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In re Steven Wallace

July 1999

§ 4 - Definitions:

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§ 4.07 - Chapter 11: A petition for a Chapter 11 "reorganization" commences a proceeding in which the insolvent debtor continues to operate as an ongoing business with certain restrictions. The business operates by the direction of the Bankruptcy Court under the management either of a court-appointed trustee or the debtor (debtor-in-possession). The Bankruptcy Act provides for an automatic stay of legal and self-help proceedings against the debtor pending the preparation and execution of a "plan of arrangement" pursuant to which the debtor "works out" its obligations to its creditors over an extended period of time.

§ 4.08 - Chapter 7: Often, Chapter 11 proceedings that fail are converted to Chapter 7 cases. A petition for bankruptcy under Chapter 7 commences a proceeding for liquidation of the debtor's assets for the benefit of its creditors. A court-appointed trustee takes possession of the business, including all items in inventory, which thereafter come under the exclusive control of the trustee. The trustee is vested with all the rights possessed by the creditors of the bankrupt debtor prior to the filing of the petition. The trustee's principal function is to marshall and, subject to the rights of secured creditors, sell the assets and distribute the proceeds proportionately to the creditors in accordance with their interests. Under § 549 of the Bankruptcy Act, "the trustee may

> avoid a transfer of property of the estate . . . that occurs after commencement of the case. . . ."

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§ 4.27 - Schedules of Assets, Debts, and Creditors: It is incumbent on the debtor in any bankruptcy proceeding to file with the court schedules of its assets, debts and creditors. All property, including goods delivered on consignment and accounts receivable, in which the debtor has any interest must be described and its location shown on the schedule of assets. Likewise, the amount of each debt and the name and address of the creditor to whom each debt is owed are required to be listed on the schedules of debts and creditors, with designations in each case as to whether the particular creditor is secured or unsecured. The schedules of secured creditors must describe with particularity the property of the debtor in which the creditor has a security interest.

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§ 2-326. Sale on Approval and Sale or Return; Consignment Sales and Rights of Creditors.

(1) Unless otherwise agreed, if delivered goods may be returned by the buyer even though they conform to the contract, the transaction is

(a) a "sale on approval" if the goods are delivered primarily for use, and

(b) a "sale or return" if the goods are delivered primarily for resale.

(2) Except as provided in subsection (3), goods held on approval are not subject to claims of the buyer's creditors until acceptance; goods held on sale or return are subject to such claims while in the buyer's possession.

(3) 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 the 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." However, this subsection is not applicable if the person making the delivery

(a) complies with an applicable law providing for a consignor's interest or the like to be evidenced by a sign, or

(b) establishes that the person conducting the business is generally known by his creditors to be substantially engaged in selling goods of others, or

(c) complies with the filing of provisions of the Article on Secured Transactions (Article 9), or

(d) delivers goods which the person making delivery used or bought for personal, family, or household purposes.

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§ 3533 - Sign Law.

If a person transacts business and identifies his place of business by a sign and fails by another sign or signs in letters easy to read and posted conspicuously in his place of business to state that he is dealing in property in which others have an interest and identifying such property, then all the property, stock of goods, money, and choses in action used or acquired in such business shall, as to the creditors of such person, be liable for his debts and be in all respects treated in favor of his creditors as his property unless the provisions of Franklin Commercial Code § 2-326(3)(b) through (d) are applicable.

First National Bank v. Marigold Farms, Inc.
Franklin Court of Appeal (1997)

In this case, we determine the priority of the claims of First National Bank (the Bank) and Marigold Farms, Inc. (Marigold) to $139,000 in a bank account (the Fund) of Pacific Wholesalers (Pacific). The trial court held that the Bank was entitled to the Fund. Marigold appeals.

The Bank had loaned $600,000 to Pacific and Pacific, in turn, had executed a security agreement granting the Bank a security interest in certain assets of Pacific. The Bank had perfected its security interest by filing a financing statement with the Secretary of State. Pacific defaulted on the loan and the Bank sued. Pacific and the Bank negotiated a settlement pursuant to which cash received by Pacific in the conduct of its business would be delivered to the Bank and applied to the balance of the loan. Marigold asserted claims to the same cash and also asserted that its claims had priority over any claim of the Bank. The court approved the settlement subject to resolution of the competing claims of Marigold and the Bank and ordered $139,000 of Pacific's cash receipts held in a "blocked" account (i.e., the Fund).

The facts of the relationship between Marigold and Pacific are undisputed. Marigold was a grower of flowers. Pacific was a flower wholesaler. They had a longstanding relationship under which Marigold would deliver flowers to Pacific and obtain a delivery receipt. Pacific would mark the flowers with Marigold's name, package them, and attempt to sell them to retail florists at prices determined by Pacific. If the flowers were sold and Pacific received payment, Pacific would remit to Marigold 75% of the sale price, retaining 25% as its commission. If the flowers were not sold, Pacific would with Marigold's approval discard them, and Marigold would receive nothing for those flowers. It is also undisputed that the Bank had no actual knowledge of the nature of the commercial arrangement between Marigold and Pacific.

The Bank's financing statement and the security agreement between Pacific and the Bank describe the collateral as: "All inventory used in Pacific's business now owned or hereafter acquired; and all accounts and rights to payment of every kind now or hereafter arising in favor of Pacific out of Pacific's business, including all proceeds from the sale of inventory."

Under the Franklin Commercial Code, it is clear that, upon delivery of Marigold's flowers to Pacific, the flowers became part of Pacific's "inventory" because they were held by Pacific for sale. The Fund consists of "proceeds" of this inventory.

Marigold contends that its sale of flowers to Pacific was a "consignment sale," that Pacific never had title to the flowers and that, therefore, Pacific never owned the collateral (inventory) to which the Bank's security interest could attach. Marigold also asserts that

Franklin Commercial Code § 2-326(3) is inapplicable in this case.

A consignment sale is one in which the merchant takes possession of goods and holds them for sale with the obligation to pay the owner of the goods from the proceeds of the sale. If the merchant does not sell the goods, the merchant may return them to the owner (or, as in this case of perishable flowers, discard them) without obligation. In a consignment sale transaction, title to the goods generally remains with the original owner. The arrangement between Marigold and Pacific was a consignment sale arrangement; Marigold was the consignor and Pacific was the consignee. Under FCC § 2-326(3), which clearly governs this transaction, the retention of title by Marigold is irrelevant to the ability of the Bank to obtain a security interest in the collateral.

Marigold does not contend that it complied with the filing requirement under the secured transactions division of the FCC as provided for in § 2-326(3)(c). Nor does Marigold claim that it complied with an applicable "sign law" under § 2-326(3)(a) or that it had delivered goods it had "used or bought for personal, family, or household purposes" as provided for in § 2-326(3)(d).[1] Rather, Marigold claims that, as provided for in § 2- 326(3)(b), Pacific was generally known by its creditors "to be substantially engaged in selling goods of others."

At the evidentiary hearing, Bank officials testified unequivocally that the Bank was unaware that Pacific was selling the goods of others. Three flower growers who also consigned flowers to Pacific testified that Pacific was "well-known as a commission selling agent" and that other flower growers knew it as well. Although it is true that consignors, all of whom are necessarily also creditors, might know that Pacific deals in the goods of others, such knowledge cannot be extrapolated into a fact "generally known by its creditors." The purpose of § 2-326(3) is to protect general creditors of the consignee from claims of consignors who have undisclosed arrangements with the consignee. To impute as

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[1] The obvious reason for the exception for goods "used or bought for personal, family, or household purposes" is to avoid the situation where one who is not a merchant, and who should not therefore be deemed to know of the intricacies by which merchants protect their interests under the commercial code, unwittingly loses his right to property. If a householder occasionally delivers an item of property to a dealer to see if the dealer can sell it for him, the FCC protects that item from claims of the dealer's creditors. On the other hand, if the deliverer is one who deals in goods of the kind sold by the person to whom he delivers the goods, he should be held to the rules in the FCC that bind merchants. There are hybrid situations such as, for example, where one collects gemstones for his personal use and enjoyment but also regularly places the gems on consignment with jewelers to test the market and sell if the price is right. At some point the casual collector crosses over the line from being the householder, whom the personal goods exception is designed to protect, to being a merchant or dealer, who is bound by the filing or other protective provisions of § 2-326. In this case, Marigold is clearly at the extreme end of the merchant spectrum.

a matter of law the self- interested knowledge of the consignors/creditors to the general creditors does not give general creditors the opportunity to protect themselves from the undisclosed interests of the consignors.[2]

A consignor asserting that the consignee is "generally known by his creditors to be substantially engaged in selling the goods of others" must establish such general knowledge by proof other than that a few other consignors know that fact. He must establish that non-consignor creditors possess the requisite knowledge. Marigold failed to meet that burden of proof.

Accordingly, we affirm.

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[2] The result might be different if all or most of Pacific's creditors were flower consignors but the fact does not appear from the evidence in this case. If all or most of the creditors were consignors, then one might be able to conclude that the creditors did have such "general knowledge."

In re Levy
Bankruptcy No. 29054
United States District Court, E. D. Pennsylvania (1993)

In December 1992, Bernard Levy, owner of a retail shoe store in Reading, Pennsylvania, filed a voluntary petition in bankruptcy. One of his suppliers, Acme Shoe Co. (Acme), had delivered a stock of shoes to Levy for resale in his store under the terms of a written agreement in which Levy, the bankrupt, acknowledged that the shoes were "on consignment" and could be returned to the consignor at any time.

Acme has filed a reclamation petition to recover the shoes it delivered to the bankrupt. The trustee resists the petition on the ground that the transaction was one of "sale or return," and, since there had been no compliance with § 2-326(3) of the Pennsylvania Uniform Commercial Code, the stock of shoes while in Levy's possession was subject to the claims of Levy's creditors.

Acme concedes that it had not filed any financing statements in the public records offices. Acme did, however, produce evidence that small cards had been placed upon certain sections of shelving in Levy's store where Acme's shoes were stored and displayed, identifying the shoes placed on those sections of the shelving as shoes manufactured by Acme.

Under § 2-326 of the UCC, if goods are delivered to a consignor primarily for resale with the understanding that they may be returned by the consignor, the transaction is one of "sale or return" and such goods are subject to the claims of the buyer's creditors while in the buyer's possession even though the consignee has retained title. The consignee may avoid the consequences of having the goods subjected to the claims of the consignor's creditors by doing one or more of three things: (a) complying with "an applicable law" evidencing a consignor's interest or the like by a sign to that effect, or (b) establishing that the consignor is generally known by his creditors to be substantially engaged in selling the goods of others, or (c) complying with the provisions for filing financing statements and other notice documents under UCC Article 9 having to do with secured transactions.

There was no filing under Article 9. There was an effort by Acme to protect its goods by posting signs on the sections of shelving where its shoes were kept, but Acme has failed to show that there is in Pennsylvania "an applicable [sign] law" as that term is used in § 2-326(3)(a). The phrase "an applicable law" means a statute, and there is no such statute in Pennsylvania. Absent such a statute or an Article 9 filing, Acme is left with the burden of proving that Levy was generally known by his creditors to be substantially engaged in selling the goods of others.

Acme argues that, although the absence of a sign law might mean that the cards Acme caused to be placed on the shelves did not invoke the "sign law" subsection of § 2-326, the cards nonetheless served to impart

knowledge that Levy was selling the goods of others. That argument might have had some merit if Acme could have shown that the cards did in fact impart such knowledge to Levy's creditors to such an extent that it was "generally known" by the creditors and that the cards also suggested that Levy was "substantially engaged" in selling goods not owned by him. On the record before the court, however, the most that can be said is that the cards were designed to impart to Levy's *customers,* not his creditors, the knowledge that the shoes were Acme's. Thus, Acme's proof fell short.

Under § 544 of the Bankruptcy Act, the trustee is vested with the rights that the creditors had prior to the filing of the petition in bankruptcy. Section 2-326(2) of the UCC expressly makes goods held on sale or return subject to the claims of the debtor's creditors. That is the situation in this case.

Acme's petition for reclamation is denied