected and senior security interests in the consigned goods; and (3) the consignment vendors do not have a right to the consignment sale proceeds except as general unsecured creditors. Depending upon the specific facts applicable to the consignment arrangement, Sports Authority asserted a variety of arguments, including that the applicable consignment vendor failed to file a UCC financing statement as required by UCC Section 9-310(a); filed a financing statement during the 90-day preference period prior to the petition date, thereby rendering such filing avoidable pursuant to Section 547(b) of the Bankruptcy Code; or failed to provide the requisite notice to Sports Authority's secured lenders as required by UCC Section 9-324(b) to obtain a first priority purchase money security interest superior to the rights of Sports Authority's secured lenders.

While it appeared that a resolution was imminent following Sports Authority's filing of a motion to approve a settlement with the consignment vendors, the secured lenders objected to the settlement and the motion was subsequently abandoned on April 20, 2016. The dispute remains open.

CONCLUSION

The *Sports Authority* bankruptcy case has put a spotlight on consignment arrangements and the competing claims that can result from a vendor's failure to comply with the UCC's purchase money security interest requirements. When a vendor enters into a consignment arrangement, it has an expectation that it owns the consigned goods and has a priority right to receive the proceeds of the consigned goods. However, this foundational premise of consignment arrangements is tenuous. If Sports Authority and its secured lenders prevail in the adversary proceedings, the consignment vendors will fall behind the secured

¹ In seeking a determination that the consignment vendor's reservation of title was ineffective, Sports Authority is seeking to establish that (1) it owns the consigned goods and, thus, can offer those goods for sale and (2) the consignment vendor's interest (if any) must be analyzed under Article 9 of the UCC.

lenders in the bankruptcy priority scheme and will be reduced to general unsecured creditors.

More broadly, vendors may be hesitant to continue consignment arrangements with troubled retailers out of fear that they may not be first in line for consignment sale proceeds and may seek to repossess the consigned inventory. This may exacerbate the struggles for many retailers that are already sinking in a challenging retail market, and if an insolvency proceeding is filed, will potentially raise its own set of bankruptcy avoidance issues for the reclaiming consignment vendor. The failure to quickly resolve the dispute with the consignment vendors has adversely impacted Sports Authority's reorganization or sale efforts, and the recovery by its secured lenders will be significantly reduced if the consignment vendors prevail in the adversary proceedings. Further, secured lenders may think twice before financing a retailer if the anticipated inventory collateral pool available for a first priority lien in favor of the lender is much smaller than the lender may have otherwise anticipated. Regardless of the outcome, the *Sports Authority* case and any decision by the court will serve as precedent in future bankruptcy cases and will impact relations among vendors, retailers, and secured lenders.