NACM'S 129TH CREDIT CONGRESS & EXPO Cleveland MAY 18-21, 2025

Recent Decisions and Trends in Bankruptcy Cases and Lessons for Trade Creditors

Presented by: Jason M. Torf, Thomas R. Fawkes & Brian J. Jackiw

Date: May 20, 2025

Session: #37044

NACM NATIONAL ASSOCIATION OF CREDIT MANAGEMENT Driving results

Tucker Ellis LLP

RECENT DECISIONS AND TRENDS IN BANKRUPTCY CASES AND LESSONS FOR TRADE CREDITORS

Presented to:

NACM CREDIT CONGRESS 2025

Presented by:
Jason M. Torf, Partner
Thomas R. Fawkes, Partner
Brian J. Jackiw, Partner
TUCKER ELLIS LLP

Cleveland, OH
May 20, 2025

THIRD-PARTY RELEASES: RECENT MAJOR CASES

Jason M. Torf
Thomas R. Fawkes
Brian J. Jackiw
Tucker Ellis LLP

THIRD-PARTY RELEASES
WHAT ARE THEY

- Power of bankruptcy lies in its ability to discharge a debtor's pre-bankruptcy debts and thereby provide the debtor with a fresh start
- However, bankruptcy has also been used to resolve the liabilities of third parties who share an interest with the debtor (*e.g.*, officers, directors and equity holders)
- This quasi-discharge is effectuated by including provisions in a chapter 11 plan that bar creditors and other interested parties from asserting their direct claims against specified third parties once the plan is confirmed

THIRD-PARTY RELEASES
WHAT ARE THEY

- In most cases, third-party releases are consensual (*e.g.*, where parties must affirmatively opt into the release) or at least deemed consensual (*e.g.*, where parties receive the option to opt out)
- Controversy arises when a plan imposes third-party releases with no ability to opt out
  - In such a case, a party would be precluded from asserting its own claims against the third parties following plan confirmation

THIRD-PARTY RELEASES
WHAT ARE THEY

- Non-consensual third-party releases conflict with the notion that the benefits of bankruptcy are reserved for parties who file bankruptcy and, in doing so, subject themselves to the bankruptcy process and everything it entails
- Accordingly, in some jurisdictions, non-consensual third-party releases are strictly forbidden
- Other jurisdictions permit such releases, but even those courts acknowledge that they represent the exception, not the rule, and are only appropriate in limited circumstances

THIRD-PARTY RELEASES
RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (Second Circuit)
  - OxyContin epidemic resulted in huge liabilities against both Purdue Pharma and its owners, the Sackler family
  - In Purdue bankruptcy, Sackler family agreed to contribute $4 billion toward Purdue's bankruptcy estate to help satisfy OxyContin tort claims in exchange for a full release of all claims against them personally
    - Bankruptcy court approved
    - On appeal, District Court reversed, holding that Bankruptcy Code does not permit bankruptcy courts broad authority to impose non-consensual third-party releases in reorganization plans
      - District Court also disagreed with bankruptcy court that Second Circuit precedent permits non-consensual third-party releases

THIRD-PARTY RELEASES
RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (cont'd.)
    - Sackler family agreed to increase their bankruptcy contribution to $5.5 billion in a revised settlement agreement
    - Second Circuit reversed, approving the third-party release and holding that bankruptcy courts have the authority to impose non-consensual releases of third-party claims in limited circumstances

THIRD-PARTY RELEASES
RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (cont'd.)
  - Seven factors articulated by Second Circuit for approval of a non-consensual third-party release
    - (1) whether there is an identity of interests between the debtors and related third parties;
    - (2) whether claims against the debtor and third party are intertwined;
    - (3) the scope of the releases;
    - (4) whether the releases are essential to the reorganization's success;
    - (5) the third party's contribution of "substantial assets" to the reorganization;
    - (6) whether the impacted claimholder class(es) "overwhelmingly" support the releases; and
    - (7) whether the plan provides fair payment of the enjoined claims.

THIRD-PARTY RELEASES
RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (cont'd.)
  - The Second Circuit's application of the factors to the Sackler family:
    - (1) because the Sacklers were directors and officers of Purdue, a closely held corporation, there was a sufficient identity of interests between the two parties
    - (2) because the bankruptcy court narrowed the release to only direct claims against the Sacklers, the claims between the parties were "sufficiently intertwined"
    - (3) & (4) Considering the third and fourth factors jointly, the court found that the releases were necessary to the reorganization and proper in scope, because they were essential to ensure that the *res* of the estate was settled and not entirely depleted
      - But the court clarified that if the only reason for including a release is the third party's contribution to the bankruptcy, then the release is not essential to the plan
    - (5) Focusing on the impact of the Sacklers' financial contribution, the Second Circuit concluded that the $5.5 billion pledged by the Sacklers - potentially the largest sum ever contributed to a bankruptcy - was a substantial contribution
    - (6) The personal injury classes "overwhelmingly" approved the plan by over ninety-five percent
    - (7) Although the estimated value of potential claims against the Sacklers surpassed their net worth, the plan provided fair payment of claims—which far exceeded the total funds available, as well as the Sackler's personal wealth

THIRD-PARTY RELEASES
RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (cont'd.)
  - Bankruptcy Code does not expressly permit third-party releases
  - However, the Second Circuit derived statutory authority to impose such releases from §§ 105(a) and 1123(b)(6) of the Bankruptcy Code
    - Those sections jointly grant bankruptcy courts "residual authority" to modify creditor-debtor relationships by including other provisions in a plan not inconsistent with the Bankruptcy Code
  - The Court further reasoned that because the Bankruptcy Code does not explicitly forbid third-party releases, such releases are not inconsistent with the Bankruptcy Code
    - Therefore, bankruptcy courts have implied equitable authority to impose such releases in chapter 11 plans

THIRD-PARTY RELEASES
RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (cont'd.)
  - Ultimately, the United States Supreme Court reversed the Second Circuit, holding that the Sackler releases could not be approved because the Bankruptcy Code does not authorize releases and injunctions benefiting third parties without the consent of affected claimants
  - Discharge – which is essentially what Purdue Pharma sought for the Sacklers – is only available for "a debtor who places substantially all of their assets on the table." Since the Sacklers did not themselves file for bankruptcy, the discharge they were being provided under the plan was improper.

THIRD-PARTY RELEASES

RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (cont'd.)
  - The Supreme Court was careful to state, however, that a plan containing *consensual* third-party releases is proper, without going into detail as to what "consensual" means
  - This decision effectively provides the death blow for non-consensual plan releases in favor of third parties

THIRD-PARTY RELEASES

POST-PURDUE PHARMA LANDSCAPE

Jurisdiction	Case	Decision
Bankr. S.D.N.Y.	In re: Spirit Airlines	Court upheld use of opt-out mechanisms for consensual third-party releases, provided creditors receive clear notice and opportunity to opt out, reflecting a more reserved view *post-Purdue*
	In re: Hal Luftig Co.	The Supreme Court's *Purdue* decision did not affect the permissibility of temporary non-debtor stay extensions under §§ 105 and 362(a), allowing such extensions if necessary for successful reorganization
	In re: Rockville	Court ruled that *Purdue* does not impact the "free and clear" aspect of section 363 sales, as long as the debtor satisfies sections 363(f)(1) and (f)(2) of the Bankruptcy Code
	In re: Genger	Court extended *Purdue's* ruling to U.S. Trustee's settlement agreements, affecting claims against non-settling parties, and denied approval of a settlement agreement that relied on non-debtor injunctions
Bankr. D. Del.	In re: Smallhold	Court allowed opt-outs with affirmative expression of consent but questioned whether unimpaired classes, typically deemed to consent, can be subject to opt-out mechanisms
	In re: Parlement Techs	Court concluded that *Purdue* affects the "likelihood of success on the merits" test for preliminary injunctions but does not prohibit non-debtor injunctions
Bankr. S.D. Tex.	In re: Robertshaw	Court confirmed that opt-out procedures are permissible for consensual third-party releases, noting that *Purdue* did not change the law in this Circuit
	In re: Pipeline Health Systems	Court upheld the opt-out procedure as a valid means to obtain consent for third-party releases in the chapter 11 plan

THIRD-PARTY RELEASES
RECENT DECISIONS

- *Ascena Retail Group* (E.D. Va.)
  - Retailer of apparel for women and girls with brands such as Ann Taylor, LOFT, Lane Bryant and Lou & Grey
  - Ascena bankruptcy Plan included broad third-party releases covering any type of claim that existed or could have been brought against any person or entity associated with the debtors as of the effective date of the Ascena Plan, including a securities fraud class action lawsuit then pending against certain prepetition executives of Ascena
  - The releases bound anyone that did not affirmatively "opt out" of such releases in a plan ballot
    - Because creditors had the ability to opt out of the third-party releases in connection with their plan ballot, the Bankruptcy Court treated the releases as "consensual“
    - Following confirmation, the United States Trustee and the securities fraud litigation plaintiffs appealed the bankruptcy court's decision to the District Court

THIRD-PARTY RELEASES
RECENT DECISIONS

- *Ascena Retail Group* (E.D. Va.) (cont’d.)
  - On appeal, District Court found that:
    - Bankruptcy Court did not have jurisdiction to approve the third-party releases
    - The releases were <u>not</u> consensual, noting that the Bankruptcy Court did not consider the proper threshold question in determining whether the releases were consensual
      - Bankruptcy Court looked only to whether a releasing party had returned the required “Release Opt-Out Form” (if not, the release would automatically be deemed consensual)
        - » District Court rejected that approach, holding that the Bankruptcy Code requires an overt act—such as affirmatively “opting in” to the release—evidencing the party’s consent to resolve the claim
        - » Inaction in the form of failing to opt out of a release was insufficient given the constitutional standard for active, knowing and voluntary consent.
  - Ascena filed and received approval of a revised Plan that did not include the third-party releases

THIRD-PARTY RELEASES
RECENT DECISIONS

- *Mallinckrodt* and *Boy Scouts of America* (Bankr. D. Del.)
  - Third-party releases are expressly permitted in the Third Circuit
  - In two different cases in the Delaware bankruptcy court in 2022, Delaware bankruptcy judges found that
    - Third Circuit precedent expressly allows non-consensual third-party releases
    - Opt-out provisions make a release consensual

THIRD-PARTY RELEASES
RECENT DECISIONS

- In *Mallinckrodt*, the Bankruptcy Court found that
  - Under precedent in the Third Circuit (which covers Delaware), the Bankruptcy Court had the requisite authority to approve the non-consensual opioid releases
  - The Bankruptcy Court possessed constitutional authority because these releases were integral to the success of the debtors' plan
  - Without the releases, settlements that were essential to the plan would not be effectuated and, without the settlements, the plan would fall apart
  - In contrast to *Ascena*, the opt-out provisions of the third-party releases rendered them consensual
    - In making this determination, the Bankruptcy Court examined the extent of the notice given and found ample evidence in the record that the debtors made every effort to ensure that the releasing parties were sent notices in a variety of ways that clearly explained in "no uncertain terms" that action was required to preserve claims

THIRD-PARTY RELEASES
RECENT DECISIONS

- In *Boy Scouts of America*, the Bankruptcy Court
  - Agreed with the *Mallinckrodt* decision that:
    - Opt-out provisions make a non-consensual release consensual
    - Non-consensual releases fall within the Bankruptcy Court's constitutional authority where the release is "integral to the debtor-creditor relationship"

19

NACM NATIONAL ASSOCIATION OF CREDIT MANAGEMENT Driving results

Tucker Ellis LLP

THE "TEXAS TWO-STEP:" RECENT DECISIONS

Jason M. Torf
Thomas R. Fawkes
Brian J. Jackiw
Tucker Ellis LLP

TEXAS TWO-STEP
WHAT IS IT

- Companies facing multidistrict litigation mass tort exposure have been utilizing a new technique to protect themselves and their related entities from mass tort claims
- Known as the Texas Two-Step, this creative use of the Bankruptcy Code gives related entities the benefit of the automatic stay without those companies having to file for Chapter 11 bankruptcy protection themselves

TEXAS TWO-STEP
WHAT IS IT

- In the Texas Two-Step, a defendant corporation will assign its liabilities to a newly-formed subsidiary under Texas law, which allows this type of divisive merger under its business corporations statute
- The subsidiary with the liabilities will then file bankruptcy, which stays the lawsuits, and seek to extend the automatic stay to its affiliated entities with the goal of resolving all MDL through the bankruptcy system
- Doing so allows companies to utilize the bankruptcy system's expedited timeline and avoid defending claims case-by-case

TEXAS TWO-STEP
WHAT IS IT

- Non-debtors seek to obtain the benefit of the automatic stay by entering into funding agreements through a Chapter 11 reorganization plan, which provides funds to be administered by a trust for the benefit of the debtor's tort claimants
- Debtors can then argue they need to protect non-debtors because there will be sufficient assets to pay tort claimants
- Debtors also argue that allowing the litigation to proceed against these non-debtors would distract the debtor from its reorganization efforts
- These creative efforts by debtors to protect their affiliates are controversial since the non-debtor affiliates obtain the automatic stay protections without having to file for Chapter 11
- Thus, nondebtor affiliates avoid the fiduciary responsibilities of Chapter 11 and do not have to disclose their assets and liabilities, permit investigations by creditors, or provide transparency of their business operations as normally required under the Bankruptcy Code

TEXAS TWO-STEP
RECENT DECISIONS

- *LTL Management* (Johnson & Johnson talc liability case) (Bankr. D.N.J.)
  - Some consumers of Johnson & Johnson baby powder alleged that they were diagnosed with cancer caused by talc, one of the powder's ingredients
  - J&J faces over 38,000 lawsuits alleging ovarian cancer and mesothelioma caused by exposure to talc
  - After many years of litigation and mixed verdicts, J&J turned to the New Jersey bankruptcy court for relief — not for itself, but for its affiliated entity, LTL

TEXAS TWO-STEP
RECENT DECISIONS

- *LTL Management* (Johnson & Johnson talc liability case) (cont'd.)
  - In 2021, J&J formed two subsidiaries
    - It moved its assets into one entity and transferred certain assets and its talc liabilities into the other, LTL
  - Shortly thereafter, LTL filed bankruptcy, which stayed the pending talc cases against LTL, but not against J&J and its other non-debtor affiliates
  - J&J and LTL then established a funding agreement for talc claim liabilities as part of the bankruptcy process
  - The Talc Claimants Committee sought dismissal of the bankruptcy petition for bad faith
  - In 2022, the Bankruptcy Court denied the motion to dismiss the LTL bankruptcy case, holding that the proceeding would address the talc claims and that LTL was in financial distress and not seeking to restructure to secure a tactical advantage
    - LTL's request for continued injunctive relief was also granted

TEXAS TWO-STEP
RECENT DECISIONS

- *LTL Management* (Johnson & Johnson talc liability case) (cont'd.)
  - Talc Claimants Committee appealed
    - Third Circuit reversed and found that LTL did not file its bankruptcy petition in good faith as LTL was not in financial distress and had the benefit of the J&J funding agreement
      - This holding would have allowed the talc claimants to continue to pursue their claims through the tort system against LTL, J&J, and their related entities
    - Third Circuit directed Bankruptcy Court to dismiss the bankruptcy case

TEXAS TWO-STEP
RECENT DECISIONS

- *LTL Management* (Johnson & Johnson talc liability case) (cont'd.)
  - Within hours of the bankruptcy court's dismissal order, LTL filed for Chapter 11 protection a second time
    - This time, J&J also agreed to contribute $8.9 billion to establish a funding agreement to resolve all current and future talc claims
  - Second LTL bankruptcy dismissed
    - New Jersey bankruptcy court found that LTL could not show sufficient financial distress to warrant bankruptcy protection, given the hundreds of billions in assets and annual financial revenue of parent company J&J

TEXAS TWO-STEP
RECENT DECISIONS

- *LTL Management* (Johnson & Johnson talc liability case) (cont'd.)
  - LTL filed Chapter 11 a <u>third</u> time
    - This time in Texas, hoping that the courts there would be more hospitable to its third attempt at bankruptcy through the Texas Two-Step
    - With an increased $10 billion settlement fund
    - This time, different from the first two bankruptcies, LTL solicited creditor support <u>before</u> filing its third bankruptcy
  - But LTL's third attempt was not successful
    - Very recently, in late March 2025, the bankruptcy court in Houston dismissed LTL's third bankruptcy case
      - The court said that
        - » the proposed settlement did not have sufficient support from tort claimants
        - » the third-party releases in favor of entities that had not themselves filed for bankruptcy – including retailers that sold J&J products and a consumer health business that J&J spun off in 2023 - were impermissible

TEXAS TWO-STEP
RECENT DECISIONS

- *Aearo Technologies* (3M earplug case) (Bankr. S.D. Ind.)
  - In 2008, 3M Co., a multinational conglomerate that manufactures industrial, safety and consumer products, acquired Aearo Technologies, a designer and manufacturer of personal protection and energy-absorbing products
  - In July 2022, Aearo filed for Chapter 11 protection in the Southern District of Indiana bankruptcy court
    - 3M placed its subsidiary into bankruptcy after it spent over $300 million in legal fees defending personal injury lawsuits involving allegedly faulty earplugs that Aearo sold to the U.S. military

TEXAS TWO-STEP
RECENT DECISIONS

- *Aearo Technologies* (3M earplug case) (cont'd.)
  - Before filing for bankruptcy, 3M earmarked more than $1 billion under a funding agreement to pay for the claims
  - Aearo's bankruptcy filing automatically stayed the personal injury lawsuits filed against Aearo, but not against 3M, and Aearo requested that the bankruptcy court extend the automatic stay to those claims
    - In August 2022, the bankruptcy court denied Aearo's request to extend the automatic stay and grant injunctive relief to 3M, forcing 3M to continue to defend itself in the personal injury litigations
    - Aearo immediately appealed

TEXAS TWO-STEP
RECENT DECISIONS

- *Aearo Technologies* (3M earplug case) (cont'd.)
  - Invoking the Third Circuit's dismissal of the LTL case, the Tort Claimants Committee in the Aearo case and over 200,000 claimants, veterans, active-duty service members, civilian contractors and consumers jointly moved to dismiss the Aearo bankruptcy cases
    - They argued that, like in LTL, the Aearo debtors were not in any financial distress when they sought bankruptcy protection and that Aearo's current and future tort liabilities to claimants were fully backstopped by 3M under a funding agreement, obviating any need for reorganization
    - On June 9, the bankruptcy court dismissed Aearo's bankruptcy filing
      - Citing LTL, the bankruptcy court held that Aearo was financially healthy and possessed a "greater deal of financial security than warrants bankruptcy protection"
      - The bankruptcy court found no evidence that the impending MDL had, or will have, any substantial effect on Aearo financially

TEXAS TWO-STEP
A LEGISLATIVE FIX?

- There are active efforts by Congress to put an end to Texas two-step bankruptcies
- In July 2024, a bipartisan bill was introduced in the U.S. Senate, the "Ending Corporate Bankruptcy Abuse Act of 2024," that would, among other things, preclude bankruptcy courts from entering injunctive relief that would prevent lawsuits from proceeding against non-bankrupt affiliates of a Texas two-step debtor
  - In other words, this bill would put a stop to exactly what the Texas two-step is designed to achieve
- The act has been referred to the Judicial Committee of the Senate for deliberations

NACM NATIONAL ASSOCIATION OF CREDIT MANAGEMENT Driving results
Tucker Ellis LLP

THE TOYS 'R' US DEBACLE: LESSONS LEARNED

Jason M. Torf
Thomas R. Fawkes
Brian J. Jackiw
Tucker Ellis LLP

SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY
CASH IN ADVANCE IS BEST ALTERNATIVE

- Questions often arise regarding the best way to protect post-bankruptcy shipments
- Cash in advance / COD is best
  - Give us the cash, we'll give you the goods
  - No risk
    - ***Proactive Pointer:*** If switching to cash in advance, make sure to get paid by wire, not by check. Payment by check still presents risk due to possibility of dishonored check after goods are shipped.

SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY
WHAT IF CUSTOMER WILL NOT PAY CASH IN ADVANCE?

- In some cases, the customer – rather than the vendor – has the leverage and will refuse to pay cash in advance
  - The conundrum
    - We place a large volume of goods with this customer and do not want to lose the revenue
    - At the same time, we want to maximize the likelihood of collection
- That was exactly the situation in *Toys 'R' Us*
- Toys 'R' Us would only buy on terms that existed pre-bankruptcy
  - For most vendors, that was net 60, or even as high as net 90
    - HUGE RISK FOR VENDORS IF TOYS 'R' US BANKRUPTCY FAILS!
      - Administrative insolvency problem

THE TOYS 'R' US DEBACLE
THE DILEMMA – TO SHIP OR NOT TO SHIP

- For most vendors, Toys 'R' Us represented a huge portion of their annual revenue
  - For many vendors, sales to Toys 'R' Us was 33% or more of their annual revenue
    - The dilemma
      - Stop shipping because Toys 'R' Us insisted on credit terms (lengthy ones) rather than cash in advance
        - » But 33% of your revenue falls off a cliff
      - Ship on terms
        - » But risk non-collection if Toys 'R' Us reorganization fails

THE TOYS 'R' US DEBACLE
SHIPPING ON TERMS

- While some vendors chose not to ship at all rather than take the risk of shipping on terms, many vendors couldn't risk losing the revenue and decided to ship
- Toys 'R' Us procurement team had conversations with many vendors that gave them false comfort and induced those vendors to ship

THE TOYS 'R' US DEBACLE
CRITICAL VENDOR STATUS

- Many vendors were offered and took critical vendor status as an apparent means to protect those vendors from potential losses for post-bankruptcy shipments and to induce continued shipments
  - Required vendors to continue to ship goods on lengthy payment terms that existed pre-bankruptcy
  - Critical vendor money was to be paid in installments and on a deferred basis

THE TOYS 'R' US DEBACLE
WHAT HAPPENED???

- The story of what happened next……

NACM NATIONAL ASSOCIATION OF CREDIT MANAGEMENT Driving results

Tucker Ellis LLP

[MORE] CRITICAL VENDOR CONSIDERATIONS

Jason M. Torf
Thomas R. Fawkes
Brian J. Jackiw
Tucker Ellis LLP

CRITICAL VENDOR TREATMENT

- Provides trade vendors priority payment of prepetition claim, usually in full and immediately rather than at end of bankruptcy case
- If you can leverage your way into becoming a critical vendor, the result can be a much better recovery in the bankruptcy
  - Swaps a prepetition, general unsecured claim for, at worst, a postpetition administrative claim

CRITICAL VENDOR TREATMENT
PROS

- May get some or all of your prepetition invoices paid in full
- Preserves ongoing business relationship with debtor
- Likely indicator that your relationship will survive sale of assets and potentially have contract assumed by acquirer of assets
- Possible preference waiver (but see subsequent slides)

CRITICAL VENDOR TREATMENT
CONS

- Typically requires execution of a critical vendor/essential supplier contract
- Typically have to extend credit terms
- May be subject to potential claw-back if debtor thinks you “misbehave”

CRITICAL VENDOR TREATMENT
DOES IT INSULATE CREDITOR FROM PREFERENCE LIABILITY?

- Might not insulate from preference liability absent “something more”
  - *See Insys Liquidation Trust v. McKesson Corp.*, Case No. 21-50176 (Bankr. D. Del. July 21, 2021)
    - Delaware bankruptcy court ruled that critical vendor status does not automatically insulate creditor from preference exposure, absent “something more,” where
      - creditor was not specifically named in critical vendor order;
      - Debtor was given discretion, but not required, to make critical vendor payments; and
      - critical vendor order expressly stated that it did not constitute “a waiver of any claims or causes of action that may exist against any creditor.”

CRITICAL VENDOR TREATMENT

DOES IT INSULATE CREDITOR FROM PREFERENCE LIABILITY?

- Under *Insys*, "something more" to help insulate creditor from preference exposure could be language in the critical vendor order that
  - requires (i.e., not discretionary) the debtor to pay the creditor's entire pre-bankruptcy balance in full;
  - expressly names the creditor; and/or
  - expressly provides for a waiver of any subsequent preference claims against the creditor
- Express waiver language likely is the best approach
- But……might not be easy to get Debtor to include any of these provisions in critical vendor order, or creditor might not have a seat at the table before critical vendor order is entered, in which case
  - Might need to deal with preference lawsuit later, even after being paid in full as a critical vendor

NACM NATIONAL ASSOCIATION OF CREDIT MANAGEMENT Driving results

Tucker Ellis LLP

CONSIGNMENTS: HOW DOING THEM WRONG CAUSED *THE SPORTS AUTHORITY* DEBACLE

Jason M. Torf
Thomas R. Fawkes
Brian J. Jackiw
Tucker Ellis LLP

CONSIGNMENTS

- In a consignment arrangement, seller retains ownership of goods
- Consigned goods are delivered to "consignee"
- When consignee sells goods, consignee remits a percentage of sale proceeds to seller and retains remainder
- Seller-consignor does not get paid up front as in a true sale, but offers a measure of protection when buyer-consignee experiences financial difficulty

CONSIGNMENTS

- Consignment treated the same as a purchase money security interest
- UCC § 9-103(d)
  - The security interest of a consignor in goods that are the subject of a consignment is a purchase-money security interest in inventory.
- This means that, if done properly, a seller-consignor has rights that are superior to buyer-consignee's secured lender

CONSIGNMENTS
HOW TO DOCUMENT A CONSIGNMENT PROPERLY

- Two required steps to properly document a consignment of inventory:
  - Must file a UCC-1 financing statement (same as a secured creditor)
    - Check the consignment box to indicate a consignment rather than a security interest
  - Must send notice to other secured creditors
    - Lien search must be done to determine existing secured creditors with a lien on inventory entitled to notice
    - Send notice to all secured creditors with a lien on inventory

CONSIGNMENTS
HOW TO DOCUMENT A CONSIGNMENT PROPERLY

- Timing
  - Both financing statement **and** notices to secured creditors **must be sent before any consigned goods are delivered**
  - Failure to do so will result in consignor's rights in any goods delivered before both of these steps are taken being subordinate to secured lender with lien on inventory

CONSIGNMENTS
HOW TO DOCUMENT A CONSIGNMENT PROPERLY

- Requirement to file a financing statement is found in UCC § 9-317(e)
  - ….[I]f a person files a financing statement with respect to a purchase-money security interest before or within 20 days after the debtor receives delivery of the collateral, the security interest takes priority over the rights of a buyer, lessee, or lien creditor which arise between the time the security interest attaches and the time of filing.
- But for inventory, disregard the idea to file within 20 days after delivery of the goods

CONSIGNMENTS
HOW TO DOCUMENT A CONSIGNMENT PROPERLY

- Notice requirement and timing requirement to perfect (i.e., file financing statement) before delivery of consigned inventory is found in UCC § 9-324(b)
  - ….[A] perfected purchase-money security interest in inventory has priority over a conflicting security interest in the same inventory…and [] also has priority in identifiable cash proceeds of the inventory to the extent the identifiable cash proceeds are received on or before the delivery of the inventory to a buyer, if:
    - (1) the purchase-money security interest is perfected when the debtor receives possession of the inventory;
    - (2) the purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest;
    - (3) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and
    - (4) the notification states that the person sending the notification has or expects to acquire a purchase-money security interest in inventory of the debtor and describes the inventory.

CONSIGNMENTS
RIGHTS OF CONSIGNOR

- A true consignment arrangement that is properly documented prevents security interest of consignee's secured lender from attaching to consignor's inventory

CONSIGNMENTS
TRAPS FOR THE UNWARY

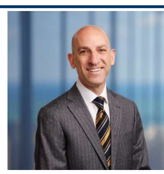
- The *Sports Authority* example
  - Approximately 160 consignment vendors
    - Only approximately 40 of those filed financing statements and sent required notice to secured creditors
    - Of those 40, only <u>three</u> filed financing statements sooner than 90 days before Sports Authority filed bankruptcy
      - Those filed within 90 days before bankruptcy were avoidable as preferences, leaving those consignment vendors in the same position as those who did not file financing statements at all

CONSIGNMENTS

TRAPS FOR THE UNWARY

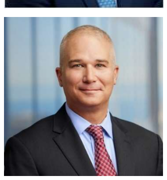
- Lessons from *Sports Authority*
  - Make sure to file a financing statement and send notice of consignment arrangement to secured creditors
    - Make sure to do this <u>before</u> shipping any consigned goods
      - Failure to do so in Sports Authority resulted in
        - » Secured lenders' liens attaching to consigned goods
        - » Secured lenders having priority over consignors
        - » All but the three consignors who properly documented and perfected their consignment arrangements receiving far less than they would have if done properly

QUESTIONS



Jason M. Torf
Partner
Tucker Ellis LLP
(312) 256-9234
jason.torf@tuckerellis.com
www.tuckerellis.com/people/jason-m-torf/
www.linkedin.com/in/jasontorf

Thomas R. Fawkes
Partner
Tucker Ellis LLP
(312) 256-9425
thomas.fawkes@tuckerellis.com
www.tuckerellis.com/people/thomas-r-fawkes/
www.linkedin.com/in/thomasfawkes/



Brian J. Jackiw
Partner
Tucker Ellis LLP
(312) 256-9426
brian.jackiw@tuckerellis.com
www.tuckerellis.com/people/brian-j-jackiw/
www.linkedin.com/in/brian-jackiw-b60ab36/