Consignment Risks: A Creditor's Perspective

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Of a credit executive's many responsibilities, one of the most important is managing credit risk. One alternative to a sale on open account (e.g., the usual net 30 days) is a sale on consignment, where the owner transfers possession of goods, but not title to the goods, to a third party. The third then sells the property and returns the proceeds to the owner, usually less a commission. Consignment sales can help minimize the risk of non-payment, and can be a desirable way of doing business with a retailer or wholesaler on shaky economic grounds.

However, a consignment transaction is not without risk. For example, inventory on consignment, or the proceeds of the same, may become the subject of a competing creditor's claim unless the consignee has complied with the Uniform Commercial Code's (UCC) requirements for perfecting a security interest in the inventory.

As the case of Bank of California v. Thornton-Blue Pacific1 illustrates below, where a consignor fails to take these steps to protect ownership of its inventory, the consignor risks losing the inventory, or the proceeds from the sale of the inventory, to a competing creditor.

Basics of Consignment Sales

The definition of a consignment sale is one in which an owner, the consignor, transfers possession of merchandise to a consignee. When the consignee sells the merchandise to a third party, the consignee becomes obligated to pay the consignor from the proceeds of the sale of the merchandise. The consignee receives a fee or commission for making the sale. If the consignee does not sell the goods after all, he or she may return them to the consignor without obligation. In a consignment transaction, title to goods on consignment remains with the consignor until the sale takes place. A consignment sale is not a true sale until the consignee actually sells the goods; until then title remains with the owner-consignor, usually the manufacturer.

Complying With the Uniform Commercial Code

Article 9 of the Uniform Commercial Code provides the means whereby a consignor can establish a valid, perfected security interest in his own inventory, even when that inventory has been delivered to a consignee. The consignor must comply with the UCC to protect itself against (a) pre-existing creditors of the consignee and a consignee's secured creditors, and (b) lenders who come later, after the consignment transaction. Compliance with the attachment/perfection requirements not only protects ownership of inventory; in the event of a dispute over the goods, the consignor will prevail over a competing creditor.

Perfecting a security interest is a multi-step process that begins with the consignor. An agreement is executed describing the relationship of the parties involved, generally with the owner as the consignor and the seller as the consignee. There is a description of the inventory and an agreement that title to the merchandise only passes to third-party buyers. The consignor also completes a UCC-1 financing statement which again describes the inventory and makes clear that the inventory is delivered on consignment. The consignor then files the statement with the state filing office for each state that the consignee operates the business. For the consignor's security interest in its inventory to prime the lien of a pre-existing creditor, the consignor should insure that its UCC-1 and consignment agreement have been recorded before the consignee receives possession of the inventory.

Secondly, the consignor must give written notice to any pre-existing, secured creditor with a lien on inventory. The consignor is responsible for identifying pre-existing creditors. The consignor can obtain this information from the filing office to determine that the consignee-debtor and its secured creditor have filed financing statements covering inventory and after acquired property. The consignor's written notice to the inventory secured creditor should state that the consignor is delivering inventory on consignment to the consignor-debtor. The notice should describe the goods with such particularity as to reasonably identify the inventory. Super generic descriptions such as "all inventory" will not suffice.

A consignor must give notice to any creditor asserting a security interest in the debtor's inventory in order to avoid any appearance that inventory coming to the consignor-debtor is free from ownership claims. This notice also distinguishes the "new" merchandise on consignment from other inventory that is subject to the after acquired property clause contained in the creditor's security agreement. The consignor that takes these steps is entitled to the identifiable cash proceeds from the sale of its merchandise, or to the return of the merchandise itself.

To have priority in the accounts receivable generated by the sale of consigned goods, the consignor must also comply with the UCC notice filing requirements as to accounts receivable. If there is a pre-existing creditor, and the consignor fails to give notice in the manner just described before the consignee receives possession of the inventory, then the consignor has failed to perfect its interest in the consigned merchandise A priority dispute would be governed by the "first to file" rule. This means that a pre-existing, inventory secured creditor's lien would take priority over the consignor's security interest.

Debtor Generally Known To Sell on Consignment

An exception to the consignor's need to comply with the UCC Article 9 notice requirement is where the debtor is generally known by its creditors to be engaged in consignment sales. However, in a priority fight over the same collateral against a competing creditor or trustee in bankruptcy, it is a heavy burden for a consignor to convince a court that the debtor's creditors in fact knew that the debtor was engaged in selling the goods of others on consignment.

For example, in Thorton-Blue Pacific, the debtor was a flower wholesaler, which packaged flowers and sold them to retail florists. The debtor did have consignment contracts with some wholesalers that if the flowers were sold and payment received, the debtor would remit 75% of the sales price to the consignor and retained 25% as its commission. If the flowers were not sold, the consignor received nothing, with no risk of loss to the debtor. In Thorton-Blue Pacific, the plaintiff, a grower, contended it too had a consignment arrangement with the debtor. The grower, however, did not perfect its interest. There was no agreement stating that the grower was a consignor and the debtor a consignee, nor that the flower inventory was delivered on consignment.

Prior to entering the purported consignment arrangement, the debtor guaranteed a bank loan on behalf of its three shareholders. The debtor granted the bank a security interest in the debtor's assets, including proceeds from the sale of the flower inventory. The shareholders defaulted on the loan, and the bank sued the shareholders and the debtor. The debtor settled with the bank by offering the proceeds from the sale of flowers held in a bank account. The grower objected to the settlement, contending that a significant portion of the cash in the account originated from the sale of its flower inventory, and that as a consignor it had priority to the proceeds by virtue of a consignment arrangement with the debtor. The trial court ruled that the bank had a superior right to the proceeds, and denied the claims of the grower.

On appeal, the consignor argued the debtor was generally known by its creditors to be engaged in consignment sales and, for that reason, the consignor was excused from complying with the notice requirements of the UCC. However, the appellate court noted there was scant evidence that creditors, especially non-consigning creditors, were aware the debtor was selling anything on consignment.

The appellate court generally observed that when non-consigning creditors know of a debtor's consignment arrangements with other creditors they can take precautions to protect their open account sales. In the matter at hand, however, the consignment arrangements were undisclosed to the non-consigning creditors. This case is similar to the infamous "secret liens" that the drafters of the UCC detest. Such undisclosed arrangements effectively take proceeds from the debtor's sales that otherwise could be used to pay unsecured creditors.

The grower argued that because the sale of flowers to the debtor was on consignment, the debtor never had title to the flowers. Therefore, the bank's security interest could not attach to the flower inventory or to the proceeds from the sale of the same. The grower argued that the bank had a senior claim only to the flowers in the debtor's possession, and not to the proceeds received upon the sale of those goods.

The appellate court disagreed, stating that the consignor became an unsecured creditor upon the sale of the inventory and had no priority claim to the proceeds unless it had complied with the perfection requirements of Article 9. The court determined that by virtue of the security agreement and financing statement, the bank had a security interest in the proceeds of the sale of the flowers.

Comply Or Risk Losing Your Goods

Consignment agreements if not properly perfected through UCC procedures, can amount to little more than the legal equivalent of a sale on open account. When a putative consignor delivers merchandise to a customer to sell, but with the right to receive back the unsold merchandise, the transaction by itself is nothing more than a sale, thus making the selling party a mere general unsecured creditor. Since adoption of the UCC, consignment sales have changed. Failure to comply with the notice provisions of the UCC puts the consignor's inventory at risk to existing and subsequent inventory lenders, trustees in bankruptcy, and unsecured creditors' committees in bankruptcy. While a non-perfected consignor waits for its inventory to be sold, creditors may rush in seeking to attach, or execute and levy upon the same inventory to satisfy their pre or post judgment claims.

Thorton-Blue Pacific reminds us that it is difficult to fall within the exception for Article 9 recording and notice requirements. It can be difficult to demonstrate that the debtor is generally known by its creditors to be engaged in consignment sales. A consignor should consider taking the time and incurring the expense to comply with Article 9's technical requirements for executing consignment agreements, recording them and providing proper notice.

If you find yourself in a dispute with a creditor, trustee, or creditors' committee, who asserts ownership of your inventory or proceeds from that inventory, and you have not complied with the UCC, obtain as many declarations from non-consigning creditors as possible, attesting that the non-consigning creditor was aware that the debtor was engaged in consignment sales.

The intent of the UCC is to compel a consignor to comply with the filing statutes. The UCC is not out to destroy consignment transactions, only secret liens. Unrecorded consignment agreements are viewed as "secret liens" and are disfavored as they do not give general creditors the opportunity to protect themselves. Creditors of a debtor in a "sale or return" transaction naturally conclude that goods held by a debtor belong to the debtor. Consignment sales that do not create a hidden lien are to be left alone. Thus, the publicized consignment sale is protected.

However, as Thorton-Blue Pacific makes clear, consignors have a heavy burden in establishing a sale is indeed sufficiently publicized. Thus, the only real option for a consignment creditor is to comply with UCC Article 9 filing and notice provisions.

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1 97 Daily Journal D.A.R. 3897 (1997).