ALL THAT GLITTERS IS NOT GOLD: GOLD MINES, REFINERIES, AND THE LAW OF BAILMENT

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Few things stir up greater emotions than gold bullion. But, what happens when a refinery of precious metals files bankruptcy and the gold mines want their gold back? In such situations, the result depends on whether a refinery's inventory of unrefined or refined gold belongs to the customers who delivered the raw, unrefined gold (termed "doré") or whether the refinery is the actual owner of such inventory. This question became center stage of numerous disputes in the Chapter 11 case of one of the nation's largest precious metals refinery, Republic Metals Corporation (n/k/a Miami Metals I, Inc., Case No. 18-13359) filed in the Southern District of New York.

The answer turns on whether the relationship and transactions between the customer and the precious metals refinery constitutes a bailment or a sale. The problem is that applying the law of bailment to the precious metals industry is not straightforward and creates a contentious situation as debtors, their secured creditors, and the customers fight over these valuable assets in a bankruptcy. The end results are mixed as the specific facts drive the outcome. In this article, we take a quick look at bailment law generally, the process of refining precious metals, the analysis courts undertake within this industry in determining whether a bailment exists, and some conclusions.

BAILMENT LAW GENERALLY

A bailment is defined as the "delivery of personalty for some particular purpose, or a mere deposit, upon a contract, express or implied, providing that after the purpose has been fulfilled it shall be redelivered to the person who delivered it, or otherwise dealt with according to his directions, or kept until he reclaims it, as the case may be."[2] In the context of bankruptcy, mere possessory interests are not sufficient to convey ownership to a bailee and, as such, bailed goods are not "property of the estate" of a bankrupt bailee.[3]

In distinguishing a bailment from a sale, the Supreme Court explained over a century ago:

> The recognized distinction between bailment and sale is that, when the identical article is to be returned in the same or in some altered form, the contract is one of bailment, and the title to the property is not changed. On the other hand, when there is no obligation to return the specific article, and the receiver is at liberty to return another thing of value, he becomes a debtor to make the return, and the title to the property is changed. The transaction is a sale.

Sturm v. Boker, 150 U.S. 312, 329 (1893). Generally, this rule applies where the object in question is transformed in some manner and both parties mutually benefit from such a bailment, such as when the particular ". . . logs are delivered to be sawed into boards, or leather to be made into shoes...."[4] As the court in *Miami Metals* reiterated, "[b]ailments for mutual benefit include bailments *locatio operis faciendi* where the bailee is obligated to perform work on the bailed item in exchange for consideration."[5] Thus, the test courts use in distinguishing bailments from sales is whether the identical article is to be returned in the same or altered form. Conversely, if the provider performing the work is not obligated to return the same wood or leather, but may deliver an item of equal value, the transaction is classified as a sale or loan, and the title of such article vests with the provider and not with the supplier or customer.

Although courts have applied this standard consistently in the context of refining,[6] they have not applied it exclusively in relation to fungible goods. The UCC defines "fungible goods" as (A) goods of which any unit, by nature or usage of trade, is the equivalent of any other like unit; or (B) goods that by agreement are treated as equivalent.[7] Where a bailee commingles fungible goods and the

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2 *Monroe Sys. For Bus., Inc. v. Intertrans Corp.*, 650 So. 2d 72, 75 (Fla. 3d DCA 1994) (quoting *Dunham v. State*, 192 So. 324, 326 (Fla. 1939)); *see Herrington v. Verrilli*, 151 F. Supp. 2d 449, 457 (S.D.N.Y. 2001) (quoting *Mays v. New York, N.H. & H.R. Co.*, 197 Misc. 1062, 1063–64 (App. Term 1st Dep't 1950)).

3 *See JP Morgan Chase Bank, NA v. AVCO Corp. (In re Citation Corp.)*, 349 B.R. 290, 296–97 (Bankr. N.D. Ala. 2006) (finding a contract to create a bailment and concluding that the debtor had no ownership interest, such that its secured lender could not assert a lien on the subject materials).

4 *Powder Company v. Burkhardt,* 97 U.S. 110, 116 (1878).

5 *In re Miami Metals I, Inc.*, 603 B.R. 727, 735 (Bankr. S.D.N.Y. 2019).

6 *See, e.g., Chisholm v. Eagle Ore Sampling Co.*, 144 F. 670, 671-72 (8th Cir. 1906) ("[I]t seems clear to us that the parties acted under the contract as though the transactions were sales of the ore upon the basis of the assay values of samples"); *Welding Metals Inc. v. Foothill Capital Corp.*, No. 3:92 CV 00607 (WWE), 1997 WL 289671, at *9 (D. Conn. Apr. 14, 1997) ("because there is no evidence that the metal returned to [the customer] was the product of the metal originally delivered, except 'solely by chance,' the arrangement between [the debtor and the customer] could not constitute a bailment"); *WESGO Division of GTE Products Corp. v. Harrison (In re Sitkin Smelting & Refining, Inc.)*, 648 F.2d 252, 254 (5th Cir. 1981) (finding no bailment where scrap material was commingled during refining and could not be returned and refiner "agreed to either purchase the precious metals recovered upon processing or return metals of like kind and quality less a processing fee").

7 U.C.C. § 1-201(18). See also Black's Law Dictionary 541 (7th ed. 2000) ("fungible" means "commercially interchangeable with other property of the same kind").

contract has an indicia of a bailment relationship (a common occurrence in the refining industry where contracts have elements of both a sale and a bailment), the commingling of such fungible goods, such as wheat or natural gas, does not destroy the bailment, even when the final product returned to the bailor is not identical to the product the bailor delivered to the bailee for alteration.[8] Thus, courts have also looked to the intent of the parties in entering into the agreement and the course of dealing between the parties in determining whether a bailment or a sale exists within the framework of fungible goods and when a transaction or contract has elements characteristic of both a bailment and a sale.[9]

Moreover, in situations where the contract has mixed elements of bailment and sale, courts will often "look beyond the four corners of the contract and examine the various circumstances that led to the contractual arrangement."[10] Some courts have also focused on the "particular purpose" aspect of the bailment definition, finding bailments where the agreement clearly contemplates a specific purpose other than a sale.[11] Additionally, courts have found that no sale occurs where parties intend for the provider of services to receive a processing fee, and not to pay a purchase price to obtain the property at issue.[12]

Finally, courts will also consider the applicability of certain provisions of Article 7 of the UCC that covers bailments versus Article 2 of the UCC that governs the purchase and sale of goods. Under § 7-102, a "Bailee" is a "person that by a warehouse receipt, bill of lading, or other document of title acknowledges possession of goods and contracts to deliver them."[13] Section 7-207 of the UCC requires that warehouses -- which refineries may fall under in conjunction with storing unrefined or refined precious metals in their vaults – must either maintain stored goods separately or may commingle fungible goods. In the case of commingled fungible goods, Section 7-207 states that the customers/bailors will own those goods in common. Thus, a bailor is entitled to its share of the proceeds of the fungible property that the bailee possesses as of the bankruptcy petition date, regardless of whether the property was liquidated post-petition, so long as the bailor can trace the property to the commingled fungible property.[14]

THE PRECIOUS METALS REFINING PROCESS

To understand how the application of bailments can be problematic in the precious metals refining industry, we must first follow the path of gold. A refinery's customer, e.g. a gold mine, partially refines gold at the mining site into bars that are called doré bars. These doré bars look like dirty/lumpy gold bullion bars and it is these bars that the gold mine ships to the refiner for refinement into pure gold. Typically, these shipments are divided into separate lots and assigned lot numbers for that customer so that they may be segregated from other customers' unrefined materials. These lots are subsequently weighed and melted to obtain a homogenous sample for assay testing (determining the precious metal content of the respective lot), generally on the same day. Customers have the right to be present to witness the weigh and assay processes. The preliminary assay results of materials provide the refiner with an estimated amount of the precious metals contained in the respective lot(s) received from a customer. To ensure the reliability of the refiner's assay, the parties would take three assay samples from the melted doré: one to be tested in the refiner's own lab, one to be tested by the customer's lab, and a third for a "referee" in the event that there was a

8 *See, e.g., In re Enron Corp.*, 2003 WL 23965469 at *3 (Bankr. S.D.N.Y. Jan. 22, 2003) ("commingling fungible goods is not categorically antithetical to a bailment" and the fact that a pipeline company "commingled natural gas in [its] pipelines would be insufficient, as a matter of law, to destroy an otherwise valid bailment."); *In re Computrex, Inc.*, 403 F.3d 807, 812 (6th Cir. 2005) ("[T]he fact that the Debtor did in fact commingle its clients' funds, does not establish that the funds were part of the Debtor's estate. The Debtor here is in essentially the same position as a bailee").

9 *See Consol. Accessories Corp. v. Franchise Tax. Bd.*, 161 Cal. App. 3d 1036, 1040 (2d Dist. Ct. App. 1984); 5 Fla. Jur. 2d Bailments § 4 ("Frequently, a particular transaction has elements characteristic of both a bailment and a sale, and the guide in any given case in determining the nature of the transaction is the expressed or presumed intention of the parties").

10 *Miami Metals*, 603 B.R. at 733 (quoting *In re Handy & Harman Refining Grp. Inc.*, 271 B.R. 732, 736 (Bankr. D. Conn. 2001)).

11 *See, e.g., In re Haase*, 224 B.R. 673, 678 (C.D. Ill. 1998) (finding bailment where cattle were delivered to debtor for the special purpose of fattening them for the market); *JP Morgan Chase Bank, NA v. AVCO Corp. (In re Citation Corp.)*, 349 B.R. 290, 290 (Bankr. N.D. Ala. 2006) (finding bailment where contract involved delivery of steel for a particular purpose of refining the steel); *Glenshaw Glass Co. v. Ontario Grape Growers' Mktg.* Bd., 67 F.3d 470, 475 (3d Cir. 1995) (finding bailment where grapes were delivered to debtors for processing and storage).

12 *See In re Medomak Canning Co.*, 25 UCC Rep. Ser v. at 444–49 (debtor-or-processor of finished pork and beans products was slated only to receive a processing fee while supplier of ingredients was to receive the finished goods for further sale, and thus, no sale occurred between the supplier and debtor-processor); *C.f. Matter of Gardinier, Inc.*, 49 B.R. 489 (Bankr. Fla. 1985) (where debtor was only entitled to a processing fee in a transaction for the sale of phosphate rock, and the supplier of phosphate was entitled to the proceeds of the sale net of the processing fee, the debtor's property of the estate excluded all but the processing fee, under Florida's law of resulting trusts).

13 UCC § 7-102.

14 *See In re Martin Fein & Co.*, 43 B.R. 623, 626 (Bankr. S.D.N.Y. 1984) ("Where the property involved, or its proceeds, has been intermingled with other goods or funds of the debtor's [sic], the owner must definitely trace that which he claims as contained in the assets of the estate. The goods sought to be recovered must be definitely traced into the property of the estate, or the proceeds thereof must be traced to a particular fund or to specific property in which it was invested").

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dispute over the results between the customer's lab and the refiner's lab. The final settlement occurs when the refiner and the customer agree on the metal content in a respective lot.

Prior to such final settlement, a customer could request that the refiner make an "advance" payment/transfer to the customer of up to approximately 95% to 99% of the estimated metal value of the applicable lot based on the preliminary assay. These payments could be in the form of USD wire transfer to the customer's designated bank account or through a "metal credit" transfer to the customer's designated "Loco London" metal account.[15] When a customer elects that metal credit be paid/transferred to its Loco London metal account, the refiner does not transfer actual physical metals, but rather metal credits are moved from the refiner's metal account to the customer's account. Like a USD wire transfer between two bank accounts where no physical cash is actually moved, a payment of Loco London metal credits is reflected as a credit in the customer's Loco London metal account and as a corresponding debit in the refiner's Loco London account.

After the melting/sampling phase, the raw materials enter the refining process. During the refining process, individual customer lots can be combined with other customer lots and various clean up material and residue material (sometimes referred to as "clean up bars"). During the refining process, the silver and gold contained in the commingled material is dissolved in acid to create a solution, analogous to dissolving sugar in hot water.

Upon completion of the refining process, the disposition of the refined metal depends on the relationship with the customer—including both the customer's contract and the parties' course of dealing. As an example, first, pursuant to a "future sale," a refinery could either purchase the metal directly from the customer or would sell the metal on the customer's behalf. Second, under a "metal return" arrangement, a refinery would refine the doré sent to it and then return refined metal to the customer. When a customer elects metal return, there would be no sale of precious metal. Third, pursuant to a "toll refining" arrangement which often involve mining companies, a refinery would provide assay and refining services only and would then deliver the refined metal to the customer's chosen metal bank. Under this arrangement, like the "metal return" arrangement, there should be no sale of the metal.

The refined metal is then stored in the refiner's vault and in many instances sold or delivered to third parties, or transferred to the refiner's mint for the production of various minted products, coins, cast bars, etc. The vaults can at times hold more than $100 million of the refined metal in the refiner's inventory. Unless there was a separate program separating and tracing the metals a customer delivered throughout the process to prevent commingling, e.g. through a single-batch closed circuit process, the refiner could not identify the raw materials delivered by customers after they were commingled with other lots for refining and during and after the dissolution process. In Miami Metals' case, it commingled the raw materials delivered by all of the customers in the ordinary course of business and none of the raw materials delivered by the customers were segregated or identifiable during or afte the refining process.

As with Miami Metals, agreements may vary from the refinery's standard terms by a customer as to when title is passed from the customer to the refiner. Delivery and receipt of the doré and the refined product, as well as the spot sales and toll refining services, contribute to the variety of terms and conditions that resulted in the various buckets into which Miami Metals' customers were placed as part of the procedure to resolve the multitude of ownership disputes that arose during the Chapter 11 case.

BAILMENT LAW WITHIN THE PRECIOUS METALS REFINING INDUSTRY

Three cases evidence the need for courts to carefully analyze the parties' contract terms and course of dealing within the precious metals industry to ascertain whether a bailment or a sale occurred.

In re Miami Metals I, Inc., 603 B.R. 727 (Bankr. S.D.N.Y. 2019):

With over 40 objections from customers to the debtor's cash collateral motion and numerous customer statements claiming ownership of the gold inventory as of the petition date, the parties determined that a resolution of these ownership disputes required classification of the types of agreements customers have into various buckets. In the referenced decision, the court focused on a summary judgment motion for Bucket 1 customers, who signed the standard terms agreement the debtor provided and argued that the contract elements evidenced both bailment and sale

15 A Loco London account is an account to support trading and transactions within the London Bullion Market and governed by LBMA, an international trade association representing the precious metals bullion market. "Loco London" refers to gold and silver bullion that is physically held in London vaults to underpin the trading activity in the market.

characteristics and would require the court to analyze the parties' course of dealing outside of the four corners of the contract. The debtor argues that the agreement clearly evidenced a contract of sale, and that the court should look no further than the contract terms.

The court proceeded to look at the New York and Florida law governing sales and bailment, and applied them to the analysis of the executed standard terms. The terms included the following provisions that indicated a contract for sale: (1) the debtor may return metals of like kind to the customers rather than the same metal in different form, (2) the customer warrants that it has good and marketable title in connection with a sale, (3) the parties are described as "merchants", (4) there is an exclusion of the term "bailment" in the agreement except for a consignment provision specifying that the property remains the property of the debtor, and (5) there are two options included for fixing the price of metals; the "spot price" and the "London PM" price.[16] While the court found that the standard terms agreement unambiguously established a framework for a sale rather than a bailment, and thus extrinsic evidence need not be considered, it still considered the parties' course of dealing, reasoning that the agreement may be supplemented by the debtor's course of performance.[17] However, it found that the course of dealing also indicated a sale rather than a bailment, reasoning that the raw metals delivered by the customers were of varying qualities, forms and included other materials that may differ from lot to lot, and thus were not fungible. These non-fungible materials were then commingled to produce a refined product that was then fungible, i.e., varying degrees of doré that included other materials besides gold to refined gold bars. Because the raw materials were deemed to be non-fungible and not identical to other customer's lots, the court distinguished the case law where bailment is found based in part on the fungibility of the material and held that the relevant Bucket One customers did not have an ownership interest in the debtor's inventory as the standard terms agreement and the parties' course of dealing indicated a sale rather than a bailment.

Delta Smelting & Refining Co. (Re), [1988] B.C.J. No. 2532, 33 B.C.L.R. (2d) 383:

In *Delta Smelting*, the British Columbia Supreme Court considered and rejected the arguments similar to the *Miami Metals* customers on similar facts. B.C.J. No. 2532, 33 B.C.L.R. (2d) 383.[18] In *Delta Smelting*, certain of the customers delivered doré to the debtor for refining. Initially, the customers' metals remained segregated while Delta assayed each customers' raw materials to determine the precious metal content. After the assay, the raw materials were commingled with material delivered by other customers and with Delta's own metal. At the end of the refining process, the refined gold was placed in the vault. However, there was no attempt made to identify the metal attributable to any customer. Rather, the customer was entitled to an equivalent quantity of gold. The court held that on those facts, no bailment could exist. The court explained:

> A bailment arises only where there is a delivery of property on the basis that the same property will be returned. Its form may be altered, but it must be the same property. Thus where the material delivered is mixed with other material, on the basis that an equivalent quantity of the same type of material will be returned, the contract is one of sale, not bailment: *Crawford v. Kingston and Johnston* (1952) O.R. 714; *South Australian Ins. Co. v. Randell*, [1886] 3 L.R.P.C. 101. (The facts are distinguishable from those in Busse v. Edmonton Grain & Hay Co. Ltd., [1932] 1 WWR 296 (BCCA), where no intermixing was contemplated and there was a right to return the identical grain and, the grain was not to be consumed).
>
> These principles negated the claim that Delta was merely a bailee with property remaining with the creditors. The refining process necessarily involved the intermixing of metal derived from various customers together with Delta's own metal. The final product was indistinguishable as to source, and was treated as such in Delta's accounting and inventory systems. All the customers bargained for was the return of a certain amount of equivalent metal in kind - not the same property they turned over to Delta.

Eastman Kodak Co. v. Harrison (In re Sitkin Smelting & Refining, Inc.), 639 F.2d 1213 (5th Cir. 1981):

In this instance, the Fifth Circuit found that a bailment existed under Alabama law where Kodak delivered film waste to the debtor for processing and extraction of silver. The parties' contract provided that Kodak's "ownership of the film waste would cease only upon its 'destruction or change in

16 *Miami Metals, 603 B.R. at 736-38.*

17 *Id.* at 740.

18 Canadian law in this respect is substantially identical to New York and Florida law.

identity.'"[19] It also contemplated both a bailment and a sale: the debtor held the unprocessed waste as a bailee, and a sale arose only after the debtor processed the waste and became obligated to purchase the recovered silver.[20] The court explained, however, that "[p]rocessing [of the film waste], of course, would result in the sale of the silver content to [the debtor]."[21] In that case, the film waste was never commingled with the debtor's other inventory or processed. It was labeled, segregated and identified at every stage of the process. The court utilized a five-factor test when the contract contemplated both a bailment and a sale: (1) the option of the customer to require the return of its material or to direct its sale, (2) evidence indicating the material was being stored on the customer's behalf, (3) responsibility for the waste transferred to the processor that is consistent with a bailee's duty of care, (4) the material was tagged, separated, and identified, apart from similar material to be processed, and (5) the processor's bookkeeping did not show the waste as a receivable.[22] 639 F.2d at 1215; *see also United States v. Fleet Nat'l Bank (In re Handy and Harman Refining Group, Inc.)*, 271 B.R. 732, 737 (Bankr. D. Conn. 2001), discussed *infra*.

CONCLUSIONS

As with the refining industry in general, contracts within the precious metals refining industry often indicate both a sale and a bailment relationship. Thus, many courts look to evidence beyond the four corners of the contract to establish the parties' intent. Here, the parties' course of dealing is paramount, notably due to the commingling of the materials as part of the refining process that creates an uncertainty as to whether the materials returned to customers are identical, albeit transformed. The considerations include whether or not the raw product and the end product are fungible, the effect of the commingling with respect to the ability to trace the customer's materials, and the care and control the refiner/processor possesses over the product. The *Miami Metals* court noted in a later decision in In re *Miami Metals I, Inc.*, No. 18-13359 (SHL), 2021 Bankr. LEXIS 61, at *31-32 (Bankr. S.D.N.Y. Jan. 13, 2021) that there are considerations that require further extrinsic evidence that include the tracing and allocation of the metal bank accounts, and the parties' intent to create a refining services relationship as opposed to a purchase and sale relationship.

In particular, the fungibility of refined gold versus the differing characteristics of the raw material is a unique aspect of this industry. Customers vary from gold mining companies to jewelry pawn shops and they all create an array of raw materials from doré (which has varying degrees of gold, silver, and other materials) to scrap shavings of gold and silver to old finished jewelry. It is noteworthy that the court in *Miami Metals* distinguishes the lack of fungibility of the raw material as it is delivered to the refiner versus the fungibility of the finished refined gold product to be sold, credited, or delivered back to the customer. There are nuances in which the tracing of the commingled metals is classified as tracking the refiner's obligation to the customer as an accounting process flow, and not tracking the physical metal itself.

Regardless, the big takeaway in attempting to avoid or lessen such ownership disputes in the bankruptcies of precious metals industry entities is to ensure that the agreement and the parties' course of dealing conforms with the actual process of how the precious metals refinery operates. If the realities of the refining operations limit the capabilities of the parties to enter into a bailment relationship, courts may interpret such relationships as a purchase and sale relationship regardless of the parties' intent in a written document. In other words, make your contracts clear as to a bailment or a sale and make sure that the realities of the refining process mimic the clear contractual arrangements. ■

19 *Id.* at 1214.

20 *Id.* at 1215.

21 *Id.* at 1217.

22 *Id.* at 1215; see also *United States v. Fleet Nat'l Bank (In re Handy and Harman Refining Group, Inc.)*, 271 B.R. 732, 737 (Bankr. D. Conn. 2001).