Simmons First National Bank v. Wells: An Interpretation of the Uniform Commercial Code's Consignment Rule

by

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CASE NOTE

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I. FACTS

On May 1, 1980, Simmons First National Bank of Pine Bluff agreed to loan $520,000 to Western Rice Mills, Inc. To secure the loan, Western gave Simmons a security interest in all of Western's real and personal property, including its total inventory and any after-acquired property.

Harold Wells was a local farmer who had sold his rice crop to Western for several years. Western, in turn, processed the rice and sold the finished product to other buyers. Wells sought a similar arrangement with his crop in the spring of 1981, but because of financial difficulties, Western was unable to purchase it outright. The parties instead reached an oral agreement whereby Western would take possession of the rice, mill it, and try to sell it for a fixed price. If the rice was sold, Western would deduct its charges for milling, and pay the balance to Wells.

In September of 1981, Western's financial problems worsened, which forced the company into receivership. Simmons began foreclosure proceedings against Western in chancery court. Wells intervened, claiming legal title to his rice in Western's possession, as well as proceeds collected from rice previously sold. Simmons maintained that the arrangement between Wells and the mill was a "sale or return" under Ark. Stat. Ann. § 85-2-326,[1] giving the bank's security interest priority.

The trial court found that the agreement between West-

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1. Ark. Stat Ann. § 85-2-326 (Supp. 1983).

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

ern and Wells was actually a bailment, and therefore that § 85-2-326 was inapplicable. This interpretation meant that Wells had maintained ownership of the rice held by Western, and that it was not subject to the lien of Simmons.

The Arkansas Supreme Court reversed the decision.[2] It held that § 85-2-326 was applicable, since the transaction between Wells and Western met the description of a "sale or return" under subsection (3). Further, since Wells had not shown that he had complied with the notice requirements of the Act to protect his interest, his claim was subordinate to the rights of the secured bank. The court also recognized the possible difficulties with this holding in light of Arkansas Legislative Act 401 of 1981,[3] but declined to resolve them

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(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 the 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 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 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 the goods of others, or

(c) complies with the filing provisions of the article on secured transactions (Article 9 [§§ 85-9-101 - 85-9-507]).

(4) Any "or return" term of a contract for sale is to be treated as a separate contract for sale within the statute of frauds section of this article (Section 2-201 [§ 85-2-201]) and as contradicting the sale aspect of the contract within the provisions of this article on parol or extrinsic evidence (Section 2-202 [§ 85-2-202]).

(5) The provisions of this section shall not apply to the placement of works of fine art on consignment.

2. Simmons First National Bank v. Wells, 279 Ark. 204, 650 S.W.2d 236 (1983).

3. Act 401 of 1981—Title to Grain Stored in Public Warehouse

77-1339. DEFINITIONS

(a) "Grain" means rice, soybeans, wheat, corn, rye, oats, barley, flaxseed, sorghum, mixed grain, and other food grains, feed grains, and oil seeds.

(b) "Public grain warehouseman" means any person, firm, or corporation who

since the issue was not raised at the original trial. Instead, the Court ordered that the impact of Act 401 be argued at a new trial, since it could affect the eventual outcome of the dispute.

II. BACKGROUND

Prior to Arkansas' adoption of the Uniform Commercial Code by the state legislature in 1961, lawsuits involving alleged consignments were often decided by the application of general maxims of common law and the Uniform Sales Act.[4] Whether a consignor maintained title to the goods consigned, even though they were in the possession of the consignee, was a question of fact which depended upon the intentions, good-faith and overall conduct of the parties to the agreement.[5] If no fraudulent circumstances were found, the consignor's rights to the goods would prevail over the claims of any lienholders of the consignee, even if the terms of the lien theoretically extended to the goods.[6] Indeed, the arrangement often closely resembled a bailment, in that a

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operates any building, structure or other protected enclosure used for the purpose of storing grain for a consideration.

(c) "Owner" means the farmer who grows and produces grain and includes the owner of the land from which the grain is produced to the extent that he has an interest in the same, and includes persons, firms and corporations engaged in growing and producing of grain whether it be as tenant, renter, landowner, or otherwise.

77-1340. TITLE TO GRAIN

Ownership of grain shall not change by reason of an owner delivering grain to a public grain warehouseman, and no public grain warehouseman shall sell or encumber any grain within his possession unless the owner of the grain has by written document transferred title of the grain to the warehouseman. Notwithstanding any provision of the Uniform Commercial Code (Act 185 of 1961 [§ 85-1-101 *et seq.*], as amended) to the contrary, or any other law to the contrary, all sales and encumbrances of grain by a public grain warehouseman are void and convey no title unless such sales and encumbrances are supported by a written document executed by the owner specifically conveying title to the grain to the public grain warehouseman.

4. *See* Ludvigh v. American Woolen Co., 231 U.S. 522 (1913); Alexander v. Tomlinson, 40 Ark. 216 (1982), Snuff Co. v. Stuckey, 197 Ark. 540, 123 S.W.2d 1063 (1939). The Uniform Sales Act (Ark. Stat. Ann. § 68-1401 - 68-1480), was, of course repealed in 1961 when the Arkansas legislature adopted the Uniform Commercial Code.

5. *Id. See also* Liebowitz v. Voiello, 107 F.2d 914, 916 (2d Cir. 1939); Taylor v Fram, 252 F. 465 (2d Cir. 1918).

6. *Recent Developments—Commercial Transactions: U.C.C. Section 2-326 and Creditor's Rights to Consigned Goods*, 65 COLUM. L. REV. 547 (1965).

consignee, at least in Arkansas, was not held liable to the consignor for the damage or destruction of goods found to be on consignment.[7]

Some courts, however, made exceptions to the "consignment rule" in instances where its application did not lead to equitable results. For example, as one federal district court noted:

> Regardless of the legal theory of the consignment, in practical operation it looks like a sales transaction in which the unpaid seller retains a secret lien in his goods. From a creditor's point of view, the consigned goods appear to be part of the regular inventory of the consignee which, therefore, ought to be subject to their claims. What is more, unlike a pre-code chattel mortgage, there is no public filing or other notoriety respecting the consignment to warn the creditors that the consignor may have rights in the goods which are superior to theirs.[8]

As a result, protection of the consignor's interest was often thwarted as a "secret lien against creditors"[9] or as a sale contemplating "repurchase."[10] Other exceptions were based on the doctrines of estoppel, ostensible ownership, and apparent authority to invalidate ambiguous transactions.[11]

The difficulties caused by consignments were not ignored by the drafters of the Uniform Commercial Code. The Code specifically dealt with these problems in Section 2-326(3)[12] by strictly limiting the "true" consignment transaction, and recognizing it as valid against the consignee's creditors only if certain rules were followed or conditions met.[13] The provision also protected creditors from ". . . any dis-

7. American Snuff Co. v. Stuckey, 197 Ark. 540, 123 S.W.2d 1063 (1939).

8. *In Re* Gross Mfg. and Importing Co., 328 F. Supp. 905, 909 (1971), citing Shanker, *Bankruptcy and Article 2 of the Uniform Commercial Code*, 40 Journal of the National Conference of Referees in Bankruptcy No. 2, reprinted in 89 N.J.L.J. 648, at 648 (1966).

9. Liebowitz v. Voiello, 107 F.2d 914, 916 (2d Cir. 1939).

10. Standard Fashion Co. v. Magrane Houston Co., 254 F. 493, 495 (D. Mass. 1918), *aff'd* 259 F. 793 (1st Cir. 1919), *aff'd* 258 U.S. 346 (1922).

11. Dolan, *The U.C.C.'s Consignment Rule Needs An Exception For Consumers*, 44 OHIO ST. L.J. 21, 22 (1982).

12. Same as ARK. STAT. ANN. § 85-2-326 (3).

13. *See supra* note 1. *See also* Ark. Stat. Ann. §§ 85-1-201, 85-9-114 and 85-9-408.

parity between ostensible and actual ownership of goods."[14] Following the adoption of the code by a majority of the states, most courts began to apply the explicit standards of 2-326(3) to consignments instead of the more difficult and abstract prior tests.

Even the rule under the Code, however, became subject to exceptions. Courts have sometimes declined to apply 2-326(3) literally in favor of creditors where the consignor was a "consumer."[15] Also, at least one case has held that the statute should not be used against the consignor where the secured creditor has actual notice of the consignment.[16]

The Arkansas legislature has recognized two exceptions to the Code rule. First, works of art were recently exempted from the statute in Ark. Stat. Ann. § 85-2-326(5).[17] Second, Act 401 of 1981 essentially created a farmer—public grain warehouseman exception to 85-2-326(3). The act was passed in reaction to the problems encountered by farmers with the increased number of grain warehouse bankruptcies that occurred in the late 1970's and early 1980's.[18] Such bankruptcies often resulted in huge losses for the farmer who had deposited his grain in a failed facility, in that the complicated (and confusing) proceedings would often take many months to resolve, and his unsecured crop gave him only secondary lien priority.[19] Public awareness of these difficulties reached a climax with the controversial decision in what was commonly known as the *James Brothers* case[20] and the

14. *Recent Developments—Commercial Transactions: U.C.C. Section 2-326 and Creditor's Rights to Consigned Goods*, *supra* note 6 at 549.

15. Dolan, *supra*, note 11 at 24.

16. GBS Meat Industry Pty. Ltd. v. Kress-Dobkin Co., Inc., 474 F. Supp. 1357, 1362 (1979) citing U.C.C. § 2-326 and official comment. Also, "actual" notice should not be confused with "legal" notice.

17. This was also known as the Artist's Consignment Act of 1983, Ark. Stat. Ann. §§ 68-1806 - 68-1811.

18. Acts of Arkansas, 1981, Vol. II, Book 1, pp. 707-08. *See also* Bankruptcy Reform Act of 1978 (Grain Elevator Insolvencies): Hearings on S.839 before the Subcommittee on Courts of the Senate Committee on the Judiciary, 97th Congress, 1st Sess. 145 (1981).

19. Missouri v. United States Bankr. Court (*In Re* Cox Cotton Co.; *In Re* Missouri), 647 F.2d 768 (8th Cir. 1981). This case provides an excellent example of the problems described.

20. *Id.*

surrounding protests by "victimized" farmers such as Wayne Cryts.[21]

Act 401, which was adopted three weeks after the Cryts incident, was designed to protect farmers from these situations by enhancing their rights to deposited grain.[22] The main provision of the Act is that a farmer is legally assumed to maintain ownership to grain he stores with a public grain warehouseman until he either gives a written waiver of this right or similarly transfers title to the warehouseman.[23] The Act specifically overrules the contrary U.C.C. provisions that would otherwise be the applicable law.[24] The apparent effect of the Act, therefore, is to bring this narrow band of transactions back within the rules of the pre-Code era, with the presumed result being a more favorable treatment of the farmers' interests by the courts.[25]

III. THE DECISION

In *Simmons*, the Arkansas Supreme Court upheld a strict reading and application of the terms of 2-326(3). Thus, Well's transaction with Western was ruled an unprotected consignment, which is treated by the Code as a "sale or return" and is subject to attachment of a valid security interest, like the one held by Simmons.

The court first considered the opinion and rationale of the lower court. The judgment there had relied primarily upon the Fifth Circuit case of *In Re Sitkin Smelting and Refining Co., Inc.*[26] In *Sitkin*, the Eastman Kodak Corporation had made an agreement with the Sitkin Company whereby Sitkin would process rejected film (made by Ko-

21. *Arkansas Gazette*, Feb. 17, 1982, at 1A. Wayne Cryts received much media attention when he violated an order from a federal bankruptcy court and removed "his" soybeans from a Missouri grain warehouse owned by the James Brothers on Feb. 16, 1982. He said it was the elevator that was bankrupt, not his beans; and that his actions would help to ". . . get a single law out of this, not a complicated mess that means a lawyer's heydey." (*Arkansas Gazette*, Feb. 18, 1982, at 12).

22. *Supra* note 3.

23. *Id.*

24. *Id.*

25. *See supra* note 20.

26. 639 F.2d 1213 (5th Cir. 1981).

dak) in order to recover its silver content. Kodak reserved complete ownership and control over the film until its ultimate "destruction or change in identity."[27] After recovering the silver, Sitkin would buy it from Kodak on the basis of a pre-arranged pricing formula.

Sitkin filed for bankruptcy soon after the contract became effective, and Kodak sued to recover a significant amount of film in Sitkin's possession. A three-judge panel held, despite one judge's strong dissent, that several factors made the parties' arrangement a bailment and not a sale;[28] therefore, Kodak's rights would prevail over a secured creditor. The court also rejected any application of U.C.C. § 2-326, on the ground that it was not relevant since ". . . the goods were not delivered for resale with an option to return."[29]

The Arkansas Supreme Court found that this approach could not be correctly applied to the *Simmons* situation. Although the facts of the cases were somewhat analogous, the court concluded that the primary issue in *Sitkin* was whether the transaction was a sale at all as opposed to a bailment. It also hinted that it found the reasoning in *Sitkin* less than satisfactory.[30] Despite this latter view, even if the trial court found a bailment under *Sitkin*, the nature of this transaction was such that § 85-2-326 should have been considered as well. The opinion stressed the fact that *labeling* a transaction as a sale or bailment does not determine the rights of the parties involved; rather, it is the character of the transaction in terms of the Code that is critical. Thus, if the agreement between Wells and Western met the criteria defining a

27. *Id.* at 1214.

28. The factors surrounding the transaction the court found indicative of a bailment were: (1) Kodak retained an option to have the film returned to it at any time; (2) Sitkin was solely responsible for the care of the film; (3) even when the film was in the possession of Sitkin, it was still labeled as Kodak's and separated from other inventory; and (4) Sitkin's accounting did not show the film as a receivable.

29. 639 F.2d 1213, 1218 (5th Cir. 1981).

30. Simmons First National Bank v. Wells, 279 Ark. 204, 208, 650 S.W.2d 236 (1983). The court stated that "[a]lthough we are not convinced that the court was correct in finding a bailment and not a sale in Sitkin . . . ."

"sale or return" in § 85-2-326(3), that section alone would govern the dispute.

In analyzing the application of § 85-2-326(3) to the claims of Wells and Simmons, the court cited a bankruptcy case, *Matter of KLP, Inc.*[31] In *KLP*, a finance company had made arrangements with KLP, Inc. for the storage of two organs it had repossessed. When the organs were delivered to KLP, which regularly sold organs and other related goods, the agreement was modified so as to allow KLP to receive offers for the purchase of the organs and sell them upon the finance company's approval. KLP later filed for bankruptcy and the finance company sued for possession of the organs. The court found that the transaction fit the requirements of a "sale or return" under U.C.C. 2-326(3); since the finance company had not complied with the applicable notice provisions, its status was secondary to the bankruptcy trustee, who was a "hypothetical lien creditor"[32] under applicable bankruptcy law.

With little discussion, *Simmons* adopted the reasoning of the *KLP* case.[33] The court simply acknowledged the opinion as "sound" and consistent with the actual language and official comments of § 85-2-326(3). Thus, since Wells delivered his rice to Western for sale, and since Western had a place of business that dealt with rice under a name different than the person making the delivery, the circumstances which create a "sale or return" under § 85-2-326 occurred. Since Wells had not filed a security interest covering the crop under Article Nine, nor proven that Western was known by its creditors to deal substantially in the kind of goods involved, Simmons' lien was indeed superior.[34]

31. *In Re* KLP, Inc. Finance Co. of America v. Morris, 7 B.R. 256 (Bankr. N.D. Ga., 1980).

32. *Id.* at 250.

33. The court did quote extensively from *KLP* concerning its discussion of the purposes behind § 2-326: "The section's importance lies primarily in the role it plays, along with the notice requirements of Article Nine, in giving disclosed claims to property priority over secret claims."

34. Arkansas does not have a "sign" statute, which essentially is another form of giving notice of ownership by placing a corresponding sign at the consignee's place of business. Therefore, this mode of protection would not be applicable.

The court then considered two additional arguments made by Wells. It quickly dispensed with his contention that there had to be a "sale" from the consignee to the consignor before § 85-2-326 could be applied.[35] The second argument, however, presented the much more difficult problem of Act 401. Wells asserted that the purpose of the Act was that the U.C.C. should no longer govern transactions between a farmer and a public grain warehouse and argued that the Act should be applied to this case even though the issue was not raised at trial.

Although the court acknowledged that it did have the power to affirm a decision on theories not argued below, it would not do so without adequate reasons to support such an action.[36] The reasons must come from the facts essential to the theory, which, in turn, must at least have been pleaded to the lower court.[37] The court held that the trial record was not sufficient to apply the Act to the case, particularly its definition of a "public grain warehouseman."[38] The court closed with a recommendation that the new trial should focus on this issue.

IV. ANALYSIS

Simmons correctly distinguished the *Sitkin* analysis, which differed from the approach *Simmons* was to take in at least two major respects. First, the somewhat ambiguous arrangement between Kodak and Sitkin required that the court there look into the circumstances surrounding the transaction to determine what the parties had intended. Further, after examining these circumstances, the *Sitkin* court used its findings to decide that § 2-326(3) was not applicable. *Simmons* did not totally reject the rationale used by *Sitkin*, but instead held that a transaction which appears

35. The court cited Matter of KLP, 7 B.R. 256 (Bankr. N.D. Ga., 1980); Bufkor, Inc. v. Star Jewelry Co., Inc., 552 S.W.2d 522 (Tex. 1977); Manger v. Davis, 619 P.2d 687 (Utah 1980); and General Electric Co. v. Pettingell Supply Co., 199 N.E.2d 325 (Mass. 1964) as authority.

36. Palmer, et al v. Cline, 254 Ark. 393, 494 S.W.2d 112 (1973).

37. *Id.*

38. *See supra* note 3.

to be a "sale or return" must first be analyzed under the explicit terms of § 85-2-326. If the transaction meets the criteria of the statute, then that statute alone governs the rights of the parties, and what may have been otherwise intended is irrelevant.

The position taken by *Simmons* in refusing to consider factors extraneous to agreements that fall within the ambit of § 85-2-326 appears to be sound.[39] This stringent interpretation has been adopted by a majority of the courts that have faced similar questions.[40] Such a view is further supported by the Code itself, which was designed in many instances to eliminate or simplify the judicial burden of determining the purposes and intentions of parties involved in commercial transactions.[41] Moreover, the official commentary to § 85-2-326 says that all reasonable doubts as to the nature of a transaction are to be resolved in favor of creditors.[42] Also, the section takes away the general legal effect of such contract terms as "on consignment" or "on memorandum," which are often used to manifest the parties' intentions in such cases.[43]

Although the results of this approach may sometimes appear harsh, the *Simmons* court's extensive reliance on the *KLP* opinion implies that the statute should be broadly applied and upheld. *KLP* emphasized an important reason for this, i.e., that requiring public notice of claims to goods held

39. It should be noted that some courts have recognized the intentions of the parties as important when there is an issue as to whether a transaction is a "true" consignment. "True" consignments are found, for example, when a manufacturer wishes to make the retailer his agent instead of selling the goods directly to him, so that the manufacturer can maintain control over price, etc. More explicitly, a "true" consignment is made for purposes other than security reasons. Ark. Stat. Ann. § 85-9-114 was drafted to deal with this type of consignment. *See also* Columbia International Corp. v. Kempler, 46 Wis.2d 550, 175 N.W.2d 465 (1970); Navman v. First Nat. Bank of Allen Park, 50 Mich. App. 41, 212 N.W.2d 760 (1973).

40. *See* Bischoff v. Thomasson, 400 So.2d 359 (Ala. 1981); American Nat. Bank of Denver v. Christensen, 28 Colo. App. 477, 476 P.2d 573 (1970); Newhall v. Haines, 10 B.R. 1019 (Mont. 1981); Sussen Rubber Co. v. Hertz, 19 Ohio App. 2d 1, 249 N.E.2d 65 (1969); *In re* Gross Manufacturing and Importing Co., Inc., 328 F. Supp. 905 (N.J. 1971).

41. Dolan, *supra* note 11, at 38.

42. Official Comment 2, § 85-2-326.

43. *Id.*

by another is a desirable element ". . . of any well-reasoned system of commercial law."[44] Further, the protections offered by the Code,[45] especially the consignor's option of filing a financial statement,[46] do not appear to be unduly burdensome.[47]

It is interesting that the only exception noted by *Simmons* to this rule was Act 401, given the state legislature's recent activities in this area and the controversial nature of the case. In choosing not to apply this exception, the *Simmons* court raised a critical question about the definitions put forth by the Act. A "public grain warehouseman" is very broadly defined, in that it is ". . . any person, firm, or corporation who operates any building, structure or other protected enclosure used for the purpose of storing grain for a consideration. . . ."[48] However, the Act itself is not clear as to how far this should be extended. Therefore, whether the Act covers a rice mill like Western, which obviously had made provisions for keeping Wells' rice even though it was not primarily a storage facility,[49] is an issue that the court in *Simmons* could not rightfully resolve on the record before it.

The solutions proposed by the Arkansas legislature in Act 401 seem, at best, problematic. In determinations of whether grain has been "sold" or merely "deposited," as well as in the area of the validity of written title transfers, the Act seems merely to reinstate problems which the U.C.C. was formulated to solve.[50] Therefore, despite the good in-

44. 279 Ark. at 210, 650 S.W.2d at 240.

45. *See generally*: § 85-9-401 through § 85-9-408.

46. Sound arguments to the contrary can, of course, be made. For example, most laymen would not be aware of the Code provisions. Also, proving that the consignee was generally known by his creditors to be substantially engaged in the sale of the kind of goods delivered can be a difficult task. *See* Weidinger Chevrolet, Inc. v. Universal C.I.T. Credit Corp., 501 F.2d 459 (8th Cir. 1974), and *In Re* Webb, 13 U.C.C. Rep. 394 (Tex., 1973).

47. 279 Ark. at 212, 650 S.W.2d at 242.

48. ARK. STAT. ANN. § 77-1339(b) (1981).

49 Interview with Mark Hesse, attorney for Simmons First National Bank, Pine Bluff, Arkansas (Sept. 20, 1983). Mr. Hesse explained that Western had no storage facilities for grain, and would ordinarily sell the milled rice on the same day it was delivered and processed.

50. For example, the requirement of a written transfer of title to prove ownership actually appears to be very similar to the security interest provision of the Code.

tentions of Act 401 in trying to protect a farmer like Wells, the Act may indeed create more of a "crisis" than the one it attempted to resolve.

CONCLUSION

Under *Simmons*, commercial transactions which satisfy the three alternative criteria of a "true consignment" under § 85-2-326(3) will be held absolutely to the terms of the statute, despite any contrary intentions of the parties involved. Therefore, unless a consignor protects his interest by complying with the statute's notice requirements, the consigned goods may be subject to the liens of secured creditors. Although results under this statute may sometimes be less than equitable, this approach is supported by the Code's language and a majority of the extant decisions. Act 401 of 1981 is a legislative exception which the court recognizes may apply to the facts of the case, but it appears necessarily to entail a return to the problems of the pre-Code era.

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