POINT SHEET

In re Steven Wallace
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DRAFTERS' POINT SHEET

In this performance test item, Steven Wallace, an artist, delivers a painting to Lottie Zelinka, an art dealer, on consignment. Lottie files bankruptcy under Chapter 11 and later converts it to a straight Chapter 7 case. Thereafter, she returns the painting to Steven, and the trustee demands that Steven return the painting to the bankrupt estate. Steven consults Eva Morales, the supervising attorney in this case.

The task for the applicant is to draft a two-part memo in which he/she: first, analyzes the facts and the law regarding the bankruptcy trustee's claim that the painting is an estate asset; second, identifies what UCC defenses are available to Steven, explains how the facts currently known support the defenses, and suggests what additional facts might be developed to support the defenses.

The File consists of the assignment memo from Ms. Morales to the applicant, notes of the interview with Steven, and some documents Steven left with Ms. Morales. The Library contains excerpts from a basic bankruptcy treatise, § 2-326 of the Franklin Commercial Code (FCC), a section of the Franklin Civil Code, and two cases. All of the materials the applicants will need to work their way through the problem are contained in the test item.

The following points that might be discussed by an applicant are suggested by the problem. Grades will be assigned depending on the degree of thoroughness, and an applicant can get an excellent grade without covering all of these points.

1. Based on the facts as they appear in the file, does the bankruptcy trustee have a legitimate claim to the painting?

   • The facts make it clear that the painting was redelivered to Steven by Lottie after the bankruptcy proceeding began. Thus, she made a "post-petition transfer" of property that was in the possession of the bankruptcy estate.

   • Drawing on the excerpts from Walker on Bankruptcy and In re Levy, the applicants should conclude that the trustee has the right to "avoid a transfer of property of the estate . . . that occurs after the commencement of the case." Walker on Bankruptcy § 4.08.

   • The real question then becomes whether the painting was "property of the estate." That calls for an in-depth analysis of the FCC provision on consignments—§ 2-326.

   • The interview notes and the Inventory Receipt show clearly that Steven (consignor) delivered the painting to Lottie (consignee) on a true consignment; i.e., he delivered it to her to see if she could sell it for him, he retained title, she would get
commission if she could sell it, and she could return it without obligation if she couldn't sell it. Thus, it was a "sale or return" transaction under FCC § 2-326.

- Unless one or more of the exceptions provided for in § 2-326(3) applies, the FCC makes it clear that "goods held on sale or return are subject to [claims of the consignee's creditors] while in the [consignee's] possession," irrespective of whether the consignor (Steven) retained title. This point is fully discussed in the *First National Bank* and *Levy* cases, and the applicants should have no problem understanding the concept.

- Thus, on the face of it, the trustee, standing as he does in the shoes of a lien creditor of Artists' Exchange, has a legitimate claim to the painting.

2. The defenses and the current and additional facts that might support them.

- **Known facts:** The applicants should discuss each of the defenses under § 2-326(3) exceptions and whatever known facts there are to support them; and, if there are no supporting facts, simply say so and move on.
  - The "sign law" exception (§ 2-326(3)(a)) probably doesn't apply on the known facts. Although Steven put a 2" x 3" label on the back of the painting identifying himself as the owner, it is not likely that it was "posted conspicuously" within the meaning of Franklin Civil Code § 3533. See, also, the discussion in *Levy* as to whether the label was calculated to inform creditors or just possible customers. Whether there was a sign posted by Lottie in the front window (as Steven seems to "think" there was) is not known at this point.
  - There is no basis, on the facts currently known, to conclude that it was "generally known to [Lottie's] creditors" that she was "substantially engaged in selling goods of others." It is arguable that the very name of the art gallery, "Artists' Exchange," communicates such a notion and that the sign Steven "thinks" he saw in the window (i.e., "All offers will be considered and forwarded to the artists") does too, but there are not enough facts currently known. Thus, the § 2-326(3)(b) exception doesn't help at this stage.
  - There is no current information that Steven filed a UCC financing statement, so there is no basis for invoking the § 2-326(3)(c) exception.
  - The strongest defense based on the known facts is that the painting, before Steven delivered it to Lottie, was "used . . . for personal, family, or household purposes," and that the exception in § 2-326(3)(d) applies. The interview
notes are ambiguous on that point. On the one hand, they show that Steven had the painting hanging in his dining room and hadn't thought about selling it until Lottie suggested it. It is also helpful that Steven and his wife had purchased a new rug with colors that complemented the colors in the painting; this is evidence that they intended to keep the painting for personal use. On the other hand, it is clear enough that Steven did regularly sell his paintings. More facts are needed on what their intentions were.

• **Additional facts, sources, and why the additional facts are important:** The notion in this part of the test item is to require the applicants to scour materials for facts that are hinted at in the File and Library, focusing on facts that would help invoke the protective exceptions listed in § 2-326(3).

• **Whether Steven filed a UCC financing statement.**
  - **Why important:** Although it is not probable that he did file a financing statement, it does not appear affirmatively from the facts that Ms. Morales even asked the question. It would help if he had because it would invoke the protective exception of § 2-326(3)(c) and might get him home free.
  - **Sources:** Ask Steven himself or make a search with the Secretary of State's office or other public filing offices.

• **Whether the painting can persuasively be characterized as "goods . . . used . . . for personal, family or household purposes"**
  - **Why important:** If that can be shown, it will, without more, invoke the protective exception of § 2-326(3)(d) and establish Steven's right to keep the painting. The footnote in *First National Bank* suggests the inquiry, and it is possible that, as to this painting, Steven might still be a "casual collector." After all, he has only recently retired to go into painting full time.
  - **Sources:** Get the facts from Steven and Ella, his wife. The interview notes suggest that, even though Steven regularly sold some of his paintings, perhaps there are some he painted and intended to keep for his own personal use. Check whatever records he maintains because they may help to show that some of his paintings (e.g., the ones he hangs in his home) are intended for "personal, family or household purposes." Ascertain what discussions

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8 This exception, found in the library version of § 2-326, is not part of the official version of the UCC. It is part of the California UCC and is included here because it makes a good test issue.
they had about keeping the painting when they purchased the rug to complement the colors in the painting. Identify what other paintings, if any, they intended to keep for themselves as opposed to selling.

- **Whether Lottie dba Artists' Exchange was in fact substantially engaged in selling goods of others.**

  - **Why important:** The threshold question (as opposed to the ensuing question whether Lottie's general creditors had such knowledge) is whether Lottie's business was in fact predominantly a consignment business. If so, then the applicant can proceed to the inquiry regarding whether the general creditors knew it sufficiently to invoke the protective exception. This inquiry is prompted by Steven's suggestion during the interview that most of the art at Artists' Exchange was on consignment and that most artists he knows of deal with galleries on a consignment basis.

  - **Sources:** Lottie herself is probably the best source of this information. The property schedules filed with the court will at least identify the inventory of art and maybe even whether a particular item was on consignment or owned by Lottie. The consignors are also creditors (see, *First National Bank*), so they will have to be listed on the bankruptcy schedules as well. The schedules will furnish their names and addresses in case it becomes necessary to contact them directly.

    The question whether art galleries in general do business predominantly on a consignment basis may be a subject for expert testimony, so a suggestion that an expert be consulted as a source for this information would be in order.

- **Whether the general creditors of Lottie dba Artists' Exchange knew that the gallery sold predominantly the goods of others.**

  - **Why important:** Proof of such "general knowledge" is essential to the invocation of the protective exception of § 2-326(3)(b). See, *First National Bank* and Levy. If it can be shown, it will get Steven home free.

  - **Sources:** The bankruptcy schedules will disclose the names and addresses of all the creditors. It may be necessary to contact the bulk of them to find out what they knew when they extended credit. Perceptive applicants might distinguish *First National Bank*. There, the court found that the knowledge of other consignors was irrelevant to the knowledge of "general" creditors.
Here, if it can be shown that almost all of Lottie's creditors were consignors, as is suggested in the footnote in *First National Bank*, then their knowledge is perforce relevant to establish general knowledge.

Ask Lottie and check correspondence and other records of communication between Lottie and her creditors for the possibility that the extent of her dealing in the goods of others was disclosed to her creditors.

Steven said during the interview that he thinks there was a sign posted in the front window of the gallery to the effect that, "All offers will be considered and forwarded to the artists." If so, that could be evidence of notice to creditors that Lottie was selling the goods of others.

The very name of the gallery, Artists' Exchange, is another source of the knowledge of the creditors. It suggests that Lottie is dealing in the goods of others and that the creditors must therefore have known it. Finally, expert testimony might help establish that creditors of art galleries were on constructive notice because almost all galleries do business on a consignment basis.

- **Whether there was a sign such as Steven thinks he saw in the front window of the gallery.**
  - **Why important:** It can serve two purposes: (1) to establish that the general creditors knew that Lottie was dealing predominantly in the goods of others, thus bringing into play § 2-326(3)(b), and (2) as evidence of compliance with the "sign law" (Franklin Civil Code § 3533). Either one will get Steven home free.
  - **Sources:** Perhaps a visit to the gallery will show that the sign is still there. Lottie herself can be asked about it. Inquiry can be made of the "general" creditors, including other consignors whose names and addresses can be obtained from the bankruptcy schedules. Photographs, if any, of the front of the gallery might be a source. If the sign was purchased by Lottie, perhaps the vendor can be ascertained and asked about it.

- **Whether other consignors of art filed UCC financing statements.**
  - **Why important:** If any significant number of the other consignors filed financing statements, it could be argued that the public nature of such filings served at least constructive notice of the fact that some substantial portion of
Lottie's business was dealing in the goods of others. This, too, would help invoke the protective exception of § 2-326(3)(b).

- **Sources:** The other consignors and secured creditors, whose names and addresses can be obtained from the bankruptcy schedules, can be asked directly or a search can be made of the filings at the Secretary of State's office. This will help establish the breadth of constructive knowledge imputable to other creditors.

- **Whether any of the other consignors of art complied with the "sign law."**
  - **Why important:** If enough of them did so effectively, it would be evidence that there was at least a form of public notice that the goods of others were in Lottie's gallery. And, if it were widespread enough, it could be argued that it imparted knowledge to the general creditors. It would, however, have to be shown that the signs were intended to impart knowledge to others than the customers of the gallery. C.f., *Levy* (small cards kept with the shoes satisfied neither the sign law nor the general knowledge requirements).
  - **Sources:** Again, the other consignors would be the best source of this information. Their identities can be obtained from the bankruptcy schedules. Lottie might also be able to provide information on this point.