

CONSIGNMENT:

HOW TO PROTECT CONSIGNED ASSETS IN THE UNITED STATES

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The Consignment.

The consignment contract is frequent in the United States. In a consignment, the seller (consignor) delivers the goods to the buyer (consignee) for further resale to third parties. The consignor retains title to the goods, which is transferred directly to the third party purchaser upon sale, and does not issue an invoice until the consignee sells the goods. In some sectors, such as jewelry, artwork and antiques, carpets and fine materials, the consignment is especially frequent. Similarly, the consignor can deliver goods not for resale, but as spare parts or raw materials to be used on the consignee equipment or to be converted into a finished product.

The consignment is an effective tool to penetrate new markets or to test market reaction to new products, even in cases where the dealer does not have the financial capacity to buy the products; it provides security² in commercial transactions when dealing with companies in financial difficulties; it allows faster delivery to end customers, usually at no warehousing cost to the supplier. A consignment of spare parts allows a manufacturer to establish a spare part deposit at the customer's facilities, thereby making up for the lack of technical assistance facilities in the country of destination and allowing the customer to maintain continuity of production. Consignment is often a necessity for a small equipment manufacturer having no direct presence in another country to reach important customers.

On the other hand, the consignment may have some drawbacks: the retailer may be inclined to push other products in its own inventory, instead of promoting the sale of the goods on consignment; the products are located off-site, but the sale is not completed and the products could be returned unsold; non-payment by the end-customer can be a risk if not properly addressed in the contract; and finally, the consignment may, in some cases, constitute a risk of a fiscal nature, as it may be deemed sufficient to create a permanent establishment in the State.

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² Provided that the formalities described below are properly followed.

The Consignment Agreement

A consignment agreement must be in writing. Often the parties enter into a Master Consignment Agreement which regulates all subsequent deliveries and is supplemented by “Memos” which govern the individual supplies. It is essential that the agreement and all other documentation consistently identify the object of the contract as a consignment and provide that title to the goods will remain with the supplier until sold to third parties.

A Consignment Agreement must regulate all aspects of the relationship. Thus the parties should regulate in detail matters such as the documentation of orders on consignment; reports on sold or used goods; use of the parties on a First-In-First-Out (FIFO) basis to avoid return of products that are no longer usable or expired; duty to keep the goods segregated, not to move them without the consignor’s consent, identify them as the property of the supplier, to insure them and to indicate the supplier as “additional insured”; provision of restocking fees in favor of the consignor in case the goods are returned; audit rights at the consignee 's locations to reconcile with existing inventory; right of the parties to terminate unilaterally, duty to return the goods upon termination against a restocking fee, and final reconciliation of inventory.

It is important that the contract be drawn up in accordance with US legal practice. The omission of certain clauses, not necessary in other countries, can result in costly consequences for the consignor. For example, the provision according to which the losing party must pay the legal fees does not apply in the United States unless expressly provided by the parties; interest in case of late payment is not due unless provided between the parties; unless excluded or limited in due form, implied warranties provided by law would apply, etc.

Protection vis-à-vis third parties

Even if a contract contains safeguards to protect the consignor as listed above, it provides no protection against other secured creditors or in case of bankruptcy. Thus, although the goods may be kept separate, duly identified, supported by Memo or orders that clearly identify them as being the property of the supplier on consignment, the consignor would have no rights in the goods and would be relegated to the status of an unsecured creditor for payment of the price.

It is customary for businesses to secure financing secured by a blanket security interest in all debtors’ present and future goods, including inventory and the proceeds thereof. The bank will have a security interest in the debtor's inventory which conflicts with the title of the consignor in goods held by the debtor on consignment. If certain steps are not taken, the bank will be able to take possession of the goods in the inventory, including the consignment goods owned by the

supplier. In the case of bankruptcy, the trustee will treat such goods as the goods of the bankruptcy, primarily to the benefit of secured creditors, and may even recover any payments made to the consignor in the 90 days prior to bankruptcy (turnover action).

To ensure that the consignment be perfected against the rights of third parties, US law provides for a procedure that includes several steps:

- The consignor must file a form (“UCC-1³ financing statement”) with the Secretary of State in the state of incorporation – not the Secretary of State of the place where its goods are located or where the consignee has its headquarters.
 - The form requires the name and address of the parties, a general description of the collateral, and the nature of the relationship.
 - Accuracy is essential:
 - The name of the consignee must be correct. If the name is misspelled, even slightly, the filing is ineffective;
 - The legal nature of the debtor must be accurate. If the type of organization is inaccurate (for instance, “Inc.” instead of “LLC” or similar), the filing is ineffective;
- The filing must be made at the Secretary of State’s office of the State in which the consignee is incorporated. It is therefore necessary to obtain from the consignee a representation as to the correct name, the type of corporate entity and the State in which the entity is established;
- The collateral can be identified in general terms (e.g., “all property, goods and merchandise on consignment delivered to consignee, including without limitation _____”). Note that it is advisable to extend the security interest to the money generated by the sale of the asset (proceeds).
- The filing is valid for 5 years and must be renewed before the expiry date by filing a similar form (UCC-3 Continuation Statement);

³ The Uniform Commercial Code that governs UCC filings has been adopted, with small variations, by 49 out of 50 States. Louisiana has a civil law system and has not adopted the Uniform Commercial Code in its entirety.

- After filing of the UCC-1, the same must be properly managed in order to maintain its effectiveness. If the consignee changes name, a filing reflecting such change must be made within 4 months, otherwise the deposit becomes ineffective with regard to goods delivered after the change of name; if the debtor reincorporates in another State, a new UCC-1 must be filed in the new State, etc.
- The UCC-1 must be filed **before delivery of the goods.**

In addition to filing, the consignor must notify all creditors that have a conflicting interest in the consigned property, such as a security interest in inventory. A UCC search must be conducted to identify creditors having a conflicting interest, and notice of the creation of the consignment must be given in writing to each such creditor.

Exceptions to the requirement of filing of UCC-1

The procedure described above is not necessary:

- When the consignee is an auction house;
- When the value of the goods is less than \$ 1,000;
- When the dealer is generally known to creditors to be substantially engaged in selling goods on consignment⁴
- The goods are not consumer goods immediately before delivery.

Other applications of UCC-1

The regime of UCC-1 filing is a necessary tool to ensure that the right to goods in the possession of a third party is perfected against third parties. For example, the right on property in leasing should be protected by filing a UCC-1 form similarly to what was described above⁵, to ensure enforceability against third parties.

Equally, in an installment sale with retention of title, unless a UCC-1 financing statement is properly filed the seller's rights to the goods in the case of non-payment will not be perfected and other secured creditors would take precedence on those goods.

⁴ This provision should not be relied on except in very limited cases since courts interpret it very narrowly.

⁵ In case of equipment the form must be filed within 20 days from delivery, and no notice to holders of conflicting interest is due.

Legal forms similar to Consignment

Different from consignment sales is the so-called “sale or return”. In a “sale or return” title in the goods is transferred to the buyer. If the same does not resell the goods within a specified period, the buyer has the right to return them to the supplier. Also in this case, it is good practice to file a UCC-1 to secure the return of property in case of nonpayment of the price.

In a bailment the goods are delivered in the custody and control of a third party, normally on the basis of a contract whereby the bailee is responsible for the custody and return (or delivery to a third party) of the goods. The goods remain the property of the bailor. A UCC-1 is technically not required in a bailment contract, but it is advisable to file a UCC-1 to obtain priority over a lender blanket security interest.