SALES

THE RECLAIMING SELLER AND THE LIEN CREDITOR: THE END OF AN UNNECESSARY CONTROVERSY

The Uniform Commercial Code, in addition to codifying certain common-law rules, purports to simplify and modernize the law of commercial transactions by introducing substantive changes.[1] One such innovation is embodied in section 2-702(2), which gives to credit sellers a limited right to reclaim goods from a buyer who received them while insolvent.[2] Until recently, section 2-702(3) limited this right by subjecting it to "the rights of a buyer in ordinary course or other good-faith purchaser or lien creditor under this Article," but in December 1966, the Permanent Editorial Board for the Uniform Commercial Code recommended that the reference to lien creditors be deleted.[3] It is the purpose of this comment to discuss the Code's enactment of the common-law remedy of reclamation and, more particularly, to examine the problems which led to the recent change in the Official Text.

At common law, the foundation of the reclamation remedy was the fraud of the insolvent purchaser.[4] A seller could recover his goods from an insolvent buyer who had either concealed the fact of his insolvency or otherwise misrepresented himself to be solvent.[5] The seller's right to reclaim was not unlimited, however, since the intervention of a third party, such as a bona-fide purchaser or lien creditor, raised difficult questions of priorities. At common law, these third parties were justifiably accorded different treatment.

By definition, a good-faith purchaser is one who pays value for goods without notice of defects in his transferor's title or of claims by remote parties. When the goods have been transferred to such an innocent third party, there are then two parties who have given value as a result of the insolvent buyer's fraud—the seller and the good-faith purchaser. Since the equities between these claimants were considered appoximately equivalent, the overriding commercial policy of free transferability of goods was relied upon to resolve the dilemma in favor of the good-faith purchaser. This consideration found expression in the common-law doctrine of "voidable title," by which the bona-fide purchaser was protected from the conflicting claims of the defrauded seller.[6]

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1 U.C.C. § 1-102(2). All Code citations are to the 1962 Official Text.

2 U.C.C. § 2-702(2) provides:

> Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

3 Official Recommendations for Amendment of the Uniform Commercial Code 1 (1966).

4 See, e.g., Donaldson v. Farwell, 93 U.S. 631 (1876); 1 Gilmore, Security Interests in Personal Property 63-65 (1965).

5 Ibid.

6 Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 Yale L.J. 1057, 1059 (1954).

A lien creditor, on the other hand, is one who has invoked judicial or statutory process to satisfy a preexisting debt.[7] He does not part with present value, and it is generally unlikely that he can base his claim to these particular goods upon the debtor's fraud. Delivery of goods to an insolvent buyer is a windfall to the creditor, the injustice of which is only accentuated when there is no *actual* lien creditor and a trustee in bankruptcy intervenes claiming the status of a *hypothetical* lien creditor.[8] Since the seller has fraudulently been induced to deliver goods on credit immediately preceding the buyer's bankruptcy, it would seem that the equities here are not at all equal, and that there is no reason to give priority to lien creditors, or especially to trustees in bankruptcy. On this basis, the pre-Code law of reclamation again reached the apparently just result; at common law, the seller was allowed to regain possession from either the trustee in bankruptcy[9] or the attaching creditor.[10] These parties were not purchasers for value and hence acquired no greater rights in the attached property than was originally held by the debtor—that is, a voidable title.

The Uniform Commercial Code codified the common-law remedy of reclamation for actual fraud and extended its operation to cover cases of constructive fraud. The reasoning of the draftsmen was sound: "Subsection (2) takes as its base line the proposition that any receipt of goods on credit by an insolvent buyer amounts to a tacit business misrepresentation of solvency and therefore is fraudulent as against the particular seller."[11] What is difficult to understand, however, is the inclusion of lien creditors within the class of third parties entitled to priority over the reclaiming seller under section 2-702(3).

As noted above, it is clear that equitable considerations do not compel such treatment for lien creditors. In addition, section 2-702(3) does not state what substantive rights of lien creditors are superior to the seller's right to reclaim. Subsection (3) does contain a reference to section 2-403, which in turn contains a general cross reference to Article 9, but section 9-301 provides only that lien creditors, including trustees in bankruptcy, will prevail over unperfected security interests.[12] The seller's right to reclaim cannot be characterized as a security interest, however, simply because there is no agreement that the seller retain an interest in the goods.[13] The confusion, then, is considerable: the Code gives priority to the rights of a lien creditor, but fails to give the lien creditor any rights. The confusion is not simply academic, however, for whatever was intended by the reference to lien creditors, this inclusion threatened to render illusory the expressed intent of section 2-702(2) to extend the common-law remedy of reclamation by enabling sellers to

[7] U.C.C. § 9-301(3) (based upon the Uniform Trust Receipts Act § 1).

[8] See Bankruptcy Act § 70(c), as amended, 11 U.S.C.A. § 110(c) (Supp. 1966).

[9] Donaldson v. Farwell, supra note 4. Accord, California Conserving Co. v. D'Avanzo, 62 F.2d 528 (2d Cir. 1933).

[10] Glenn, Fraudulent Conveyances 207-10 (1st ed. 1931).

[11] U.C.C. § 2-702, Comment 2.

[12] U.C.C. § 9-301(1)(b), (3).

[13] U.C.C. §§ 9-105(h), -204(1). U.C.C. § 1-201(3) defines an agreement as "the bargain of the parties in fact as found in their language or by implication from other circumstances . . . ."

reclaim without proving actual fraud.[14] If the seller could not recover from lien creditors, especially bankruptcy trustees asserting the rights of hypothetical lien creditors, there would have been no reason to enact section 2-702(2) at all. The buyer must be insolvent before the remedy is available, and insolvency usually means that lien creditors and bankruptcy trustees will be after everything in sight. It seems incredible that this remedy should be defeated by a trustee in bankruptcy, but that is exactly what happened in *In Re Kravitz*,[15] the first case decided under the section.

In *Kravitz*, a seller had delivered goods to an insolvent buyer only three days before an involuntary petition in bankruptcy was filed against the buyer. The court held that, under the Bankruptcy Act,[16] the trustee could assert the rights of any lien creditor of the buyer, and that under Code section 2-702(3) the seller's right to reclaim was subordinate to the rights of "lien creditors under this Article." Since the Code did not specifically provide the lien creditor with any rights, the court felt compelled to use non-Code law under section 1-103 which provides: "Unless displaced by the particular provisions of this Act, the principles of law and equity, including . . . the law relative to . . . fraud [and] . . . misrepresentation . . . shall supplement its provisions."[17] Under non-Code Pennsylvania law, one who extended credit subsequent to the sale, and obtained and executed a lien on the goods before the defrauded seller demanded their return was allowed to prevail.[18] Thus, because it was theoretically possible for such a creditor to have come into existence, the trustee in bankruptcy was allowed to defeat the seller's right to reclaim.

Apart from the fact that the court's rationale ignores the Code's policy of uniformity, one may criticize Pennsylvania's continued protection of this reliance lien creditor. It may be questioned today how often, if at all, a creditor is misled by the debtor's ostensible ownership of property, since in a modern commercial community, it is far more likely that credit is extended on the basis of financial statements from the borrower or the reports of a credit agency.[19] It should be noted, in addition, that it is problematical whether such a reliance lien creditor may exist at all, since he must extend credit subsequent to the sale and obtain and execute a lien before the seller demands reclamation. Moreover, even if such a limited class of creditors does exist and is theoretically entitled to protection, it must be remembered that the trustee in bankruptcy can defeat the seller's right to reclaim by asserting all rights afforded *any* lien creditor by state law, whether or not such a creditor actually

[14] It is difficult to attribute this reference to lien creditors to mere inadvertence. One possible explanation is that the drafters might have been particularly anxious to safeguard the right of creditors to levy upon goods held by the debtor on consignment, and that it was to this right, as contained in § 2-326, that the reference was intended to have been directed.

[15] 278 F.2d 820 (3d Cir. 1960).

[16] Bankruptcy Act § 70(c), as amended, 66 Stat. 429 (1952), 11 U.S.C. § 110 (c) (1964).

[17] 278 F.2d at 822.

[18] Schwartz v. McCloskey, 156 Pa. 258, 27 Atl. 300 (1893); Smith v. Smith, Murphy & Co., 21 Pa. (9 Harris) 367 (1853); Mann v. Salsberg, 17 Pa. Super. 280 (1901).

[19] See Honnold, Sales & Financing 401-02 (2d ed. 1962).

exists.[20] It may have been either of these considerations which left Pennsylvania apparently unique among the states in its pre-Code protection of the reliance lien creditor.[21]

The *Kravitz* result, then, was contrary to the common-law remedy and the expectations of the Code draftsmen only because of the peculiarities of the non-Code Pennsylvania law. Ultimately, of course, the Pennsylvania law came to be controlling only because of the reference to lien creditors in section 2-702(3). Since the result was such a departure, it provoked a flurry of conflicting commentaries[22] and a movement to amend the section by deleting the phrase.[23] Until recently, however, the Permanent Editorial Board remained firm in its view that *Kravitz* was an anomaly and not worth all the trouble it was causing.[24]

One of the many commentaries proposed a construction of section 2-702 which reached the conclusion that the lien creditor and the trustee in bankruptcy should always prevail over the reclaiming seller on the ground that such was the result dictated by the Code.[25] This construction ultimately relies upon Article 9, asserting that the right to reclaim is really a security interest, governed by section 9-113 as "arising solely under the Article on Sales (Article 2)." Since, however, the "debtor" is always in possession of the goods, the interest can never be perfected because there is no security agreement[26] or financing statement.[27] It is thus concluded that the right to reclaim must always be an unperfected security interest specifically subordinated by section 9-301 to the rights of lien creditors, including the trustee in bankruptcy. The sounder interpretation would seem to be that the right to reclaim is not a security interest at all, because there is no agreement that it attach,[28] but rather that it is a *remedy*[29] given by law, which arises only after the debtor has acquired possession.

As additional support for the view under consideration, it is argued that other Code sections indicate a general intent to protect lien creditors. For example, section 2-326, which allows creditors to reach goods held on consignment, is cited as support for the proposition that creditors may reach all goods in the possession of a merchant. That section is not particularly relevant

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20 Bankruptcy Act § 70(c), as amended, 11 U.S.C.A. § 110(c) (Supp. 1966); 4 Collier, Bankruptcy ¶ 70.49 (14th ed. 1966).

21 Vold, Sales 402-03 (2d ed. 1959). See also Gilmore, op. cit. supra note 4, at 63-65; Glenn, op. cit. supra note 10, at 207-10.

22 E.g., Hart & Willier, Forms & Procedures Under the Uniform Commercial Code ¶¶ 12.02, .03[2][c], 24.32[1], .42[2] (1966); Braucher, The Uniform Commercial Code—A Third Look? 14 W. Res. L. Rev. 7 (1962); Shanker, A Reply to the Proposed Amendment of U.C.C. Section 2-702(3): Another View of Lien Creditor's Rights vs. Rights of a Seller to an Insolvent, 14 W. Res. L. Rev. 93 (1962).

23 To date, California, Illinois, Maine, New Jersey, New Mexico, and New York have deleted "or lien creditor" from U.C.C. § 2-702(3).

24 Report No. 2 of the Permanent Editorial Board for the Uniform Commercial Code 48 (1965).

25 Shanker, supra note 22.

26 U.C.C. § 9-113. See U.C.C. § 9-204.

27 U.C.C. §§ 9-302, -402.

28 U.C.C. § 9-204.

29 Article 2, Part 7 is entitled "Remedies."

in the present dispute, however, in that it was designed to prevent collusion between a consignment seller and a merchant by which creditors of that merchant might be misled; it is not at all indicative of a Code policy in a situation where the reclaiming seller, himself, is a defrauded party.

Section 2-403 is cited as support for the argument that lien creditors may be considered good-faith purchasers, but this section is admittedly weak support, since section 1-201(32) shows a definite intent to include only *voluntary* transfers of property within the Code's definition of "purchase." Furthermore, no attempt is made to explain why the term "good-faith purchasers" was not considered adequately descriptive, eliminating the need for a distinct category for "lien creditors."

The arguments offered to support this construction do not cumulatively or individually support the conclusion that the trustee in bankruptcy or lien creditor must prevail. This construction conflicts with the history of the remedy and the stated purpose of the draftsmen to extend the common-law remedy; nevertheless, it might have had superficial appeal as the correct interpretation of the Code.

Another construction of the Code's remedy of reclamation, in keeping with the apparent intent of section 2-702 and corresponding to pre-Code law, admitted the ambiguity created by the reference to lien creditors in section 2-702(3).[30] The conflict, however, was resolved by regarding the reference as meaningless because the section subjects the seller's right to reclaim to only those rights of lien creditors established by the Code itself. Article 9 merely defines the rights of a lien creditor against an unperfected security interest,[31] and Article 2, to which specific reference is made in section 2-702(3), is even less definitive. It is argued, moreover, that the rights of lien creditors should not be determined by extra-Code law as in *Kravitz*, for this is in violation of the Code's policy of uniformity.[32] Rather, a solution should be reached by regarding the reference to lien creditors in section 2-702(3) as essentially surplusage which should be disregarded. According to this interpretation, based upon the implied intent of section 2-702 and the Code's policy of uniformity, the credit seller would be allowed to reclaim despite the intervention of a lien creditor or trustee in bankruptcy. If the *Kravitz* interpretation were followed in all states, reclaiming sellers would usually prevail because the pre-Code law of most jurisdictions afforded them priority over intervening lien creditors.[33] Therefore, the principal difference between this approach and the *Kravitz* construction is that here the seller's right to reclaim would not be dependent upon the vagaries of non-Code lien law.

Thus, section 2-702, as presently enacted in most states, has engendered: one judicial construction by which non-Code law was held to be determinative of the right of a seller to exercise a Code remedy; one commentary construction by which the trustee in bankruptcy was allowed to prevail; and another which liberally interpreted the Code remedy so as to allow sellers to reclaim despite

30 Hart & Willier, op. cit. supra note 22, ¶¶ 12.02, .03[2][c], 24.32[1], .42[2] (1966).

31 U.C.C. § 9-301(1), (3).

32 See U.C.C. § 1-102(2)(c).

33 E.g., Manly v. Ohio Shoe Co., 25 F.2d 384 (4th Cir. 1928); Oswego Starch Factory v. Lendrum, 57 Iowa 573, 10 N.W. 900 (1881).

the intervention of a lien creditor or trustee in bankruptcy. Six states apparently felt that the ambiguities of section 2-702 could not be effectively resolved by construction of the section as originally drafted. California, Illinois, Maine, New Jersey, New Mexico, and New York have definitively settled the controversy by deleting "or lien creditor" from section 2-702(3). This response, a legislative codification of the liberal construction of the section, completely precludes the possible operation of Section 70(c) of the Bankruptcy Act, and thus creates an effective remedy recognized historically as achieving an equitable result.

Presented with the confusion created by the reference to lien creditors, the conflicting interpretations of the section, the original intent to extend the historical remedy, and resolution by amendment in six states, the Permanent Editorial Board for the Uniform Commercial Code has recommended that "or lien creditor" be deleted from section 2-702(3), stating that: "There seems to be no other practicable route to uniformity among the states."[34] This amendment should find acceptance as a simple and effective resolution of a Code controversy, which will further enable the Code to fulfill its avowed purposes: "to simplify, clarify and modernize the law governing commercial transactions . . . and to make uniform the law among the various jurisdictions."[35]

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[34] Official Recommendations for Amendment of the Uniform Commercial Code 2 (1966).

[35] U.C.C. § 1-102.