

## Misguided California Court Changes “Consignment” Standard

Because it is often difficult to distinguish a true consignment relationship — where the consignee acquires possession of goods, holds them for sale, and then remits a portion of the sale proceeds to the consignor — from a security device, revised Article 9 treats many true consignments as a security interest. As a result, consignors must generally file a financing statement to perfect their interests and send notification of their transactions to existing inventory lenders to have PMSI priority.

One of the exceptions to this rule is if the consignee is “generally known by its creditors to be substantially engaged in selling the goods of others.” See UCC § 9-102(a)(20)(A)(iii). A true consignment to such a consignee is governed by the common law of bailments, with the result that the consignor need not file a financing statement and the goods are not available to the creditors of the consignee.

The California Court of Appeals misapplied this standard in *Fariba v. Dealer Services Corp.*, 178 Cal. App. 4th 156, 2009 WL 3191538 (Cal. Ct. App. 2009). The case involved a priority dispute between a used car dealer’s inventory lender and a consignor.

**The facts.** The inventory lender, California Auto Sales & Leasing (CASL) had a perfected security interest in the dealer’s inventory. Fariba, an auto wholesaler, supplied about 45% of the dealer’s inventory, all through consignment. Under their arrangement, Fariba delivered the vehicles, retained the title, and agreed with the dealer on a sales price for the vehicle, to be paid after the dealer sold the car. Fariba released the title only upon receiving payment but did not file a financing statement.

The dealer defaulted on its loan from CASL and went out of business. At that time, Fariba had 45 vehicles on the dealer’s lot, separated from the remainder of the dealer’s inventory. The dealer told Fariba that he could retrieve the vehicles at any time and gave Fariba the keys to the cars. Fariba arranged for drivers to pick up the cars and successfully removed 31 vehicles. When the Fariba’s drivers returned to get the remaining 14 vehicles, they found CASL repossessing

them. The parties disputed what occurred after that point and what representations were made, but the end result was that CASL obtained the cars and Fariba sued for conversion. The jury returned a special verdict. It concluded that: (i) CASL had actual knowledge that the dealer was substantially engaged in the business of selling vehicles that belonged to others; and (ii) Fariba had possession of the vehicles when CASL repossessed them. The trial court therefore entered judgment for Fariba.

**The court’s analysis.** CASL appealed, challenging the jury instructions. The appellate court began its analysis with UCC § 9-319, which provides that “while the goods are in the possession of the consignee, the consignee is deemed to have rights and title to the goods identical to the consignor.” From here the court moved to UCC § 9-102(a)(2), which defines a “consignment.” The court correctly quoted the definition and then noted that Fariba had not attempted to prove that the dealer was generally known to be selling the goods of others. Rather, Fariba had sought to prove and the jury had found that

CASL had actual knowledge that the dealer was substantially engaged in selling the goods of others. The court ruled that this was sufficient to take the transaction outside Article 9. The court based its conclusion on the policy underlying Article 9 and pre-revision cases.

**Why the court was wrong.** The court's analysis is unfortunate. It transforms what is supposed to be a purely objective inquiry into a subjective one — or perhaps to a mix of both subjective and objective tests. In *In re Downey Creations, LLC*, 2009 WL 11941 (Bankr. D. Ind. 2009), the court held that a putative consignor bears the burden of proof on whether a transaction fails to qualify as an Article 9 consignment because the consignee is “generally known by its creditors to be substantially engaged in selling the

goods of others”; this requires evidence that a majority of creditors—determined by their number, not the amount owed to them—knew that the debtor was substantially engaged in selling the goods of others. It is an objective test.

In using a subjective standard, the California court did not seem to understand or appreciate how anomalous the analysis might become. Under the court's view, the nature of a transaction between A and B (a consignor and consignee, respectively) — and the law that governs it — is determined by what C (a creditor of B) knows. The court gave no consideration to the fact that there may be multiple Cs, some of whom know the nature of B's business and some of whom do not. In such a case, the consignment transaction between A and B would apparently be both inside and outside Article 9. Presumably this could lead to circular priorities, with no

### A Consignment Table

Set forth below is a table dividing all consignment-like transactions into four types—illustrating very different legal frameworks.

Transaction	Description / Attributes	Governing Law	Rights of Third Parties
True Consignment Not Covered by Article 9	Consignor retains title and has a right to get the goods back and one or more of the following is true: (i) the consignee is known by its creditors to be substantially engaged in selling the goods of others; (ii) the aggregate value of the goods is less than \$1,000; or (iii) the goods were consumer goods in the hands of the consignor	Law of Bailments	Goods are not subject to creditors of the consignee.  Proceeds of the goods may be held by the consignee in trust for the consignor.
True Consignment Covered by Article 9	Consignor retains title and has a right to get the goods back and none of the three conditions is true.	Article 9	Goods and their proceeds are subject to creditors of the consignee.
False Consignment	Consignment structure is a security device. No realistic chance that “consignor” will ever get the goods back, perhaps because the “consignee” will use them in a manufacturing process or has an obligation to buy them.	Article 9	Goods and their proceeds are subject to creditors of the consignee.
Sale or Return	Title to the goods is transferred to the buyer, but the buyer has the option to return the goods.	Article 9	Goods and their proceeds are subject to creditors of the buyer.

logical way to break the circle. Courts should not so blithely depart from the statutory text.

**The relevance of continued possession for consignments.**

The second portion of the court's analysis was even more intriguing. Recall that Fariba was, with the dealer's permission, in the process of retrieving the vehicles when CASL repossessed them. The jury had found that Fariba was in possession. The court accepted this finding, concluding that physical custody and control was not necessary for possession. "It is sufficient to have actual custody and control, with the intent of exercising such control." Because the cars were segregated and the dealer had given the keys to Fariba agents, there was a sufficient basis for the jury's determination.

What the court left unsaid was the significance of possession. By accepting the conclusion that Fariba, not the dealer, was in possession of the cars, the court seems to have concluded that UCC § 9-319 was no longer applicable. Section 9-319 provides that if a consignment is governed by Article 9, the consigned goods are available to the consignee's creditors "while" the goods are in the consignee's possession. This appears to be a temporal limitation on attachment. In other words, while the consignee has possession, the consignee may grant a security interest in the goods. But, if the consignee releases possession, UCC § 9-319 no longer applies. The implications from this are twofold. First, the consignee cannot now grant a new security interest in the goods. Second, any security interest the consignee previously granted apparently de-attaches. If that is what the court meant, its conclusion is questionable.

**Some concluding thoughts.** Consider how this might apply in other contexts. Debtor grants a security interest to Inventory Lender, who properly perfects. Supplier consigns goods to Debtor in a transaction governed by Article 9. Supplier either fails to perfect or fails to give prior notification of the transaction to Inventory Lender. As a result, Supplier fails to obtain PMSI priority under UCC § 9-324(b) and Inventory Lender has priority under UCC § 9-322. Yet if Supplier repossess the goods, Inventory Lender's security interest de-attaches and Supplier is the only person with an interest in the goods. It is highly doubtful that UCC § 9-319 was intended to upset established priorities in this manner.

**The story above was written by Stephen L. Sepinuck,**

**Professor, Gonzaga University School of Law. Professor Sepinuck is the former chair of the UCC Committee of the American Bar Association and currently serves as the ABA Advisor to the Joint Review Committee for Article 9 of the UCC.**

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