PLACING YOUR GOODS "ON CONSIGNMENT" WITH YOUR AMERICAN BUSINESS PARTNER:

WHAT THE FOREIGN EXPORTER AND ITS FINANCING BANK OR FACTOR SHOULD KNOW

By

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PART I: INTRODUCTION

From a strictly commercial perspective, a "consignment" arrangement is one where:

(i) one party, the consignor, delivers goods to another party, the consignee,
(ii) for sale by the other party, the consignee,
(iii) with the understanding that only if the consignee sells the goods will he have to pay the consignor the agreed price for them.

Foreign companies (meaning non-U.S. companies) rather frequently use "consignment" arrangements in their U.S. business dealings. Their reasons for doing so might include:

- **The U.S. dealer or distributor cannot or will not finance the payment for the goods. By setting up a "consignment stock" in the U.S. party's possession, the U.S. side only has to pay the consignor the agreed price after it sells the goods. And, if the U.S. party is the distributor or dealer of the foreign party, the arrangement permits quick delivery to customers.**

- **If the consignor has been warehousing the goods in the USA, it may no longer wants to pay the warehouse charges. Typically, its U.S. dealer or distributor will not charge the consignor for storing the goods in its own warehouse facility.**

The U.S. consignee could be a completely independent party. Or, it might be the U.S. subsidiary of the foreign consignor, or a U.S. joint venture company in which the consignor holds some ownership percentage, either directly or through another company in its group.

From both a practical, legal and tax standpoint, consignment arrangements in the U.S.A. pose certain risks and dangers, particularly from the consignor's standpoint. That is also true to some degree from the U.S. consignee's perspective. Also, there may be unexpected results. That is so whether the U.S. consignee is completely independent of the consignor or is its U.S. subsidiary or a JV entity.

Before deciding upon setting up a "consignment" arrangement for the U.S.A., competent legal advice should be sought.

In this short Guide, we will point out some of some of the major points that the consignor should keep in mind.

PART II: RISKS, DANGERS AND SURPRISES REGARDING U.S. "CONSIGNMENT ARRANGEMENTS": OVERVIEW

Here are some of them.

- **Often, the parties do not utilize a first class contract, American style, for their "consignment" arrangement. Instead, they set forth their agreement in some letter or memorandum they or one of them has prepared. Or, they use some non-U.S. style contractual document. Or, they agree orally. That is a very big mistake, especially for the consignor. A first class contract, U.S. style, is a must.**

- **There is always the possibility that the consignee will not pay the consignor the agreed price for the goods after the consignee makes sales. That can occur, for example, because of the consignee's financial problems or bankruptcy; because a dispute arises between the consignor and consignee; or because the consignee claims that its customers found the goods to be defective.**

- **The consignor may find at some point that some of the "consignment goods" in the consignee's possession are missing and not accounted for. The consignee may refuse to permit the consignor to examine the consignment stock and/or its books and records.**

- **If and when the distributorship relationship or contract ends, the consignee may refuse to return the remaining "consignment" goods because of some claim it has against the consignor.**

- **U.S. income tax and state personal property tax issues will have to be evaluated by the foreign party before deciding in favor of a "consignment" arrangement.**

- **Placing goods on consignment with a U.S. party, in the States, whereby the consignor claims to retain ownership until it receives payment for them, may make it easier for a third party to sue the consignor, particularly (but not necessarily only) in the U.S. State in which those goods are located. Product liability cases are one important type. The consignment arrangement will probably weaken the foreign seller's argument that the U.S. court did not have "jurisdiction" (that is, the power to decide) over it.**

- **To protect its interest in the "consignment stock" against attack from the consignee's creditors, including any eventual bankruptcy representative of the consignee (<u>syndic en faillite</u>, <u>Insolvenzverwalter)</u>, the consignor must take certain action. The most important will be, in addition to a proper written agreement, the filing in one or more U.S. registries of a standardized form document---a "UCC financing statement". <u>Under U.S. law, a contract clause by which the consignor retains title to the goods will not accomplish that. That is so even if the consignment contract (or the consignor's General Terms of Sale) states that it is governed by its home country law.</u>**

- **Under U.S. law, most "consignment" arrangement will be characterized as a "sale or return". One of the main features of a "sale or return" is this: if the consignee does not actually return (not offer to return, but return) the unsold "consignment" goods within a "reasonable time", the consignee has definitely and finally purchased them, and will have to pay the consignor the agreed price for them.**

  Of course, if the parties' agreement clearly states otherwise, then the agreement's provisions will override that rule.

We will only discuss a few of these points in the following sections.

PART III: MOST CONSIGNMENT ARRANGEMENTS IN THE USA WILL TREATED AS A "SALE OR RETURN"

A. What is a "Sale or Return"

Most U.S. consignment-type arrangements will be treated legally, under U.S. law, as a "sale or return".

There is a uniform law applicable in all U.S. states called the "Uniform Commercial Code" or "UCC", and a particular long Article of it, Article 2, deals with the law of sales of goods. The "sale or return" is contained in two sections of that Article.

A "sale or return" arises when

- **goods are delivered to a party primarily for resale by that party (the "consignee-buyer"),**

- **with the express or implied agreement or understanding that the consignee-buyer can return them to the consignor-seller (even though the goods are not defective, damaged, and are the agreed goods),**

Unless the parties' contract regarding the "consignment" makes it very clear that no "sale or return" is intended, U.S. courts tend to treat most consignments arrangements under which the consignee is to resell (rather than use) the goods as a "sale or return".

There are three main consequences of a "sale or return":

- **If the consignee-buyer does not <u>actually return</u> the consigned goods to the consignor <u>within a "reasonable time</u> in <u>substantially their original condition</u>, the consignee-buyer is considered to have definitely bought them and must pay the consignor-seller the agreed price for them. What is a "reasonable time" is decided case by case depending on the particular circumstances. The idea is that unless the parties have very explicitly otherwise agreed, the consignee-buyer cannot hold the goods indefinitely without having to pay for them. Many "consignees" in the USA---and their lawyers, are not aware of this rule.**

Of course, if the parties have agreed on the time by which return of the goods is to be made, or made some other agreement about return of the goods, that agreement will normally apply rather than the rule just above.

- **unless otherwise agreed, the consignee-buyer bears the risk of loss and expense of returning the goods to the consignor-seller.**

- **the consignment goods <u>are subject to the claims of the consignee-buyer's creditors while they are in that party's possession.</u> Title (<u>propriété, Eigentum)</u> to the goods passes to the buyer-consignee upon delivery, even if, by contract (or the seller's General Terms of Sale), the consignor-seller has retained title thereto until receipt of payment in full. That means that unless the consignor-seller takes certain measures to protect its rights in those goods----particularly, a proper agreement with the consignee-buyer and the filing of a particular form in one or more registries----certain creditors of the consignee-buyer and that party's trustee in bankruptcy[1] would have superior rights in and to the goods.**

A "sale or return" is really a sale, but subject to a condition subsequent that the buyer can actually return the goods to the seller in substantially their original condition within a reasonable time and not pay any price for those goods returned. That is why the terms "consignor-seller" and "consignee-buyer" are used above.

B. <u>The "Sale on Approval"</u>

If goods are delivered <u>primarily for the U.S. party's use (rather than resale)</u> and the U.S. party is given the right to return them to the

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[1] **Typically, a company in U.S. bankruptcy reorganization functions as its own trustee in bankruptcy subject to the control of the bankruptcy court----it is a "debtor in possession". Thus, there may not be a true "Insolvenzverwalter" as in Germany.**

seller without having to pay for them, then unless otherwise agreed, the transaction is a "sale on approval". In effect, the goods are delivered to the buyer on a "trial basis". The consequences---unless otherwise agreed by the parties--- are:

- **If the buyer does not notify the seller within a reasonable time that it wants to return the goods (and not pay for them), then the buyer is considered to have accepted them and must pay for them. Actual return is not required as with the "sale or return", but just notice of the decision to return them.**

- **title to the goods passes to the buyer once he accepts the goods.**

- **on return of the goods, the buyer bears the risk of loss and the expense, but must follow the seller's reasonable instructions.**

- **until the goods are accepted by the buyer, they are not subject to the claims of the buyer's creditors (or its trustee in bankruptcy, in case of the buyer's bankruptcy[2]).**

The situations in which "sale on approval" will occur are much less common than "sale on return".

C. The "True Consignment"

If a particular transaction is a "true consignment", then the above rules on "sale on return" will normally not apply. A "true consignment" will have many or most of the following characteristics not normally associated with a "sale or return":

- **The consignee is the consignor's agent for purposes of selling the consigned items and must follow his instructions;**

- **The consignor dictates, controls or approves the price and terms by which the consignee can sell the consigned items and sometimes, the customers to which the sale may be made.**

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[2] **See footnote 1.**

● The consignor, rather than the consignee, typically invoices the customers for the consigned items sold.

● The consignee's compensation for selling or arranging the sale of the items for the consignor is normally a commission, rather than the proceeds of the sale.

● If the consignee receives the money from the sale of the consigned items, it must normally keep it segregated from its other moneys, in trust for the consignor until the money is turned over to it.

● The consignor normally requires the consignee to segregate the consigned items in its possession from its other goods and items, and often, to post a sign close to the consigned items stating that they are the property of the consignor.

● The consignor has the right to demand back and take immediate possession of the consigned items by all legal means.

● The consignor can, by law, inspect the consignee's pertinent books and records and the consigned goods in the consignee's possession.

● Risk of damage or loss from the elements and theft is normally born by the consignor while the consigned items are in the consignee's possession.

● Title to the consigned items remains in the consignor ---it does not pass to the true consignee.

Quite probably, a foreign company would only very rarely conclude a "true consignment" with a U.S. party. With respect to certain types of goods, like diamonds and precious gems, the "true consignment" is more commonly used.

PART IV: SECURING RIGHTS IN "CONSIGNMENT GOODS"---WHAT THE "CONSIGNOR-SELLER" SHOULD DO

There are many things a consignor-seller should to properly protect itself, assuming it has decided to proceed with such an arrangement with a U.S. party. In this Part, we will mention only a few key ones.

The consignor-seller will normally want to prevent any third parties from seizing, attaching and/or claiming any rights to the "consignment" goods.

The "security interest" is the most U.S. common mechanism used to secure payment for the sale of "goods". Sellers of goods (including exporters) frequently use it. Also, banks and other lending institutions normally require their company borrowers to grant them security interests. A security interest functions somewhat like a mortgage on real property. However, the collateral (actif mis en gage, Sicherungsgueter) cannot be real property. It can be nearly any type of personal property and rights, tangible or intangible, including accounts receivable, whether already existing or acquired in the future by the debtor.

If, as will normally be the case, goods for resale will be placed "on consignment" with a U.S. distributor, dealer or similar contract partner, then the consignor-seller should have its U.S. lawyer prepare and file in the appropriate U.S. registry(ies) a particular form----a UCC financing statement----specifying the goods and possibly other agreed assets of the debtor (e.g., accounts receivable from the resale of those goods, proceeds from resale) as the collateral. By doing so, that will normally give the consignor-seller protection (priority) over most creditors of the consignee-buyer and over a trustee in bankruptcy of the latter[3]. Conversely, not filing will expose the goods to the claims of third parties. That filing is called "perfecting" and what is being perfected is a "security interest" in favor of the consignor-seller in the goods.

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[3] **See footnote 1.**

However, that cannot be done unless there is a written agreement between the parties creating a "security interest" in the goods concerned in favor of the consignor-seller. That agreement can be part of the consignment agreement that the two parties would sign, or an Exhibit to it.

There is, however, an important preliminary step before implementing the above. First, a registry investigation (a "search") should be done to see that the consignee-buyer has not already granted rights in future inventory to some creditor, such as a bank, which has already filed a UCC financing statement covering future inventory of the consignee-buyer (as collateral). If that search reveals such a creditor, the consignor-seller can still obtain priority protection in the consigned goods by filing in the appropriate U.S. registry(ies) a "UCC financing statement", but that filing must be done and a special written notification must be sent to that creditor before the consignee-buyer receives possession of the goods. The consignor-seller may also be able to secure and obtain priority over the proceeds of the consignee-buyer's resale of the goods.

A point made earlier merits repetition. A contractual provision (including one in the seller's General Terms of Sale ("GTS") by which the seller retains ownership in the "consigned" goods (droit de retention de propriété, Eigentumsvorbehalt) will have practically no value in the USA. It will not protect the goods against third parties (creditors of the U.S. party, or that party's trustee in bankruptcy[4]. Only the measures mentioned above creating a "perfected security interest" will do that. That is true even if the contract between the consignor-seller and consignee-buyer, or the consignor-seller's General Terms of Sale state that the law of the seller's country or some other law applies.

In fact, sometimes a foreign party's General Terms of Sale which have not been specially adapted to U.S. transactions, can be a major obstacle when problems arise. The reader may be interested in

[4] **See footnote 1.**

receiving from this writer, at no cost, a copy of the Guide dealing with General Terms of Sale for the U.S. market.[5]

Even if the transaction might be characterized as a "true consignment", the consignor should go through the filing (perfection of security interest) process and related procedures described above. That may even be advisable if the transaction were a "sale on approval", even though under U.S. law goods sold "on approval" are not subject to claims of the buyer's creditors. The concept is to secure maximum protection of the consignor's rights in the property.

PART V: LAWSUITS AND TAX CONSIDERATIONS

A consignment-type arrangement whereby the foreign (e.g., German) party claims to own the U.S. consignment stock may make it an easier target for U.S. lawsuits. For purposes of "jurisdiction (competence, Kompetenz) over the foreign party, a U.S. court, particularly (but not necessarily only) one located in the same U.S. state as the consigned goods, may find it easier to conclude that the foreign party can be sued there. That is particularly so if the U.S. consignee is its distributor for those products for all or most of the USA. Product liability suits are one type to which that point may apply, but there may be others.

From a tax standpoint, normally a foreign company will want to avoid having a permanent establishment ("PE") in the USA. That is a tax concept contained in income tax conventions the US has concluded with most European and many other countries. The consequences of being found to have one can be negative, taxwise. Maintaining a consignment-type stock in the USA stored in the U.S. distributor's or dealer's warehouse normally will not, in and of itself, cause the foreign company to have a PE. But if one or more other factors do exist, such as the foreign company maintaining a sales office, e.g., on the U.S. distributor's facility, or stationing one of its employees in the USA, that could trigger a PE. Where the seller's country has not concluded an

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5 **That Guide is called "*General Terms of Sale for Exports to the USA, the Western Hemisphere Generally, and Worldwide*". A German language text of that Guide will be available shortly.**

income tax treaty with the USA, then the issue will be whether, from a U.S. standpoint, the foreign company is "doing business in the USA". Foreign enterprises will normally want to avoid that characterization.

Moreover, if the U.S. contract partner acts as the foreign party's agent, and has the authority and in fact does conclude contracts in the foreign party's name, that may cause the latter to have a PE in the USA. A "true consignment" arrangement might well be one example of such a situation.

Many U.S. states have a personal property tax. Problems can sometimes arise with the state tax authorities connected with a "consignment" of goods, if the U.S. consignee takes the position that it does not own the goods and thus, does not have to declare and pay tax on them, rather, the consignor does. This will normally not a very serious problem, and can typically be managed and resolved. It properly should be dealt with in the contract between the parties.

VI. ASSIGNMENT OF ACCOUNTS RECEIVABLE TO A BANK OR FACTOR

It is fairly common in Europe and elsewhere for companies to finance their accounts receivable resulting from sales of its goods--- including its U.S. sales--- by use of a bank or factor. The seller typically assigns its accounts receivable to a bank or factoring firm (for short, "factor") in exchange for quick payment for a factoring fee.

The factor should take various measures to protect itself and its purchased accounts receivable and claims. Our experience has shown that frequently, the factor does not do so sufficiently.

An entire guide could be written on what a factor should do to properly protect its interests. We will confine ourselves to only a few points.

One thing the factor should do is to see to it that an agreement equivalent to a "security agreement" is concluded with its client company, and with the debtor, valid under U.S. law; that the appropriate U.S. registry search is done, and that UCC financing

statements are filed, either by the client company (and then assigned to the factor) or by the factor itself, covering the desired "collateral".

Another is to insert provisions in the factoring contract with the exporter-seller to afford the factor very strong protection against fraud and deceit by the seller company and its owners), who should personally agree to be bound by those "antifraud" clauses and for the resulting damages and costs in if such occurs. Here is one type of fraud that sometimes arise. The factor's client (exporter-seller) makes a secret agreement with the customer for its goods (e.g., U.S. distributor) that the goods are "on consignment", only to be paid for when and if the U.S. party sells them. Neither party ever tells the factor about the secret agreement. The foreign exporter then issues one or more normal invoices to the U.S. party for those goods, e.g., showing payment for them is due with "X" days, submits them to the factor, receiving payment for them. The factor will have notified the U.S. party of the assignment of accounts receivable and claims, and probably will have the seller place a notice thereof, including instructions to pay the factor directly, on all invoices to the U.S. party. The U.S. party does not pay for the goods, or pays a lesser amount than invoiced, because it has not resold the goods ----but does not tell the factor that. The factor then decides to sue the U.S. party in the States, and finds that the U.S. party's defense is the "consignment agreement". By that time, the exporter has serious financial problems or is bankrupty, and the factor cannot recover the money it paid to the exporter. The factor might win or lose that U.S. case, but either way, it may incur substantial costs, particular legal fees, that it may not be able to recover (see below). With proper "antifraud" provisions in the agreements, particularly in the factoring agreement with its customer, and close follow up, monitoring, and records inspection of the U.S. party and its own client, the factor's can significantly reduce its risks.

Exporters should insert in their General Terms of Sale = "GTS" in connection with U.S. sales----and their factors should require it of them--- certain key clauses not normally included in typical foreign (e.g., European) GTS. One would be that in case of litigation, the exporter-seller, if it wins, will be entitled to recover, as damages, its legal fees incurred in connection with the litigation against the U.S. buyer. Since the law of several foreign (e.g., European) countries allows the winner to recover its legal fees without any contractual agreement,

such a clause is not normally found in the GTS of a company from such a country. But that is not the case in the USA. <u>With few exceptions, the winner will not be able to recover its legal fees unless there is a contract between the parties so stating, phrased in a proper manner.</u> Such a contract can be the exporter's GTS, but <u>only if the U.S. party has agreed in writing to be bound by those GTS.</u>

Regarding that last point, both U.S. domestic sales law and the international convention on the formation of contracts for the sale of goods (to which the US and many other countries adhere) state, indirectly but clearly enough, that clauses that are "special" contained in any document, including GTS, that the buyer has not accepted in writing, will not be binding on the buyer. Such clauses include, among others: 1. legal fee clauses as above; 2. limitations or exclusions of seller's warranties, exclusion or limitation of damages, shortened statutes of limitations on claims brought by the buyer; 3. with certain exceptions, arbitration clauses and clauses conferring jurisdiction on a court or courts other than one in the buyer's particular location; 4. clauses by which the buyer grants a "security interest" to the seller.

Moreover, typical GTS of a European seller will state that its country's law applies, and that a particular court in its home country has exclusive jurisdiction over lawsuits resulting from the transactions. Such clauses can be a major obstacle if the decision is made to sue the U.S. party in the States. Care and thought must be given to preparing GTS, particularly when they will be used for U.S. transactions. Similar problems will also arise for the exporter when selling to other countries. In fact, it is possible to draft for the foreign seller of goods, one GTS that will be effective, protective of the seller's (and thus, the factor's) interests and accomplish the desired purposes, for that seller's worldwide sales. [6]

The GTS should be in English----that is, proper and correct legal English. They can be in a second or third language as well,, but definitely in proper, correct English. If the GTS will be multilingual, the texts should be identical, prepared and reviewed by competent counsel.

[6] **See footnote 5.**

The GTS should state that all of the rights and prerogatives of the seller set forth therein, have been assigned to the factor.

PART VII: CONCLUSIONS

Our conclusions will be very brief and general.

1. **Before deciding to conclude any type of "consignment of goods" arrangement for the U.S. market, the exporter should consult with competent U.S. counsel regarding the advisability, the benefits, the dangers and risks etc., and whether and how those dangers and risks can be properly "managed".**

   A consignment-type arrangement for the U.S. market is not necessarily a way of doing business that a company should avoid. In certain circumstances, it may be appropriate and beneficial-----but only if properly planned and done correctly.

2. **The same general point applies to factors or assignees of accounts receivable resulting from its customer's U.S. sales, in terms of how the factor can best protect itself.**

3. **Most of the points made in this Guide apply where the U.S. consignee or buyer is the direct or indirect subsidiary or affiliate of the foreign consignor or seller. Just because the foreign consignor or seller controls or has a strong voice in the U.S. entity does not eliminate or even reduce many of the risks and potential problems mentioned in this text.**

Some of the points in this Guide may be difficult for a non-lawyer to understand fully. The idea is not grasp every point, but rather, to

have an overall understanding of the important considerations, and to know the questions to ask.

PART VIII: SHORT CASE STUDIES

Case Study 1: **A European exporter-seller sells and delivers goods to a U.S. buyer. It is a "straight sale", not any kind of "consignment arrangement. The sales contract signed by the parties or the seller's AGB on its order confirmation and invoice state that the seller retains ownership of the goods until it receives full payment for them. The U.S. buyer goes into bankruptcy owing the seller money from that sale. The exporter wants to recover the remaining goods based on its title retention clause. The buyer's bankruptcy representative argues: "No, you can't. The retention of ownership clause is not binding on me---it does not allow you to recover the goods. You are just an ordinary, general creditor, with no priority rights whatsoever."**
Result: **The bankruptcy representative is right. To have priority over other creditors and be able to recover the goods, the seller would have had to have a valid, perfected "security interest" in the goods. That means, a legally valid "security agreement" and the filing of a UCC financing statement in the proper registry(ies). If there was any existing financing statement filed by a third party covering, as collateral, the debtor-buyer's future-acquired goods (e.g., inventory), then the to prevail, the seller would have had to comply with certain other requirements mentioned in the text above.**

Another point. If buyer did not agree in writing to the seller's GTS, then provisions like the title retention clause might well not be binding on the buyer. If the buyer, in fact, had so agreed in writing, then the title retention clause would quite probably be treated, legally, as a "security agreement", and if the seller had filed in the proper U.S. registry(ies) an otherwise properly prepared UCC financing statement and, where applicable, met other requirements, it would have prevailed. Note, however: the typical title retention clause found in a European-style GTS do not go far enough to protect the seller in U.S. transactions.

Case Study 2: **The same facts as in Case Study 1, except the U.S. buyer is not the subject of any bankruptcy. Rather, a bank holds a valid,**

perfected (by filing) "security interest" in all of the U.S. buyer's presently owned and after –acquired goods. The buyer defaults on its debt to the bank, and the bank forecloses on its security interest. It takes possession of the goods and intends to sell them to satisfy, in whole or in part, that debt. The seller argues: "The goods are our property. We have a title retention clause in our GTS, and under our country's law, which applies, we can legally get them back because the buyer didn't pay us for them. You have no right to take possession of them, sell them, and apply the money against your own debt. "
<u>Result:</u> The bank wins, the seller loses. Only by having a valid "security agreement" with the U.S. buyer, and filing a UCC financing statement in the appropriate registry(ies) and fulfilling other conditions mentioned in this Guide, <u>before</u> the goods were delivered to the buyer, could the foreign seller have prevailed.

<u>Case Study 3:</u> An exporter places a stock of goods (inventory) "on consignment" with a U.S. party, to be paid for only when and if the latter sells (or, if you prefer, resells) them. The parties' contract and the seller's GTS placed on its order confirmations and invoices states that the seller retains ownership of the goods until receipt of full payment for them.
Either A. the U.S. party goes into bankruptcy; or

B. a creditor of the U.S. party owed substantial moneys who has a "perfected security interest" in all present and after-acquired inventory of the U.S. party, is ready to take possession of it, sell it off, and apply the proceeds against the debt.

The exporter wants to recover its goods.
<u>Result:</u> In all likelihood, the exporter loses. Since the goods were supplied to the U.S. party primarily for resale, the transaction would quite probably be treated as a "sale or return", and as such, the goods are subject to claims of the U.S. party's creditors. If the U.S. buyer did not agree in writing to the exporter's GTS, then there is substantial doubt whether the title retention clause is binding on the buyer. But even if that hurdle could be overcome and the clause were considered a binding "security agreement", the fact that the exporter did not file a properly prepared UCC financing statement in the appropriate registry(ies) and, where applicable, comply with the other legal requisites, would defeat its claim.