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## Comment/Consignments and the Rights of Creditors Under the Uniform Commercial Code

THE COMMERCIAL ARRANGEMENT known as the consignment, whereby goods are entrusted by a manufacturer or wholesaler to an agent, usually a retailer, who is called a consignee, commission merchant, or factor, has long been employed by suppliers of goods as a convenient method of marketing their products. The legal rights and duties of the parties to a consignment, as well as the legal relationships between such parties and third persons such as creditors and innocent purchasers, have been established by many judicial decisions, and are also to some extent governed by statutes. In recent years, substantial changes in these laws have been inaugurated by the Uniform Commercial Code (U.C.C.). Extensive adoption of the Code by the states in recent years makes it important to understand such changes.<sup>1</sup> The purpose of this comment is to detail the rights of the various parties to consignment arrangements as those rights have developed prior to the arrival of the U.C.C., and to indicate the important changes which the Code has effected. Other recent related developments in the law of consignments, such as their validity as price-fixing arrangements under the antitrust laws, will not be discussed, although a recent decision of the United States Supreme Court, *Simpson v. Union Oil Co.*,<sup>2</sup> is of considerable importance to any discussion of consignments because of its holding that the perfection of a consignment under state law does not control the validity of the consignment under the proscriptions of the federal antitrust laws. Particular attention will instead be directed to the rights of creditors of bankrupt or insolvent consignees, and to the various legal solutions proposed for resolving the conflicting claims of such creditors and the consignor. The many uncertainties in this area have been resolved by the Uniform Commercial Code in a new and, it is submitted, equitable manner. The first major interpretation of the U.C.C. provisions on

<sup>1</sup> The Uniform Commercial Code has now been enacted in twenty-eight states. See *Uniform Laws Annotated*, Un. Com. Code (1962).

<sup>2</sup> 377 U.S. 13 (1964).

consignments was recently given in *General Electric Co. v. Pettingell Supply Co.*,<sup>3</sup> and for this reason that case should be given particular consideration.<sup>4</sup>

#### CHARACTERISTICS OF A CONSIGNMENT

When a manufacturer or wholesaler desires to move his goods into the market, he may do it in any of several ways: by an outright sale, by a conditional sale, by a sale or return, or by a consignment. If he chooses a sale, or a sale or return, title to the goods passes to buyer at the time of the performance of the contract. If a secured transaction such as a conditional sale is employed, title remains in the secured party until fulfillment of the conditions of payment. The distinguishing feature of an effectively created consignment, on the other hand, is the retention of title in the consignor.<sup>5</sup> The consignee, or factor, becomes a bailee of the goods for the purpose of selling the goods, and a principal-agent relationship arises between consignor and consignee. Thus, the general duties imposed on agents by the laws of agency, such as the duty of care of the goods,<sup>6</sup> the duty of loyalty and good faith,<sup>7</sup> and the duty not to sell to himself,<sup>8</sup> are all likewise imposed on consignees. Since the consignee is not selling the goods for his own account, but for his principal's, he holds the proceeds as a fiduciary and must remit them to the consignor according to their agreement.<sup>9</sup> The consignee is ordinarily required for this purpose to keep regular and separate accounts of his sales proceeds.<sup>10</sup> Conversely, the consignor is required, either expressly in the agreement, or by implication, to compensate the factor upon the sale of the goods,<sup>11</sup> and the agent enjoys a possessory lien, called a factor's lien, on either the goods or their proceeds, to insure payment.<sup>12</sup> The means of payment is ordinarily by a commission based on percentage of profits.<sup>13</sup>

The generic category of "consignee" also includes certain types of brokers who have duties to the public which they serve. Statutes have been enacted by both the states and the federal government which regulate the conduct of such brokers, and which usually require licensing to conduct business. Based

<sup>3</sup> 199 N.E.2d 326 (Mass. 1964).

<sup>4</sup> The provision on consignments is contained in UNIFORM COMMERCIAL CODE § 2-326.

<sup>5</sup> *Neild v. District of Columbia*, 71 App. D.C. 306, 110 F.2d 246 (1940).

<sup>6</sup> *U.S. Fidelity & Guaranty Co. v. Slifkin*, 200 F. Supp. 563 (D. Ala. 1961).

<sup>7</sup> *Blanchard v. Elmer Wood Co.*, 204 Ia. 255, 214 N.W. 583 (1927).

<sup>8</sup> *Midwest Farmers v. United States*, 64 F. Supp. 91 (D. Minn. 1945).

<sup>9</sup> *Raymond v. Independent Growers*, 284 P.2d 57 (Cal. 1955).

<sup>10</sup> *Hill, Harris & Co. v. Averett*, 14 La. App. 240, 129 So. 399 (1930).

<sup>11</sup> *Torres v. International General Electric, S.A. Inc.*, 303 F.2d 615 (1st Cir. 1962).

<sup>12</sup> *In Re Freeman*, 294 F. 2d 126 (3d. Cir. 1961). Some states have statutory provisions for factors' liens. See, e.g., REV. STAT. N. J., 2A: 44-178 *et. seq.* The *Freeman* case notes that

(t)he modern factor, however, is a financier who generally lends monies and takes in return an assignment of accounts receivable or some other security. He is not a selling agent. . . . It is the modern factor who is the primary beneficiary of the factors' lien statutes of the various states.

<sup>13</sup> On other laws relating to factors, see generally, 35 C.J.S. FACTORS, § 1-7; 2 WILLISTON, SALES, § 270 (rev. ed. 1948).

on the need to secure the public's protection, such laws are considered proper exercises of government police power. These regulatory enactments have been established, for example, to regulate brokers in the meatpacking,<sup>14</sup> and in the perishable foods<sup>15</sup> industries. Brokerage types of consignments, however, are not ordinarily thought to be subject to the same rules which apply to consignments of consumer goods because of their essentially statutory foundation. Since brokerage consignments form such a unique category, they will not be considered as included in the term "consignment" as used in this article.

With respect to the immediate parties to a consignment agreement, there arise few controversies which are not settled by the application of rather definite principles of agency, as discussed above. It is the arrival of third parties onto the scene that inserts into the arrangement the difficulties posed to courts and legislatures. More particularly, the problem that arises is the protection which the law should afford to bona fide purchasers of goods entrusted to consignees who are not authorized to make a particular sale, and to creditors of consignees who have become bankrupt or insolvent. The right of a creditor to claim as an asset goods in the hands of a consignee is the one most affected by the Uniform Commercial Code.

#### A. *Before the Code*

The common law right of the owner of goods to reclaim them from even a bona fide purchaser who acquired them from a party not authorized to make the sale gave rise to early legislative protection for the purchaser who acquired the goods from a consignee. A consignee in possession of goods or documents of title to goods is manifestly the owner of the goods, apparently authorized to transfer title to them, for he is clothed with all the appearances of ownership. The mere fact that he may be authorized to sell them only at a certain minimum price, or on certain specified terms, or with other restrictions, would not ordinarily be known to the purchaser. Nevertheless, if the consignee sold the goods to an innocent purchaser, in violation of the terms of the consignment, the common law allowed the consignor to reclaim his goods. The first step taken to remedy this unprotected position of innocent purchasers came in England with the passage of the Factors' Acts.<sup>16</sup> This statute, and subsequent similar acts passed in many American states,<sup>17</sup> provides essentially that any person entrusted with possession of goods for sale, or with documents of title thereto, is deemed the true owner of the goods for the purpose of giving validity to a sale or contract of sale. The purchaser thus takes title unless he has notice of the fact that his seller does not have actual title. Such statutes

<sup>14</sup> Packers & Stockyards Act, 42 Stat. 159, 7 U.S.C. §§ 181 *et seq.* (1921).

<sup>15</sup> Perishable Agricultural Commodities Act of 1930, 46 Stat. 531, 7 U.S.C. §§ 499 *et seq.*

<sup>16</sup> 4. Geo. IV chap. 83 (1823).

<sup>17</sup> See, *e.g.*, N. Y. CONSOL. LAWS—Personal Property, § 43.

are still in effect in those states adopting the Uniform Commercial Code.<sup>18</sup>

The problem of protecting creditors of the consignee is made immensely more difficult than the bona fide purchaser problem because of the nature of the consignment as an agency and not a sale. Since title to the goods remains in the consignor, it would seem, under ordinary agency rules, that he could revoke the agency at any time and reclaim the goods. This is generally correct.<sup>19</sup> But, does this rule obtain when the consignee is insolvent and his creditors are competing with the consignor for his assets? Is not the consignor's position one of a preferred creditor, which works an injustice on other creditors? No general answers to these questions can be given under the laws of states which have not enacted the Uniform Commercial Code. Many courts, taking the position that it is desirable to protect all creditors equally, have found consignment agreements invalid in many cases, and on various theories. Arrangements which undoubtedly would have been considered effective consignments as between the parties were interpreted to have become invalid, or to have been transformed into a sale by the conduct of the parties,<sup>20</sup> or to have been tainted with fraud, bad faith, or intent to evade creditors,<sup>21</sup> in order to safeguard the rights of the creditors. In such cases, the consignor will participate in the distribution of the assets of the consignee equally with all creditors.

This judicial posture is obviously the result of a policy consideration which seeks equal treatment for all creditors. But policy choices must be transformed into legal rules, and the task in this area is to establish at least a broad standard by which to judge the validity of a consignment as between consignor and creditor. The most fruitful standard developed prior to the Uniform Commercial Code's overhaul of the subject is found by turning to decisions of the federal courts, whose exclusive jurisdiction over bankruptcy cases has allowed them to work out a consistent test for the validity of consignments against creditors' claims. The standard employed is called the "good faith" test. As formulated by the Supreme Court in *Ludvigh v. American Woolen Co.*,<sup>22</sup> this test upholds the validity of a consignor's title as against creditors, if the agreement was made in good faith, fully performed according to its terms, without intent to create a secret lien against creditors. Under this test, there must first be an effective consignment, *i.e.*, retention of title in the consignor, remission of proceeds, etc., and then, that consignment must be fulfilled according to its terms and in good faith. The good faith test gave considerable aid to federal courts sitting in bankruptcy cases. In *Liebowitz v. Voiello*,<sup>23</sup> for

<sup>18</sup> UNIFORM COMMERCIAL CODE § 2-403 (2) provides that a bona fide purchaser will take good title even as against the true owner, but this applies only "in ordinary course of business," which excludes most wholesale transactions.

<sup>19</sup> *Lion v. Lilienfeld*, 30 N.Y.S. 2d 866 (Sup. Ct., App. Div. 1941).

<sup>20</sup> *Tele-King Distrib. Co. v. Wylie*, 218 F.2d 940 (9th Cir. 1955).

<sup>21</sup> *Liebowitz v. Voiello*, 107 F.2d 914 (2d. Cir. 1939).

<sup>22</sup> 231 U.S. 522 (1913).

<sup>23</sup> *Supra* note 21.

example, the *Ludvigh* test was applied to an agreement in which quantities of flour were transferred by the defendant to the consignee, who later became bankrupt. Half of the price of the flour was to be paid on delivery. This was a sale, the court concluded, although the parties had designated it a consignment, because the fact of nearly full payment showed an intent to make a sale, and indicated bad faith with respect to creditors. Other courts developed various tests to determine whether bad faith was present. As summarized in *Yarm v. Lieberman*,<sup>24</sup> these include: whether periodic and separate accounts are kept, whether the goods are kept separate from the consignee's own goods, whether payments are made regularly to the consignor, whether a commission is paid, and whether the invoices refer to the consignment. The absence of any one of these characteristics does not of itself defeat the claim of the consignor. It is a fact question in each case whether the parties acted in good faith.<sup>25</sup>

The final resolution of all these cases depends upon a determination of whether a transaction creates a consignment or a sale, since the location of title to the goods determines whether they are subject to creditors' claims. Even under the good faith test, the object of ascertaining the bona fides of the parties is to determine whether title effectively remains in the consignor. Because of this, courts have been especially troubled by a form of sale called a "sale or return." This is defined as "a contract by which property is sold, but is liable to be returned to the seller at the option of the buyer."<sup>26</sup> Title vests in the buyer, who has the privilege of rescinding the sale if he finds that the goods do not meet with his approval. A sale or return is thus very similar to a consignment, and it is utilized by merchants as a means to get goods into the hands of retailers for resale. (A sale or return may be preferred to a consignment in instances where the seller is skeptical about his buyer's financial condition. As will be seen, a consignment is really a security arrangement for the extension of credit.) The distinction between the two forms of agreement is, however, vital when they are affected by rights of creditors. Since title does pass in a sale or return, and the buyer pays for the goods, the goods are subject to his creditors. Each agreement must therefore be examined in light of all the facts to determine whether the parties intended to pass title. If so, the agreement is a sale or return regardless of the use of the term "consignment" by the parties.<sup>27</sup>

The re-taking by a consignor of goods in the possession of a consignee who is subsequently adjudicated a bankrupt may give rise to a claim by creditors that such action constitutes preferential treatment in violation of the Bank-

<sup>24</sup> 46 F.2d 464 (E.D. N.Y. 1931).

<sup>25</sup> *Rio Grande Oil Co. v. Miller Rubber Co.*, 31 Ariz. 84, 250 P. 564 (1926).

<sup>26</sup> *Id.* at 564.

<sup>27</sup> *D. M. Ferry & Co. v. Hall*, 188 Ala. 178, 66 So. 104 (1914).

ruptcy Act, § 60a (1),<sup>28</sup> if the repossession occurs within the four month period prior to the petition in bankruptcy. The important criterion, as stated in § 60, is whether the goods are "the property of a debtor." Thus, if a consignment conforms to the *Ludvigh* good faith test, and title to the goods is in the consignor, he may properly reclaim the goods even within the four month period. It is evident that such a situation could be an open invitation to manufacturers to transfer goods on consignment solely to protect their interests. The consignment thus becomes a device for evading laws relating to perfection of security interests. It would not be necessary to create a chattel mortgage if the consignment serves the same purpose. The difficulty of showing a lack of good faith in this situation is apparent. What is good faith? How is it proved? Courts closely scrutinize these arrangements for evidence of hidden purposes. In *Matter of American Merchandising Co., [Inc.]*<sup>29</sup> an agreement transferred the good will and merchandise of the Florence Auction Sales Co. to American Merchandise, subject to the right of the former to retake the merchandise on failure to comply with terms of payment. Florence reclaimed the goods a day before American's creditors petitioned for an adjudication of bankruptcy. The court held that Florence's repossession was a voidable preference under § 60. It held:

Although repossession by a bailor under a valid contract of bailment does not constitute a voidable preference (citing *Ludvigh*), a showing of good faith in establishing the bailment must be made before this result will occur. The provision in the contract in this case attempting to create a consignment *ab initio* plainly demonstrates a lack of this requirement. No matter what validity such a provision may have *inter partes*, it will not be permitted to impair the rights of third parties — the general creditors represented by the trustee. As a patent attempt to circumvent § 60 of the Bankruptcy Act, the provision endeavoring to construct an *ex post factor* consignment must be ignored.<sup>30</sup>

This decision thus places the burden of showing good faith on the consignor. Avoidance of the strictures of § 60 is thus made more difficult. Even under such a holding, however, the parties could create a consignment valid under state law, and carry it out faithfully, nevertheless having as a concealed motive, the preference of the consignor over creditors. It was to remedy such a situation that the drafters of the Uniform Commercial Code decided to enact a more absolute rule than was provided by the good faith test, and to make the creation of such a preference more difficult.

<sup>28</sup> 64 Stat. 25, 11 U.S.C. § 96 (1950) states that:

A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

<sup>29</sup> 136 F. Supp. 952 (D.N.J. 1955).

<sup>30</sup> *Id.* at 954.

### B. *Consignments Under the Code*

Only one subsection in the Uniform Commercial Code directly relates to consignments — Section 2-326 (3). This provision resolves the problem of creditors' rights in a completely new manner. The essence of the new approach is the treatment of all but three categories of consignments as "sale or return," and thus subject to claims of creditors of the purchaser. A sale or return is defined in § 2-326 (1) (b) as being created "if the goods are delivered primarily for resale."<sup>31</sup> If a transfer is a sale or return, § 2-326 (2) provides that the goods are subject to creditors' claims "while in the buyer's possession." The next provision, § 2-326 (3), then describes the forms of transactions which are "deemed" to be on sale or return, and this description is applicable specifically to consignments:

Where goods are delivered to a person for sale and such person maintains a place of business at which he deals in goods of the kind involved, under a name other than the name of the person making delivery, then with respect to claims of creditors of the person conducting the business the goods are deemed to be on sale or return. The provisions of this subsection are applicable even though an agreement purports to reserve title to the person making delivery until payment or resale or uses such words as "on consignment" or "on memorandum."

This subsection then proceeds to make the above provision inapplicable in three cases — where the party making delivery:

- (a) complies with an applicable law providing for a consignor's interest or the like to be evidenced by a sign.
- (b) establishes that the person conducting the business is generally known by his creditors to be substantially engaged in selling the goods of others, or
- (c) complies with the filing provisions of the Article on Secured Transactions (Article 9).<sup>32</sup>

Creditors of consignees are thus placed by the Code in a definitely enhanced position over their previous common law status.<sup>33</sup> Even though title is reserved to the consignor, creditors prevail unless the consignee conducts business under the same name as the consignor,<sup>34</sup> or unless one of the three exceptions obtains. Relatively few businessmen have the same name as that of the party making delivery. A consignor desiring to protect his goods may now do so

<sup>31</sup> § 2-326 (1) (a) defines a similar agreement, a "sale on approval", as one where the goods are delivered "primarily for use". This applies to purchases by a consumer who may return the goods if not satisfied. Such goods are not subject to creditors' claims until the buyer accepts unconditionally.

<sup>32</sup> UNIFORM COMMERCIAL CODE § 2-326 (3).

<sup>33</sup> The official comment of the drafters of the Code notes that "subsection (3) resolves all reasonable doubts as to the nature of the transaction in favor of the general creditors of the buyer." UNIFORM COMMERCIAL CODE § 2-326, Comment on subsection (3).

<sup>34</sup> The most prominent example of such an arrangement is that of oil companies which dispense retail gasoline through independent dealers bearing their names. See *Simpson v. Union Oil Co.*, *supra* note 2.



safely only by complying with the third exception of § 2-326 (3), requiring him to perfect a security interest under Article 9.<sup>35</sup> All rights of parties will therefore be governed by Article 9 rather than by Article 2 on Sales, since by the operation of § 2-326 (3), a consignment is for all practical purposes a secured transaction. This is made clear by § 9-113, which provides that a security interest arising under Article 2 is subject to the provisions of Article 9 if the debtor is in possession of the goods. The entire complexion of the consignment has thus been changed by the Uniform Commercial Code. Being governed by Article 9, a consignment, to be effective against creditors, must be filed.<sup>36</sup> The Code has recognized expressly the situation with respect to consignments which existed prior to its adoption, for in fact a consignment has always been utilized by suppliers of goods as a means of retaining a security interest in goods. Its major advantage, moreover, has been as a device to get goods into the hands of retailers who may be unable to pay for them on delivery. It was an anomaly that such an arrangement, which so closely resembles a conditional sale, should be allowed to be governed by the same rules as apply to conditional sales, and yet avoid the requirements for perfecting such a security interest.

Are all consignments now to be governed by Article 9? It would seem that every consignment, to be valid against creditors, excepting only certain types stated in § 2-326, must be perfected under Article 9. It has been suggested that only those consignments intended by the parties to be security interests will come under Article 9.<sup>37</sup> Some justification for this is found in § 9-102 (2), which provides that Article 9 applies to "security interests created by . . . consignment intended as security." Under this view, if a consignment is created for the purpose of allowing the consignor to fix prices to his goods without violating the antitrust laws, then the intent of the parties is not to create a security interest, and thus the consignment would still be governed by Article 2. But such a result may not always be possible, for the agreement would circuitously arrive back under the provisions of Article 9 if the parties decide that they want to perfect their transaction against creditors. There can be no clear-cut distinction between a price-fixing consignment and a security consignment if, as is the case, it is possible to perfect a security interest in goods consigned under a pricefixing consignment. Ascertaining the intent of the parties in such a case is not as important as determining whether the plain language of § 2-326 (3) requires filing. It is precisely the element of intent that is de-emphasized by the Code, for its purpose is to eliminate the problem of

<sup>35</sup> Certainly no consignor will assume that his consignee's creditors have knowledge of the consignment, and very few states have the "sign" method of giving notice. These exceptions will seldom be employed.

<sup>36</sup> UNIFORM COMMERCIAL CODE § 9-302.

<sup>37</sup> Hawkland, *Consignments Under the Uniform Commercial Code: Sales or Security?*, B.C. U.C.C. CO- ORD. 395 (1963).

determining "good faith," which involves the intent of the parties. However, if the intent of the parties is to create a security interest, then admittedly § 9-102 suggests that Article 9 is always applicable.

The "good faith" test as announced in the *Ludvigh* case and generally adopted by the courts prior to the Uniform Commercial Code is evidently eliminated by § 2-326. No amount of good faith would exempt the transaction from being considered a sale or return unless the consignor takes steps to safeguard his position, and this will almost always require filing under Article 9.

The strength which § 2-326 gives to the position of consignees' creditors was recently demonstrated in *General Electric Co. v. Pettingell Supply Co.*<sup>38</sup> The plaintiff, General Electric, delivered a supply of large commercial lamps to Pettingell "as agent to sell or distribute." Pettingell later assigned the lamps to one Miller, for the benefit of its creditors. The plaintiff replevied the lamps. The lower court ruled that because of § 2-326, which was adopted by Massachusetts,<sup>39</sup> the plaintiff was required to return the goods. The case on appeal presented an ideal opportunity for testing the scope of § 2-326, since the plaintiff did not contend that it had complied with any of the section's exception provisions. There was no contention that the consignment was governed by Article 9, and the plaintiff asserted that the agency was not intended as a security interest, and no such interest was filed. The only contention forwarded by General Electric was that § 2-326 (3) was inapplicable to a transaction which was solely a principal-agent consignment, that only sales were governed. The court disagreed, quoting § 2-326 (3) that applied the rules of that subsection even though the "agreement purports to reserve title to the person making delivery until payment or resale or uses such words as 'on consignment' . . .". But, contended the plaintiff, the word "re-sale" implies that the original transaction had been a sale. The court likewise disposed of this contention:

The subsection is concerned with transactions 'deemed' to be of 'sale or return' and the first sentence is carefully drafted to apply to transactions which might not ordinarily be characterized as sales.<sup>40</sup>

The *Pettingell* decision properly suggests the purpose of § 2-326. No mention was made by the court of good faith. The transformation of a consignment into a sale or return for purposes of protecting creditors is automatic and requires no discussion of good faith.<sup>41</sup> The only way General Electric could have prevailed would have been to file a security interest under Article 9,

<sup>38</sup> *Supra* note 3.

<sup>39</sup> MASS. GEN. LAWS, ch. 106 (1957).

<sup>40</sup> 199 N.E.2d at 329.

<sup>41</sup> The official comment to § 2-326 states that the new good faith test is not one only applicable as between the parties, but also "as against interested third parties."

whereas prior to the Uniform Commercial Code, a showing of good faith by the plaintiff would have resulted in its successful recovery of the goods.

It seems likely that the position of the *Pettingell* approach, namely, a strict interpretation of § 2-326, will be followed by other state courts, or by federal courts in bankruptcy cases. The *Ludvigh* good faith test will thus be replaced, or at least severely tightened up.

#### CONCLUSION

The protection of creditors has always occupied the attention of courts, and it is doubtless desirable to discourage devices created to subvert creditors' rights. The enactment of § 2-326 should be encouraged because it reaches a reasonable result which protects the proper interests of all parties.<sup>42</sup> The consignor may be protected by having the security protection afforded by filing under Article 9. The creditor is protected by being given an automatically paramount position in the absence of filing.

<sup>42</sup> "The result is desirable, because it makes it possible for a consignor to perfect his interest, and for creditors to protect themselves by resorting to credit information and public records." Hawkland, *supra* note 37, at 401.