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Navigating Turbulent Economic Waters; Using the Uniform Commercial Code to Steady the Boat

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Hundreds of North Americans are losing jobs and avoiding malls as the general weakness in retail and manufacturing persists. During the last several years, hundreds of automotive parts manufacturers failed or contracted as a weakening economy, dropping demand for new cars and lack of liquidity within the financial markets forced automakers to slash production.\(^2\) Millions of homes remain caught in foreclosure and the tightened credit market refuses to loosen its grip on the United States manufacturing and service economies.\(^3\) Although pundits see optimism, those assigned to guard their company’s exposure to customers caught in today’s turbulent economic waters must equip themselves with life preservers to do their job.

Suppliers to manufacturers, retailers, and financial institutions are all being asked or “forced” to sell services

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and goods at reduced prices. Each day brings more Chapter 11 liquidation cases and an increase in out-of-court restructurings and liquidations. In today’s economic storm, each company should take a close look at its own customers and work to avoid the risk that the increased tension in the financial markets pose to business relationships and the ability to be paid for goods and services sold. Such an early assessment may assist companies in crossing these stormy and often turbulent economic waters.

This article provides a review of the various alternative strategies available in the Uniform Commercial Code (UCC) that provide protection for sellers of goods. Certain of these strategies may even assist sellers of services, who are not specifically protected by the UCC.

Part I of this Article details the proper procedure for demanding and receiving adequate assurances from potentially distressed buyers. Next, in Part II, the Article discusses when a seller possesses sufficient justification in interpreting a buyer’s actions as anticipatorily repudiating a contract. Part III outlines when a seller can stop delivery of goods in transit. Part IV describes the remedy of reclamation both under the UCC and the United States Bankruptcy Code and Part V highlights the proper way to sell goods on consignment and the benefits of doing so.

Now is the time for companies to evaluate their relationships with each of their customers and explore the options available to them. Companies may be able to avoid risks by exercising one of these strategies before their customer files for Chapter 7 or Chapter 11 relief, or simply closes its doors.

**Part I. — Adequate Assurance**

Often certain factors will lead a seller to believe that its buyer is experiencing financial difficulties which may result in the buyer's inability to pay for the seller's goods. This belief may stem from knowledge of turmoil in the buyer's industry, the failure of the buyer to pay for past invoices, or

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5 The U.C.C. has been adopted in all of the fifty states and a number of territories. The version used in this Article is that of the text and Official Comments of Article 2 as amended through 2002 as published by Thomson/West in 2010 in *Selected Commercial Statutes*.

6 U.C.C. § 2-102 states that Article 2 applies to transactions in goods which are defined in § 2-105(1).
other reasonable indications of insolvency, including the bankruptcy of the buyer. The UCC allows a seller to demand assurance of future performance under § 2-609.

Section 2-609 states:

(1) A contract for sale imposes an obligation on each party that the other’s expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either party the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return.

(2) Between merchants the reasonableness of any assurance offered shall be determined according to commercial standards.

(3) Acceptance of any improper delivery or payment does not prejudice the aggrieved party’s right to demand adequate assurance of future performance.

(4) After receipt of a justified demand, failure to provide within a reasonable time not exceeding 30 days such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract.

A court will determine the reasonableness of a seller’s grounds for insecurity according to the specific factual situation and not a particular legal standard.\(^7\) Both the Official Comments to the UCC and case law provide guidance regarding whether reasonable grounds for insecurity exist. The Official Comments state that the insecurity need not arise from the specific contract in question. “[A] buyer who falls behind in ‘his account’ with the seller, even though the items involved have to do with separate and legally distinct contracts, impairs the seller’s expectation of due performance.”\(^8\)

While a court will judge each situation by its particular

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\(^7\) See, By-Lo Oil Co. v. Partech, Inc., 2001 U.S. App. LEXIS 11402 (6th Cir. 2001) (listing factors sufficient to support a demand for adequate assurance, which may include failure to return phone calls and provide information)

\(^8\) U.C.C. § 2-609 Comment. 3; but see Cassidy Podell Lynch, Inc. v. SnyderGeneral Corp., 944 F.2d 1131, 15 U.C.C. Rep. Serv. 2d 1225 (3d Cir. 1991) (noting that although the buyer was beyond terms, this did not justify a failure of the seller to ship where the number of days beyond
facts, the standard of reasonableness remains an objective standard, not based upon subjective fears. What courts consider most frequently is whether there has been a change in circumstances that gives rise to the fear of non-payment or other inability to perform the buyer’s side of the agreement. The information regarding the buyer’s changed circumstances should come from a trustworthy source and serve as the basis for a reasonable belief that the buyer cannot perform. For example, information found in a reputable business or trade journal reporting that the buyer lost its largest customer, announcements in 8-K Securities and Exchange Commission submissions that a bankruptcy filing is close at hand, news of a down-grade of the buyer’s credit rating, loss of a line of credit with a lender, demonstrations of inability over a period of time to make payments timely and according to terms, may all be deemed reasonable grounds for insecurity by a court.

Section 2-609 authorizes the seller, upon reasonable grounds for insecurity, to demand adequate assurances of performance or the ability to pay and, until it receives such performance, to suspend any performance for which the seller has not already received the agreed return. The purpose of the demand under § 2-609 is to permit a party

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11See In re Pacific Gas and Electric Co., 271 B.R. 626, 47 U.C.C. Rep. Serv. 2d 598 (N.D. Cal. 2002); (finding that adequate basis for insecurity existed where company announced in its 8-K an impending bankruptcy, down-grade of its credit rating, its bank refused to honor a borrowing request and it failed to pay $33 million in maturing commercial paper); Clem Perrin Marine Towing, Inc. v. Panama Canal Co., 730 F.2d 186, 38 U.C.C. Rep. Serv. 490 (5th Cir. 1984) (holding that lessee of a tugboat had reasonable grounds for insecurity when its option to purchase the tugboat at lease-end became impaired when the lessor was found to have encumbered the tugboat with multiple mortgages); Rad Concepts, Inc. v. Wilks Precision Instrument Co., Inc., 167 Md. App. 132, 155, 168–169, 891 A.2d 1148, 1162, 1170–1171 (2006) (noting that seller had reasonable ground for insecurity where the buyer fell behind in payments and would not take seller’s telephone calls).
12See, e.g., In re Amica, Inc., 135 B.R. 534, 17 U.C.C. Rep. Serv. 2d 11 (Bankr. N.D. Ill. 1992) (asserting that seller was “obviously insecure” due
likely to be injured by the other party’s non-performance to take steps to protect itself without worrying that its own non-performance will later be construed as a repudiation.

To exercise the remedy of “adequate assurance”, the UCC requires a clear demand so that both buyer and seller are aware that, absent assurances, the demanding party will withhold performance.\textsuperscript{13} The plan language of § 2-609 does not require a written demand but prudence suggests that the seller create a written record of the demand to use if the dispute results in litigation.\textsuperscript{14}

The written demand should clearly state that the buyer of goods must provide adequate assurance within a specific

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\textsuperscript{13} U.C.C. § 2-609(1); see also AMF, Inc. v. McDonald's Corp., 536 F.2d 1167, 19 U.C.C. Rep. Serv. 801 (7th Cir. 1976) (asserting that actual notice, coupled with a promise to correct the deficiency, excused the failure to submit a written demand); Kunian v. Development Corp. of America, 165 Conn. 300, 334 A.2d 427, 12 U.C.C. Rep. Serv. 1125 (1973).

\textsuperscript{14} See AMF, Inc., 536 F.2d 1167, 19 U.C.C. Rep. Serv. 801. Kunian v. Development Corp. of America, 165 Conn. 300, 334 A.2d 427, 12 U.C.C. Rep. Serv. 1125 (1973) (finding that plaintiff’s oral demand for adequate assurance that defendant pay past due installments before plaintiff would make future deliveries was equivalent to a written demand for adequate assurance. Because defendant failed to make payments, plaintiff has reasonable grounds for insecurity and ultimately the contract was repudiated); See also Larry T. Garvin, ADEQUATE ASSURANCE OF PERFORMANCE: RISK, DURESS AND COGNITION, 69 U. Colo. L.Rev, 71, 100 (Winter 1998).
time, generally at least 30 days.\(^{15}\) The seller should state which specific assurances it deems acceptable. Failure to clearly state the request for adequate assurance may lead a buyer, and ultimately a court, to find that no actual request for adequate assurance occurred. For example, the court in Ward Transformer Co. v. Distrigas of Mass. Corp., 779 F. Supp. 823 (D.D.N.C. 1991), held that the letter the seller relied upon as a “demand for adequate assurance” did not clearly contain demand and additional evidence was required. The letter stated as follows:

This letter serves to acknowledge our telephone conversation of 5/4/90. We understand that Distrigas will take delivery of the equipment purchased by Distrigas on your P.O. #9015-203 during the first week of July. Your purchase contract states that the delivery of the transformer must take place six to eight weeks after receipt of your purchase order. We are more than happy to store the unit at our facilities . . .; Distrigas must, however, pay Ward Transformer the amount due on the enclosed invoice #46096 within 30 days of the invoice date. Your signed acknowledgement is expected.\(^{16}\)

In Ward Transformer Co., the court found that it simply was not clear that the demand was for adequate assurance of payment for all future purchases and seems to have questioned whether the buyer understood that this was a demand under § 2-609. Thus, the demanding party must clearly state the demand for adequate assurance and the time in which the demand must be met.

After the buyer supplies the “assurance”, the seller must be reasonable in assessing whether the assurance is reasonable. The Official Comments to § 2-609 provide some instruction as to what constitutes reasonable assurance. The Comments state, “[W]here the buyer can make use of a defective delivery, a mere promise by a seller of good repute that he is giving the matter his attention and that the defect will not be repeated, is normally sufficient. Under the same circumstances, however, a similar statement by a known corner-cutter might well be considered insufficient without the posting of a guaranty or, if so demanded by the buyer a speedy replacement of the delivery involved.”\(^{17}\)

If the seller refuses to perform after receiving reasonable

\(^{15}\) U.C.C. § 2-609(4).

\(^{16}\) 779 F. Supp. at 826.

\(^{17}\) U.C.C. § 2-609, cmt. 4.
assurance within 30 days, a court may find that the demanding supplier is in breach or has itself repudiated its performance.\textsuperscript{18}

Seller's rights found in § 2-609 do not disappear if a bankruptcy petition is filed by the buyer of goods. Often parties to supply contracts find themselves in the position where they must continue to supply goods to the debtor without assurance that the debtor will even be in existence at the time payment is due.\textsuperscript{19} Furthermore, the debtor is under no requirement to make payments on the past due balance until such time as the supply contract is assumed under 11 U.S.C.A. § 365. The automatic stay which comes into effect the moment the bankruptcy petition is filed requires that prior to the seller’s cessation of shipments, it seek an order from the bankruptcy court.\textsuperscript{20} Furthermore, the debtor is not required to assume or reject any executory contract, including supply contracts until such time as the debtor's plan is confirmed.\textsuperscript{21} Thus the non-debtor party is required to continue to supply and the debtor is not required to pay past due pre-petition invoices. If the debtor ultimately determines that it will assume the supply contract or assume it and assign it to another party, it must cure the pre and post-petition arrearages and provide adequate assurance of future performance.\textsuperscript{22} If the debtor determines that it will not assume the supply contract and has not paid for post-petition

\textsuperscript{18}U.C.C. § 2-610.


\textsuperscript{20}11 U.S.C.A. § 362.


\textsuperscript{22}11 U.S.C.A. § 365(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption,
shipments under the contract, the non-debtor party to the contract may be left holding an administrative claim against an insolvent estate.

Bankruptcy courts have protected suppliers by requiring cash in advance during the post-petition period or otherwise requiring the debtor to provide adequate assurance that post-petition deliveries will be paid. In the current climate of fast sales in the bankruptcy courts, a fear that post-petition deliveries to a debtor whose assets will be sold prior to the invoice due date is certainly not an unfounded fear. In the recent motion filed in the Visteon case, Panasonic Automotive Systems argued that the debtor had admitted in its schedules that it was insolvent, had only a small window during which it would have access to cash collateral and had not been able to arrange for Debtor-in-Possession financing. Furthermore, if Panasonic shipped to the debtor, payment would not be due for 55 days and Panasonic had no confidence that in 55 days, Visteon would be in existence, much less be able to pay the outstanding post-petition invoices.

except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.

23 In re Kellstrom Industries, Inc., 282 B.R. 787, 48 U.C.C. Rep. Serv. 2d 613 (Bankr. D. Del. 2002) (when the supplier stopped delivery of goods despite the fact that debtor already had legal title to goods which the debtor sought to sell under § 363 of the Bankruptcy Code) holding that the passage of title as part of contract did not eliminate or impair supplier’s right to stop delivery of parts under U.C.C. 2-702 and 2-705 and allowing the debtor to sell the goods provided that adequate protection was provided in the form of full payment in cash for all parts); In re Ike Kempner & Bros., Inc., 4 B.R. 31, 32–33, 1 Collier Bankr. Cas. 2d (MB) 544 (Bankr. E.D. Ark. 1980) (ordering supplier to continue to ship product subject to pre-petition contract so long as debtor paid cash in advance); In re Sportfame of Ohio, Inc., 40 B.R. 47 (Bankr. N.D. Ohio 1984) (ordering the seller to deliver but requiring to pay cash in advance or COD (where the seller refused to ship goods post-petition because of pre-petition arrearage)); In re Blackwelder Furniture Co., Inc., 7 B.R. 328, 341, 6 Bankr. Ct. Dec. (CRR) 1337 (Bankr. W.D. N.C. 1980) (requiring pre-petition suppliers to continue shipping goods for cash).
Thus, Panasonic argued it was entitled to adequate assurance under § 2-609.24

Requests for adequate assurance in the bankruptcy context require a more measured approach and the filing of a motion seeking adequate assurance. The basic premise of the UCC that a sale on credit even if a part of an on-going supply contract does not require that the seller deliver without a reasonable assurance that it will be paid.

**Part II. — Anticipatory Repudiation**

In a typical relationship between seller and buyer, certain factors, including statements or actions of the buyer, may lead the seller to believe that the buyer will be unable to continue to perform its obligations pursuant to applicable agreements. If the seller correctly interprets the buyer’s actions, the buyer may be deemed to have anticipatorily repudiated the contract. Section 2-610 of the UCC provides for this remedy:

When either party repudiates the contract with respect to a performance not yet due the loss of which will substantially impair the value of the contract to the other, the aggrieved party may

(a) for a commercially reasonable time await performance by the repudiating party; or

(b) resort to any remedy for breach (Section 2-703 or Section 2-711), even though he has notified the repudiating party that he would await the latter’s performance and has urged retraction; and

(c) in either case suspend his own performance or proceed in accordance with the provisions of this Article on the seller’s right to identify goods to the contract notwithstanding breach or to salvage unfinished goods (Section 2-704).25

A seller must cautiously proceed with respect to anticipatory repudiation, which is only deemed to occur when the statements or actions are unequivocal, definite and final, or where an action reasonably indicates a rejection of the

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24 Panasonic and Visteon have apparently settled the dispute as the motion was withdrawn approximately a month after filing. In re Visteon Corporation, Case No. 09-11786, Bankruptcy Court for the District of Delaware, Docket No. 661.

25 U.C.C. § 2-610.
continuing obligations. The danger for sellers lies in the risk of misinterpreting the alleged repudiation or inference that the other party cannot perform. If the seller infers incorrectly, it may be deemed the breaching party and incur damages for non-performance.

Because a lack of clarity may exist regarding whether a customer has repudiated, prudent sellers utilize the UCC remedy of anticipatory repudiation only after demanding adequate assurance as described in Part I. Without providing the customer with the chance to provide adequate assurance that it can perform, the supplier places itself in jeopardy of being found the breaching party if a court later determines that the apparent repudiation was not sufficiently clear and unequivocal to constitute an anticipatory repudiation justifying non-performance. In most states, courts require a clear indication that the buyer or seller, after receiving a request for adequate assurance of performance, provided no such assurances.

To qualify as an anticipatory repudiation, the performance repudiated must substantially impair the value of the contract to the other party. Thus, for example, under a requirements contract, the failure to order the required amount during the term may not suffice for anticipatory

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27 Neal-Cooper Grain Co. v. Texas Gulf Sulphur Co., 508 F.2d 283, 16 U.C.C. Rep. Serv. 7 (7th Cir. 1974) (finding that a seller incorrectly construed the buyer's actions as anticipatory repudiation of the contract and holding the seller liable to the buyer for damages when the seller suspended its own performance).


repudiation.\textsuperscript{30} A failure to perform which leaves a buyer facing a need to resource a part to another supplier may, however, be adequate to support the remedy of anticipatory repudiation.\textsuperscript{31} Similarly the failure to pay for past shipments under a supply contract after a demand that payment be made has been found to support repudiation of the contract.\textsuperscript{32} The primary requirement which a seller must meet prior to exercising anticipatory repudiation is a clear manifestation from the buyer of a positive intention not to perform.\textsuperscript{33} The manifestation may be in either words or conduct but must clearly demonstrate the intention not to perform. For example, in Gateway Aviation, Inc. v. Cessna Aircraft Co., 577 S.W.2d 860 (Mo. App. 1978), the court held that the purchaser’s failure, prior to and at the time it tendered two past due payments under an agreement for the purchase of an aircraft, to properly maintain, insure, and license the aircraft, as it was required, combined with the moving of the aircraft away from its home airport, in violation of the agreement, constituted a clear repudiation of the agreement on the purchaser’s part, justifying the seller in refusing to accept the delinquent payments, rescinding the contract and repossessing and reselling the aircraft.

\textbf{Part III. — Stopping Delivery of Goods in Transit to Buyer}

The UCC also provides a remedy for companies that recently shipped goods, before learning that their intended buyer is insolvent. UCC § 2-705 allows a seller to stop delivery of goods already in transit to the now insolvent buyer, but which have not yet been received by the buyer.\textsuperscript{34} Reduced to its essential elements, under UCC § 2-705, a

\begin{itemize}
  \item \textsuperscript{30}U.C.C. § 2-610 3.
  \item \textsuperscript{31}Fabrica Italiana Lavorazione Materie Organiche, S.A.S. v. Kaiser Aluminum & Chemical Corp., 684 F.2d 776, 11 Fed. R. Evid. Serv. 312, 34 U.C.C. Rep. Serv. 1193 (11th Cir. 1982) (finding anticipatory repudiation where seller realized it could not ship by contract deadline and buyer was forced to purchase other substitute goods).
  \item \textsuperscript{32}Kunian v. Development Corp. of America, 165 Conn. 300, 313, 334 A.2d 427, 12 U.C.C. Rep. Serv. 1125 (1973).
  \item \textsuperscript{33}LeTarte v. West Side Development, LLC, 151 N.H. 291, 855 A.2d 505 (2004).
  \item \textsuperscript{34}Specifically, U.C.C. § 2-705 states:
    Seller’s Stoppage of Delivery in Transit or Otherwise.  
    (1) The seller may stop delivery of goods in the possession of a carrier or other bailee when he discovers the buyer to be insolvent (Section
seller may stop the delivery of goods in transit if it discovers the buyer is insolvent and the goods have not been received by the buyer. The seller must notify the bailee to stop delivery and will be responsible to the bailee for any charges or damages it incurs.

The most often litigated issue with respect to stoppage of delivery of goods in transit is whether the buyer is in "receipt" of those goods. "Receipt" of goods occurs when the buyer is in physical possession of the goods. Therefore, stoppage must occur before the buyer has actual physical

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2-702) and may stop delivery of carload, truckload, planeload or larger shipments of express or freight when the buyer repudiates or fails to make a payment due before deliver or if for any other reason the seller has a right to withhold or reclaim the goods.

(2) As against such buyer the seller may stop delivery until:

(a) receipt of the goods by the buyer; or

(b) acknowledgement to the buyer by any bailee of the goods except a carrier that the bailee holds the good for the buyer; or

(c) such acknowledgement to the buyer by a carrier by reshipment or as a warehouseman; or

(d) negotiation to the buyer of any negotiable document of title covering the goods.

(3)

(a) To stop deliver the seller must so notify as to enable the bailee by reasonable diligence to prevent delivery of the goods.

(b) After such notification the bailee must hold and deliver the goods according to the directions of the seller but the seller is liable to the bailee for any ensuing charges or damages.

(c) If a negotiable document of title has been issued for goods the bailee is not obliged to obey a notification to stop until surrender of the document.

(d) A carrier who has issued a non-negotiable bill of lading is not obliged to obey a notification to stop received from a person other than the consignor

35U.C.C. § 2-705(1)-(2).

36U.C.C. § 2-705(3)(a)-(b).

37See, e.g. U.C.C. § 2-705(2)(a).

38U.C.C. § 2-103(1)(c). The Official Comment to § 2-103(1)(c) differentiates between "delivery" and "receipt." "Receipt' must be distinguished from delivery particularly in regard to the problems arising out of shipment of goods, whether or not the contract calls for making delivery by way of documents of title, since the seller may frequently fulfill his obligations to "deliver" even though the buyer may never 'receive' the goods.
possession of the goods. Constructive possession is irrelevant. Many buyers have argued that, pursuant to terms of their agreement with a seller, title to the goods passed from seller to them and therefore, the seller’s right to stop delivery of the goods expired. Buyers lose when they make this argument. Official Comment 1 to Section 2-702 of the UCC states, “The seller’s right to withhold the goods or to stop delivery except for cash when he discovers the buyer’s insolvency is made explicit in subsection (1) regardless of passage of title.” (Emphasis added)

Courts will look past the “F.O.B.” designation to the actual conduct of the parties when determining if a seller’s right to...
A seller’s right to stop goods in transit ends if an agent of the buyer comes into physical possession of the goods at issue. Courts are often asked to determine whether particular parties are agents or bailees of the buyer such that the right to stop goods has ended, or if they are “mere intermediaries” or “links in transit” which does not terminate a seller’s right to stop delivery.

This situation often arises when a seller conveys the goods to a third party for delivery to the buyer. The right to stop delivery is cut off if a carrier acknowledges to the buyer that it is holding goods for the buyer where the carrier is either a

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43 Interlake, Inc. v. Kansas Power and Light Co., 79 Ill. App. 3d 679, 34 Ill. Dec. 954, 398 N.E.2d 945, 949, 28 U.C.C. Rep. Serv. 689 (1st Dist. 1979). Although the face of a document indicated it was a buy-sell agreement, the court determined that the agreement was in fact treated by the parties as a transportation arrangement, disqualifying a tank owner from being a “subpurchaser” which would terminate seller’s right to stop delivery.


46 In In re Trico Steel Co., L.L.C., Inc., 302 B.R. 489 (D. Del. 2003), the seller (Cargill) and the buyer (Trico Steel) entered into an agreement for the purchase of pig iron, “CIFFO New Orleans.” Cargill purchased the iron from another company and arranged for carriers to ship and deliver the iron to New Orleans. Trico Steel contracted with Celtic Marine Corp. (“Celtic”) to arrange barge transportation for the iron from New Orleans to Trico Steel’s facility in Decatur, Alabama. Celtic in turn arranged for the barge carrier, Volunteer Barge & Transport, Inc. (“Volunteer”) to convey the iron to Decatur. When the iron arrived in New Orleans, stevedores hired by Trico Steel loaded the iron onto the barges. While the iron was in transit from New Orleans to Decatur, Cargill learned Trico Steel was insolvent and contacted Celtic to stop delivery of the iron. Cargill filed an adversary action seeking a declaratory judgment that it was entitled to immediate possession of the iron. The Bankruptcy Court entered a declaratory judgment in favor of Cargill and Trico Steel appealed. On appeal, Trico Steel asserted that Cargill’s right to stop delivery was cut off upon the stevedores’ unloading of the iron from Cargill’s carrier and loading it on Volunteer’s barge. Trico alleged that the stevedores were its agents and therefore, Trico Steel was in “receipt” of the iron within the meaning of Section 2-705(2)(a) when the stevedores unloaded the iron and then re-loaded it for transfer to Decatur. Cargill claimed the stevedores were “merely links in the transit” and that the iron had not reached its final destination, which was Decatur, Alabama. The court agreed with Cargill, finding “[t]he Bankruptcy Court correctly found that the stevedores hired by the Debtor were merely intermediaries or links in transit and not agents or employees of the Debtor who received the pig iron within the meaning of Section 2-705.”
“carrier by reshipment” or a “warehouseman.” To be considered either of these, an “acknowledgement by the carrier as a ‘warehouseman’ within the meaning of this Article requires a contract of a truly different character from the original shipment, a contract not in extension of transit but as a warehouseman.”

Acknowledgement has been found where goods were shipped to a buyer in care of a third party who was to coat pipes and then ship them where directed by buyer, and where the seller acknowledged to the buyer in agreements and other documents that the buyer had purchased goods and the seller was holding them for buyer for sale purposes.

Secured creditors of the buyer often join in litigation to assert that because they have a pre-existing, valid security interest under Article 9 of the UCC on property owned by a debtor/buyer, their interests are superior to a seller’s right to stop delivery under Article 2. Following examination of interrelated sections of the UCC, courts have rejected this argument.

UCC § 9-110 details the rights of Article 2 security interest holders under Article 9. However, this section does not cover a seller’s right to stoppage of goods before delivery. Official Comment 5 discusses this omission by noting that § 9-110 does not specifically address the conflict between a security interest created by a buyer and a seller’s right to stop goods under Section 2-702(l).

These priority conflicts are governed by the first sentence of Section 2-403(1), which provides “[a] purchaser of goods

47 U.C.C. § 2-705(2)(c).
48 U.C.C. § 2-705, cmt. 3 Looking at the Trico Steel shipment arrangement, Celtic and Volunteer were both parts of the “original shipment” of iron from Cargill to New Orleans then to Decatur and there was no “contract of a truly different nature.”
51 U.C.C. § 9-110.
52 U.C.C. § 9-110.
53 U.C.C. § 9-110, cmt 5.
acquires all title which is transferor had or had power to transfer except that a purchaser of a limited interest acquires rights only to the extent of the interest purchased."\textsuperscript{54}

Courts have determined that a buyer’s secured creditor’s rights “rise no higher than the Debtors’ rights. If the Debtors or [the secured creditor] want to terminate the right of [the seller] to withhold and stop delivery of the Parts, then they have to make a cash payment for the Parts in accordance with section 2-702(1).”\textsuperscript{55}

Good faith purchasers fare no better under the UCC. Knowing that a seller can stop delivery of goods any time up to when the goods come into actual physical possession by the buyer, courts have determined that “a seller’s right of stoppage is not cut off by the intervention of a third party good faith purchaser.”\textsuperscript{56}

\textbf{Part IV. — Reclamation}

Another, but more unique, remedy of a creditor under the UCC is that of reclamation.\textsuperscript{57} It is unique in the sense that it has a statutory counterpart embedded in the federal Bankruptcy Code.\textsuperscript{58} Reclamation concerns the ability of a seller of goods to regain possession of, or reclaim, goods it sold on credit and previously delivered to and which are in the hands of an insolvent buyer. If successful, a reclaiming creditor should come out whole, or the next best thing to being indefensibly paid for these goods. Unfortunately, this remedy, in both the UCC and bankruptcy contexts, can be toothless based on statutory limitations.

The right of reclamation is provided at UCC § 2-702 and states:

(2) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within 10 days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within 3 months before delivery the 10

\textsuperscript{54}U.C.C. § 2-403(1).


\textsuperscript{57}U.C.C. § 2-702.

\textsuperscript{58}11 U.S.C.A. § 546(c).
day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

(3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser\(^{59}\) under this Article (section 2-403).

As noted, to take advantage of this remedy, the seller must make demand within 10 days after the buyer receives the goods.\(^{60}\) Although the UCC does not require a seller to make the demand in writing, a prudent seller will make a written demand and transmit it on an expedited basis by overnight courier, email and/or facsimile to the buyer. This demand should contain a list of the specific goods shipped by invoice number and description. The seller should retain records concerning proof of delivery, the invoices for the reclaimed goods and the actual written notice of reclamation in the event judicial enforcement of the demand is necessary.

Also note that the buyer must have been insolvent when the goods were received.\(^{61}\) The UCC defines the term "insolvent" as a person "who either has ceased to pay his debts in the ordinary course of business or cannot pay his

\(^{59}\) A prior version of Section 2-702(3) of the U.C.C. made the seller's right subject to the rights of a "lien creditor" in addition to the rights of a buyer in the ordinary course or other good faith purchaser. By referencing U.C.C. Section 2-403, however, which addresses the confines of a good faith purchaser, a lien creditor as contemplated under Article 9 of the U.C.C. on secured transactions is viewed as the equivalent of a purchaser of goods. Nonetheless, the issue arises whether or not the claims of a secured creditor can nonetheless defeat the reclaiming seller's rights. Most courts have held that the secured party qualifies as a good faith purchaser. However, and in an interesting decision, the United States Court of Appeals for the Sixth Circuit held in Phar-Mor, Inc. v. McKesson Corp., 534 F.3d 502 (6th Cir. 2008) that secured creditors are not the equivalent of good faith purchasers, at least where the secured creditor's claim was repaid, retroactive to the petition date through a post-petition loan. While that may have little significance where the buyer ends up in bankruptcy because Bankruptcy Section 546(c) expressly applies to lien creditors, the Sixth Circuit suggested another basis by which secured claims may not serve to trump reclamation claims. That is where the seller (soon to be debtor) ordered the goods in contemplation of bankruptcy. The court deemed such an event fraudulent such that the buyer obtained no rights in the goods to which the secured party's lien could attach and thus it would not have a secured claim in these goods.

\(^{60}\) U.C.C. § 2-702(2).

\(^{61}\) U.C.C. § 2-702(1).
debts as they become due or is insolvent within the meaning of federal bankruptcy law." 62 In many instances, the event which triggers the seller's suspicion of the buyer's insolvency is hearing that the buyer has ceased business or where the buyer fails to pay one or more delinquent invoices at a promised date or the filing of an involuntary bankruptcy against the buyer. Moreover, and while the UCC does not require that the demand state the basis of the insolvency, it remains good practice to do so in creating an evidentiary record. Also note that the 10-day maximum recovery period is excepted where the buyer has misrepresented the condition or status of its solvency in the prior three months, for instance, if the buyer provided a false financial statement to the seller. 63

For the seller to successfully recover goods, the goods must be in the same shape or condition as when they were delivered to the buyer. 64 If the goods are altered or integrated into another component or otherwise consumed or further sold, they cannot be recovered, even if the seller made an ap-

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62 The Bankruptcy Code, at Section 101(32), defines “insolvent” to mean:

(a) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of—

(i) Property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and

(ii) property that may be exempted from property of the estate under section 522 of this title;

(b) with reference to a partnership, financial condition such that the sum of such partnership's debts is greater than the aggregate of, at a fair valuation—

(i) all of such partnership's property, exclusive of property of the kind specified in subparagraph (A)(i) of this paragraph; and

(ii) the sum of the excess of the value of each general partner's non-partnership property, exclusive of property of the kind specified in subparagraph (A) of this paragraph, over such partner's non-partnership debts; and

(c) with reference to a municipality, financial condition such that the municipality is—

(i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or

(ii) unable to pay its debts as they become due.

63 U.C.C. § 2-702(2).

appropriate and timely demand. Of course, the goods need to still be at the buyer’s location once the demand is received.\textsuperscript{65}

The largest impediment to the successful assertion of a reclamation demand is the subjection of the seller’s rights to a buyer in the ordinary course or other good faith purchaser under Section 2-702(3). Pursuant to this provision, a seller’s reclamation rights are “subject to”\textsuperscript{66} the rights of a secured creditor with a security interest in inventory, which, as previously noted, is deemed to be a good faith purchaser. Consequently, reclamation of the goods may not be possible if a creditor of the buyer holds a security interest in inventory that attaches to like goods sold on credit.

In a vast majority of instances, the buyer will finance its working capital and this financing will be secured by a lien on the buyer’s inventory, thus cutting off the efficacy of this remedy to the seller. Nonetheless, if the reclamation demand is proper and the goods are not subject to the lien of a secured lender and have not been consumed or sold, the seller has the right to a return of the subject goods. Under the UCC, the seller may use “self-help” to obtain possession of the goods, but may not breach the peace to do so.\textsuperscript{67} Thus, if the buyer refuses to turn over the goods, the seller may be required to file a replevin action in state or federal court to obtain possession.

Further, also note that should the reclamation demand prove successful, the seller should act diligently in seeking to recover its goods. Some courts have held that the demand is not effective as to the seller’s goods in the debtor’s hands at the time the demand was made but rather at the time the seller actually sought to reclaim them.\textsuperscript{68} Thus, for instance, if the debtor files bankruptcy at a point where the initial

\textsuperscript{65}Id.

\textsuperscript{66}Note that the advent of a creditor having a prior lien in the buyer’s inventory does not serve to extinguish the reclaiming seller’s rights, but rather subordinates these rights to the secured creditor. Of course, if the secured creditor is fully secured, this is a distinction without a difference inasmuch as the reclaiming seller’s rights will be valueless. See Bindley Western Industries v. Reliable Drug Stores, Inc., 181 B.R. 374, 379, 33 Collier Bankr. Cas. 2d (MB) 817 (S.D. Ind. 1995), aff’d, 70 F.3d 948, 34 Collier Bankr. Cas. 2d (MB) 1496, Bankr. L. Rep. (CCH) P 76740 (7th Cir. 1995).

\textsuperscript{67}U.C.C. § 9-609(b).

demand is beyond the lookback period provided under the Bankruptcy Code counterpart, then the seller is out of luck inasmuch as the automatic stay would serve to cut off the seller’s otherwise legitimate right to reclaim its goods in the buyer’s possession.\footnote{See, e.g., Matter of Crofton & Sons, Inc., 139 B.R. 567, 22 Bankr. Ct. Dec. (CRR) 1457, 17 U.C.C. Rep. Serv. 2d 782 (Bankr. M.D. Fla. 1992), but see Matter of Griffin Retreading Co., 795 F.2d 676, Bankr. L. Rep. (CCH) P 71251, 1 U.C.C. Rep. Serv. 2d 1187 (8th Cir. 1986).}

The Bankruptcy Code preserves the seller’s ability to reclaim goods sold to a buyer on credit prior to the bankruptcy filing irrespective of the automatic stay and subjects the trustee’s so called “strong-arm powers” to these rights.\footnote{11 U.S.C.A. § 546(c)(1).} The reclamation provision in the Bankruptcy Code is in some instances more expansive, but also more rigid than its UCC counterpart. While the overall intent of the remedy may be the same, i.e. to allow a seller to regain possession of goods sold to an insolvent buyer, the efficacy of this particular provision may be even less availing than its UCC cousin although the “administrative reclamation claim” described later greatly enhances the seller’s rights to be paid.

The statute (11 U.S.C.A. § 546(c)(1)) provides:

Except as provided in subsection (d) of this section and in section 507(c), and subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under sections 544(a), 545, 547, and 549 are subject to the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller’s business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days before the date of the commencement of a case under this title, but such a seller may not reclaim such goods unless such seller demands in writing reclamation of such goods—

(a) not later than 45 days after the date of receipt of such goods by the debtor; or

(b) not later than 20 days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.

While the “lookback” period is expanded to 45 days irrespective of whether or not the buyer misrepresented the condition of its solvency, the Bankruptcy Code reclamation right is expressly subject to the rights of a creditor who possesses a security interest in that type of good or its proceeds. However, if the creditor is over-secured, there may be a basis
for the reclamation claimant to obtain its goods or a replacement lien or administrative claim in the amount of the goods.

In order to avail itself of this right, the seller must make a written demand within the requisite time periods, and the goods at issue must have been sold to the buyer in the ordinary course of the seller’s business.\footnote{Thus, the remedy might not apply to a sale of items not routinely sold by the seller or if the sale was the first sale of such goods to the buyer.} In addition to the prescribed requirement that the demand be in writing, it is also good practice for the notice to specifically identify the goods in question and include copies of invoices or other documentation which further identify the goods and also the delivery or receipt date on the buyer’s end. Again, the seller must be able to demonstrate that the debtor was insolvent at the time the demand is made.\footnote{U.C.C. § 2-702(1).}

The second part of the Bankruptcy Code reclamation remedy at Section 546(C)(2) provides:

If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9).

Section 503(b)(9) provides for the allowance of an administrative claim for the “value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor’s business.”\footnote{11 U.S.C.A. § 503(b)(9).}

It is because of these rights and because of the difficulties in sustaining a reclamation demand that many seller creditors bypass the Section 546 remedy solely in favor of a seller’s rights under Section 503(b)(9).

The benefit to a holder of a 503(b)(9) claim is not just the fact that its claim is given administrative priority\footnote{The Bankruptcy Code establishes a scheme of what type of claim is to be repaid in what order. Administrative claims fall in second place in this scheme, immediately behind secured creditors and ahead of general unsecured creditors. While there are a variety of allowable administrative claims, they share equal priority to the extent of available funds.} but also, and unlike the reclamation remedy, the prior lien of a secured creditor in the goods will not serve to defeat the 503(b)(9) claim. Although in many cases, the debtor, with the court’s and oftentimes with the creditor’s committee’s
approval, will establish a procedure (including a deadline) for the filing of these types of claims. In the absence of such a procedural order, a reclamation administrative claim is submitted as any other administrative claim, that is, pursuant to the requirements of Bankruptcy Code § 503(a) which merely provides for the filing of a “request for payment of an administrative expense.”

The 503(b)(9) “reclamation” administrative claim is somewhat of a misnomer in that the traditional administrative claim relates to post-petition activity, whereas the 503(b)(9) claim concerns a pre-petition act. Nonetheless, Congress afforded this select group of pre-petition creditors administrative claim status such that these claims are entitled to priority in payment the same as all other administrative claims. How much alike the 503(b)(9) administrative claim is to other administrative claims has been, and will likely continue to be, the subject of developing case law.

One issue which has generated much debate in the case law and literature since the enactment of this statute is when reclamation administrative claims are to be paid. The weight of the case law treats these claims as most other of the various allowable administrative claims such that they are not entitled to payment until plan confirmation pursuant to Code Section 1129(a)(9)(A) unless the claimant agrees to another time or it is within the discretion of the bankruptcy court, as with any other administrative claim.

Two other issues considered by courts include whether or not Section 503(b)(9) applies to a sale of goods in which the seller itself maintained a security interest and whether or not the debtor could offset pre-petition claims it had against the seller. In re Brown & Cole Stores, LLC, (Brown & Cole Stores, LLC v. Associated Growers, Inc.), 375 B.R. 873 (B.A.P. 9th Cir. 2007), the bankruptcy court found that 503(b)(9) applies as equally to secured claims (whether

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75 Note that in the absence of a procedural order, there is no set deadline for filing the claim other than it be “timely” pursuant to this Bankruptcy Code Section (or even tardily if permitted by the Court “for cause”).

76 Code Section 503(b)(9) came into being, along with the current version of Code Section 546(c), in 2005 upon the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (or BAPCPA, for short).


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claim is over or undersecured) but that the debtor could not offset its pre-petition claim against the seller’s administrative claim. The 9th Circuit Bankruptcy Appellate Panel affirmed on the issue regarding the secured claim, but reversed on the setoff issue because even though the 503(b)(9) claim is an administrative claim, it arises from pre-petition conduct and thus, is subject to setoff against the pre-petition debt as there is a congruence of the requisite temporal mutuality of the debts.

Another recently contested issue is whether or not Bankruptcy Code Section 502(d) can serve as a bar to allowance of the 503(b)(9) administrative claim. Code Section 502(d) provides that the bankruptcy court “shall disallow any claim of any entity from which property is recoverable under Section 542, 543, 550 or 553 . . . or that is a transferee of a transfer avoidable under section . . . 544, 545, 547, 549, 549 . . . , unless such entity or transferee has paid the amount or turned over any such property, for which such entity or transferee is liable . . ..” In its most typical application, 502(d) serves to bar a creditor’s claim against the debtor where the creditor received avoidable transfers under the preference provisions of Bankruptcy Code Section 547.

Although not specifically involving a 503(b)(9) claim, the Second Circuit in ASM Capital, LP v. Ames Department Stores, Inc. (In re Ames Department Stores, Inc.), 582 F3d 422 (2nd Cir. 2009) cert. denied, 2010 WL 596884 (No. 09-726) decided that Section 502(d) does not serve to bar payment of administrative expenses under Code Section 503(b), in general, and thus by extension, to 503(b)(9) claims. However, a bankruptcy court specifically dealing with a 503(b)(9) claim held that Section 502(d) does require the “temporary” disallowance of 503(b)(9) claims (although not other administrative claims) relying on the distinction that 503(b)(9) claims relate to pre-petition acts. Here, the court conceded to the majority view that 503(b) administrative claims (or more appropriately, expenses) are prohibited from attack under section 502(d) because they are not “claims” (even though so referred at various provisions in the Bankruptcy Code) in the sense they originate from the filing of a proof of claim.

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78 In re Bookbinder’s Restaurant, Inc., at 876.
79 In re Bookbinder’s Restaurant, Inc., at 881.
and are not “disallowed” as are general unsecured claims under Section 502. The 503(b)(9) claim is, however, a claim that is subject to Section 502(d) because it arises out of prepetition activity and a creditor sought this claim initially by filing a proof of claim. Pursuant to this court’s thinking, by temporarily disallowing the 503(b)(9) claim pending the trustee’s preferential recovery or other avoidance action, a court can prevent the 503(b)(9) claimant from receiving a windfall by both being paid on its 503(b)(9) claim and using the same claim as the basis for a new value defense to defeat all or a portion of the preference claim. Other courts, however, have held that a creditor can take advantage of its unpaid pre-petition shipment of goods by both receiving an administrative claim in the amount of the goods and to also use that amount as new value to offset preference exposure.

The Bankruptcy Code does not define “goods” which has also led to a variety of issues concerning the scope of a seller’s right to qualify for this favorable treatment. The Courts which have confronted this issue generally rely on the UCC definition of goods (“all things which are moveable”). Similarly, bankruptcy courts have applied UCC case law to determine that the provision of services does not qualify for 503(b)(9) treatment; but in the context of mixed goods and services, the portion of the claim relating to goods (to the extent it can be isolated) is entitled to 503(b)(9) treatment, even if the “predominant” nature of the transaction may be the provision of services. In an interesting twist, although following similar reasoning, courts have also found that the supply of certain utility services (i.e. electricity) is not covered by 503(b)(9) whereas others (i.e., the supply of

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81 In re Circuit City Stores, Inc., at 7–9.
82 In re Circuit City Stores, Inc., at 7–9.
84 U.C.C. § 2-105.
natural gas and water) are. Lastly, the “goods” at issue must have been (although perhaps constructively) delivered to the debtor not, for instance, to the debtor’s customer in order for the creditor to reap the benefits of the statute.

**Part V. — Consignment**

If a customer is purchasing goods on open credit terms and files bankruptcy or is subject to a senior security interest in its inventory, the goods which have been sold and delivered to the buyer are not retrievable by the seller if the buyer is unable to pay. Thus, one pre-bankruptcy strategy is to structure the sale of the goods that will be stored as inventory as a consignment sale. Although consignment sales require additional paperwork, monitoring, and the filing of a UCC-1 financing statement, under the right circumstances such sales may allow the seller to repossess the goods not sold to bona fide purchasers for value.

In order for a seller to properly take advantage of the benefits offered by structuring a sale as a consignment, it must make sure that all of the elements of an Article 9 consignment relationship exist. Under Article 9, a valid consignment consists of: 1) a transaction where a person delivers goods to a merchant for sale; 2) where the merchant deals in goods of that kind, is not an auctioneer, and is not generally known by its creditors to be substantially engaged in selling the goods of others; 3) where the aggregate value of the goods exceeds $1,000; 4) the goods are consumer goods immediately prior to delivery; and 5) the transaction does not create a security interest that secures an obligation.

Article 9 refers to a party that places goods for sale on

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88 Specifically, U.C.C. § 9-102(a)(20) provides that “Consignment” means a transaction, regardless of its form, in which a person delivers goods to a merchant for the purpose of sale and:

(A) the merchant:

(i) deals in goods of that kind under a name other than the name of the person making delivery;

(ii) is not an auctioneer; and

(iii) is not generally known by its creditors to be substantially engaged in selling the goods of others;
consignment as a consignor and the party receiving the goods to sell as a consignee.\textsuperscript{89}

The goods must be delivered to a merchant for sale. The Uniform Commercial Code defines a merchant as a “person that deals in goods of the kind or otherwise holds itself out by occupation as having knowledge or skill peculiar to the practices or goods involved in the transaction or to which the knowledge or skill may be attributed by the person’s employment of an agent or broker or other intermediary that holds itself out by occupation as having the knowledge or skill.”\textsuperscript{90}

In order for the provisions of Article 9 to be applicable to a consignment sale, the goods for sale cannot be delivered to a merchant who is regularly known by its creditors to be substantially engaged in selling the goods of others.\textsuperscript{91} Such knowledge can defeat a consignment relationship for purposes of Article 9.\textsuperscript{92} The policy behind this distinction centers upon the protection of merchants extending credit from “secret liens” on a consignee’s inventory.\textsuperscript{93} Creditors doing business with those \textit{generally known} to be \textit{substantially engaged} in the business of dealing in consigned goods would not place value on blanket lien rights when evaluating the credit risk. Absent this general knowledge of substantial

(B) with respect to each delivery, the aggregate value of the goods is $1,000 or more at the time of delivery;
(C) the goods are not consumer goods immediately before delivery; and
(D) the transaction does not create a security interest that secures an obligation.

\textsuperscript{89}U.C.C. §§ 9-102(a)(19) and (21).

\textsuperscript{90}U.C.C. § 2-104(1).

\textsuperscript{91}U.C.C. § 9-102(a)(20)(A)(iii).

\textsuperscript{92}See, e.g., Nasco Equip. Co. v. Mason, 229 S.E.2d 278, 285 (N.C. 1976) (noting that the purpose of the statute is to protect innocent creditors from deception by ostensible ownership) (internal citations omitted). Note that goods that are delivered to a merchant generally known by its creditors to be substantially engaged in the sale of goods to others are not considered inventory under Article 9 and thus are not subject to the same risks that goods placed with merchants not known to be selling the goods of others.

\textsuperscript{93}In re G.S. Distribution, Inc., 331 B.R. 552, 561 (Bankr. S.D.N.Y. 2005) (stating that U.C.C. 9-1-2(a)(20)(A)(iii) was designed to make sure that a consignee’s general creditors are put on notice of the consignor’s interest in the property and to protect such general creditors from claims of consignors that have undisclosed consignment relationships with the consignee that result in secret liens on the consignee’s inventory).
engagement in consigned goods, creditors are entitled to rely on a search of lien records.94

Most courts interpreting this element of the consignment test require evidence that a majority of a merchant’s creditors possessed knowledge that the merchant regularly sold the goods of others in order to defeat a finding of consignment.95 However, at least one court found that actual knowledge by a particular creditor will defeat the consignment relationship with respect to that particular creditor.96

Article 9 defines what constitutes a security interest in certain objects of personal property, provides instructions on perfecting security interest, and governs which security interests are given priority when more than one party possesses a security interest in any given object.97 Article 9 also

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94 See White and Summers, Uniform Commercial Code § 30-4 (5th ed).
95 In interpreting Indiana’s consignment law, an Indiana bankruptcy court in In re Downey Creations, LLC, 414 B.R. 463, 70 U.C.C. Rep. Serv. 2d 44 (Bankr. S.D. Ind. 2009), recently found that the burden of proof rests with the consignor to prove that the majority of its creditors knew that it was substantially engaged in selling the goods of others to avoid its responsibility to file a financing statement. Id. at 471. The court further held that the consignor bears the burden of demonstrating that the majority of its creditors knew that it was substantially engaged in selling the goods of others and noted that testimony as to general practice in the industry was insufficient to establish knowledge by a majority of creditors. Id. The court recognized that consignors should bear the risk of failure to file: “. . . if a consignor chooses not to file a financing statement, it must then bear the burden of proving that the transaction is not subject to Article 9 if and when a dispute arises.” Id. at 470. The court also recognized the public policy reasons behind encouraging disclosure of consignment relationships. “[P]lacing the burden of proof on the consignor provides some incentive for the consignor to file a U.C.C. financing statement to protect its interest simply out of an abundance of caution. That, in turn, not only discourages ‘secret liens’, but also provides more predictability, thereby reducing the need for costly litigation such as the case at hand.” Id. at 471.
96 Fariba v. Dealer Services Corp., 178 Cal. App. 4th 156, 100 Cal. Rptr. 3d 219, 70 U.C.C. Rep. Serv. 2d 193 (4th Dist. 2009), review denied, (Jan. 21, 2010) (holding that actual knowledge of a creditor with a perfected security interest in inventory that a consignee was substantially engaged in selling the goods of others defeats the rights of that particular creditor in the inventory because he is not the innocent creditor the statute was designed to protect).
governs the competing interests of parties in consigned goods and the priority of security interests in consigned goods. 98

When a party places property with a consignee to be sold on consignment, it is deemed to be a consignor under Article 9. 99 Article 9 provides that a consignor's security interest in a consigned good is a purchase money security interest in inventory in the goods being consigned. 100 Therefore, upon placement of property on a consignee's lot or warehouse to be sold on consignment, a consignor's interest in the property converts to a purchase money security interest in inventory in the property.

When a consignor places property on a consignee's lot or warehouse for sale, the property becomes part of the consignee's inventory and thus subject to any blanket security interests on inventory filed against the consignee, unless the consignor takes proper steps to protect its interest in the goods. In commercial transactions, parties commonly grant blanket security interests in their personal property, including inventory and accounts receivable, in exchange for the extension of credit. Typically, borrowers grant creditors blanket security interests in inventory through security agreements. 101 Parties perfect their blanket security interests in inventory by filing UCC-1 Financing Statements with the Secretary of State's Office for the state in which the grantor of the interest is incorporated. 102 Financing Statements provide notice to third parties, who can search the Secretary of State's database where a company is located and discover any liens against that company's inventory. 103 Consignors must be aware of these blanket security interests and take the proper precautions to protect their security interest in goods placed for sale on consignment.

98 U.C.C. § 9-324.
100 U.C.C. § 9-103(d) (stating “[t]he security interest of a consignor in goods that are the subject of a consignment is a purchase-money security interest in inventory”).
101 See U.C.C. § 9-110 (describing the general effectiveness of a security agreement to create a security interest in property).
102 U.C.C. § 9-310 (providing for perfection of security interests through the filing of financing statements).
103 Allen v. First Nat. Bank of Monterey, 845 N.E.2d 1082, 1085, fn. 6 (Ind. Ct. App. 2006) (“A properly filed financing statement serves as notice to the rest of the world that the secured party has taken a security interest in the collateral.”).
In general, Article 9 abides by a “first in time, first in right” rule with respect to the perfection of security interests. However, in order to protect holders of purchase money security interests from prior holders of blanket security interests, Article 9 provides special rules for the perfection and priority of purchase money security interests. Under Article 9, a holder of a purchase money security interest in inventory can perfect its interest in property and gain priority over previously filed blanket liens by: (1) filing a UCC financing statement with the applicable Secretary of State and (2) sending timely notices to the other creditors who hold blanket security interests in the consignee’s inventory.

Thus, under Article 9, if an owner wants to place property with another party to be sold on consignment, it should first run a simple UCC Financing search on the applicable Secretary of State’s webpage to determine if anyone possesses a prior security interest in the consignee’s inventory. In order to protect itself from prior blanket liens in inventory, a consignor should file a UCC Financing statement of its own with the applicable Secretary of State’s Office and send existing lien holders notice informing them of its purchase money security interest in the specified property. If a consignor follows these three simple steps, its purchase money security interest in the consigned property will trump prior blanket security interests in inventory filed against a consignee.

If a consignor fails to file a UCC Financing Statement of its own, it will be left with an unperfected security interest. Under Article 9, an unperfected security interest is junior and subordinate to all perfected security interests. Similarly, if a consignor files a UCC Financing Statement but fails to send PMSI notices to prior blanket lien holders of the consignee, it will have a perfected security interest but its perfected security interest will not trump previously

104 U.C.C. § 9-322(a)(1).
105 U.C.C. §§ 9-324(b); 9-502 et seq.
106 U.C.C. § 9-324(b).
filed blanket liens. Instead, the typical “first in time, first in right” rules of Article 9 will apply and the consignor will have priority over only those liens perfected after it filed its Financing Statement.

As noted above, selling products on consignment allows a consignor to avoid previously filed blanket liens on a purchaser’s inventory. This can prove particularly valuable when a consignor sells inventory to a struggling business whose creditors are more likely to foreclose on such liens and repossess inventory. Because consigned property is not property of a consignee, when a consignor properly perfects its security interest, a consignee’s creditors are prohibited from foreclosing on the consigned property. Similarly, if the goods are properly sold on consignment, and the consignor takes the proper steps to perfect its security interest; in the event of a bankruptcy, the consigned goods are not the debtor’s property and thus are not part of the bankruptcy estate.

109 U.C.C. § 9-317(a); see also generally Bruce S. Nathan, Consignment the Wrong Way or How to Become Last in Line, 21 Am. Bankr. Inst. J. 14 (Nov. 2002).
