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Reclamation of Goods from a Fradulent Buyer

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RECLAMATION OF GOODS FROM A FRAUDULENT BUYER

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SECTIONS 2-702(2) and (3)[1] of the Uniform Commercial Code (Code), defining the right of a seller to reclaim goods from an insolvent buyer, have for years been the subject of controversy.[2] The sponsors of the Code have stood firm on the basic policy of these sections for more than twenty-five years, but, in its 1966 Official Recommendations for Amendment of the Uniform Commercial Code, the Permanent Editorial Board includes an amendment striking the words "or lien creditor" from section 2-702(3). That change has already been made in six states: California, Illinois, Maine, New

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1. § 2-702. Seller's Remedies on Discovery of Buyer's Insolvency.

. . . .

(2) 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) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser [or lien creditor] under this Article (Section 2-403). Successful reclamation of goods excludes all other remedies with respect to them. (Brackets indicate language to be deleted.)

2. See ENLARGED EDITORIAL BOARD, SUPPLEMENT NO. 1 TO THE 1952 U.C.C. 106-07 (1955); 1 REP. N.Y. LAW REV. COMM. 105, 129 (1954); 1 *id.* at 547-49 (1955); 1 *id.* at 395 (1956); 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE U. C. C. 72; Bigham, *Tennessee Law and the Sales Article of the UCC*, 17 VAND. L. REV. 873, 905-07 (1964); Braucher, *Sale of Goods in the UCC*, 26 LA. L. REV. 192, 220-21 (1966); Braucher, *The UCC—A Third Look?*, 14 W. RES. L. REV. 7, 16 (1962); Duesenberg, *Title: Risk of Loss and Third Parties*, 30 MO. L. REV. 191, 209-10 (1965); Hawkland, *The Relative Rights of Lien Creditors and Defrauded Sellers—Amending the UCC to Conform to the Kravitz Case*, 67 COM. L.J. 86 (1962); Hogan, *The Highways and Some of the Byways in the Sales and Bulk Sales Articles of the UCC*, 48 CORNELL L.Q. 1, 28-29 (1962); Hogan, *The Marriage of Sales to Chattel Security in the UCC: Massachusetts Variety*, 38 B.U.L. REV. 571, 578 (1958); Kennedy, *The Trustee in Bankruptcy Under the UCC: Some Problems Suggested by Articles 2 and 9*, 14 RUTGERS L. REV. 518, 549-56 (1960); MacLachlan, *Two Wrongs Make a Right*, 37 TEXAS L. REV. 676, 680 (1959); Malcolm, *The Proposed Commercial Code*, 6 BUS. LAW. 113, 145, 161-62 (1951); Peters, *Remedies for Breach of Contracts Relating to the Sale of Goods Under the UCC*, 73 YALE L.J. 199, 218-23 (1963); Shanker, *A Reply to the Proposed Amendment of UCC Section 2-702(3)*, 14 W. RES. L. REV. 93 (1962); Williston, *The Law of Sales in the Proposed Uniform Commercial Code*, 63 HARV. L. REV. 561, 585 (1950); 45 CORNELL L.Q. 566 (1960); 79 HARV. L. REV. 598, 608-13 (1966); 1962 U. ILL. L.F. 418, 436-37; 68 YALE L.J. 751, 757 (1959).

Jersey, New Mexico, and New York. In order to understand and evaluate it, one must unravel an intricate tangle of state and federal law.

I. The Problem

Since *In re Kravitz*[3] must be considered in any discussion of reclamation under the Code, we can use its facts to pose the basic situation with which sections 2-702(2) and (3) deal. In *Kravitz,* radios were bought on credit on Thursday and delivered on Friday. The following Monday a petition in bankruptcy was filed against the buyers, and on Tuesday the seller took the necessary steps to rescind the sale. A petition to reclaim the goods from the trustee in bankruptcy was filed, but by stipulation the goods were sold and the proceeds substituted. The referee in bankruptcy denied reclamation and allowed the seller a general claim for nearly $21,000. The district court and the court of appeals affirmed.

The referee was prepared to find that on Thursday the buyers knew they were hopelessly insolvent and could not pay for the goods, and knowingly concealed their insolvency from the seller. He thought it unnecessary to decide whether there were actual misrepresentations or whether under Pennsylvania law something less would entitle the seller to rescind. Under Pennsylvania law, he held, a defrauded seller could not reclaim goods from a levying creditor of the buyer if the creditor's claim arose after delivery of the goods to the buyer; under section 70c of the Bankruptcy Act, the trustee had the rights of such a creditor. The district court reached the same result as the referee but took a somewhat different view—that the seller could reclaim only if there had been a positive misrepresentation, and that there was no proof of such a misrepresentation.[4] The court of appeals affirmed but adopted the referee's analysis.[5]

II. Pre-Code Law

A. *State Law*

The Uniform Sales Act contained no provision on reclamation by a seller by reason of insolvency or fraud of the buyer. It was gen-

3. 278 F.2d 820 (3d Cir. 1960). The referee's decision is reported at 33 Ref. J. 57 (1959); *accord, In re* Units, Inc., 3 U.C.C. Rep. 46 (D. Conn. 1965); *In re* Eastern Supply Co., 1 U.C.C. Rep. 151 (W.D. Pa. 1963), *aff'd,* 331 F.2d 852 (3d Cir. 1964); *cf.* Metropolitan Distribs. v. Eastern Supply Co., 21 Pa. D. & C. 2d 128 (C.P. 1959).

4. Dist. Ct. opinion in *Kravitz,* [1956-1959 Transfer Binder] CCH Banker. L. Rep. ¶ 59,607 (E.D. Pa. 1959).

5. 278 F.2d at 823.

erally assumed that a defrauded seller could replevy the goods sold as against the buyer himself, but that insolvency without fraud was not a basis for rescission and replevin.[6] Amid some dispute, there was substantial authority that a hopelessly insolvent buyer who received goods on credit was fraudulent if he knew payment was extremely unlikely and failed to disclose that fact, even though he intended to pay if he could.[7]

The right of the seller to reclaim from the insolvent buyer himself is largely academic, since control of the goods could also be obtained by a levy under a judgment for the price.[8] The question whether there is a right to reclaim ordinarily becomes critical only when there is a third-party claimant. Bona fide subpurchasers from the insolvent buyer have long been protected against avoidance of the buyer's voidable title.[9] But it has been widely held that a levying creditor of the fraudulent buyer is not such a purchaser, at least where he extends credit before the fraudulent sale.[10] Even where credit is extended after the sale, the orthodox rule would protect the levying creditor only if he purchases at an execution sale and pays the purchase price without notice of the fraud, or if there is an estoppel.[11] The defrauded seller is estopped if by words or conduct he induces the creditor to believe that the fraudulent buyer is the owner of the goods, if he has reason to know that the creditor is likely to extend credit in reliance on the apparent ownership, and if the creditor does extend credit in reliance thereon.[12]

A few cases, however, have applied a flat rule that creditors who extend credit to the buyer after he has taken possession under his fraudulent purchase and who levy on the goods are not subject to the seller's right to reclaim. Pennsylvania decisions to this effect

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6. See 3 WILLISTON, SALES §§ 636-37 (rev. ed. 1948); RESTATEMENT, CONTRACTS §§ 471-76 (1932).

7. See, *e.g.*, California Conserving Co. v. D'Avanzo, 62 F.2d 528 (2d Cir. 1933).

8. Such levies are commonly free of any exemption claim by the buyer. See *In re* Rade, 205 F. Supp. 336 (D. Colo. 1962); Kennedy, *Limitation of Exemptions in Bankruptcy*, 45 IOWA L. REV. 445, 458 (1960); 68 YALE L.J. 1459, 1470 (1959). *Contra*, Helton v. Vanderpool, 251 Ky. 312, 64 S.W.2d 883 (1933); *cf.* Annot., 150 A.L.R. 1329 (1944) (burden of identification).

9. See UNIFORM SALES ACT § 24; 3 WILLISTON, *op. cit. supra* note 6, at § 650; RESTATEMENT, CONTRACTS § 476 (1932); *accord* under the Code, *In re* Haywood Woolen Co., 3 U.C.C. Rep. 1107 (D. Mass. 1967); *cf.* Evans Prod. Co. v. Jorgensen, 421 P.2d 978 (Ore. 1966).

10. See 3 SCOTT, TRUSTS §§ 308-09.1, 313, 475 (2d ed. 1956); 3 WILLISTON, *op. cit. supra* note 6, at § 620; Annot., 21 A.L.R. 1031, 1033 (1922).

11. See RESTATEMENT, RESTITUTION § 173 (1937) comments j and k, referring to RESTATEMENT, TRUSTS §§ 306-09, 313 (1935).

12. See RESTATEMENT (SECOND), TRUSTS § 313 comment a (1957).

were relied on in *In re Kravitz*,[13] and there are a few decisions in other states suggesting a similar rule.[14] Some decisions seem to treat any levying creditor without notice of the fraud as a bona fide purchaser,[15] and occasionally an assignee for the benefit of creditors has been treated as a purchaser for value.[16]

B. *Bankruptcy Law*

The right of a seller to reclaim goods from a fraudulent buyer has probably been litigated most frequently in cases in which the buyer was bankrupt. Under the Bankruptcy Act of 1867, the Supreme Court held that only the defeasible title of the fraudulent buyer passed to his assignee in bankruptcy and that the assignee could not recover goods which had been returned to the seller before bankruptcy or retaken by him from the assignee.[17] Those decisions were followed in a large number of cases arising under the Bankruptcy Act of 1898,[18] and the right of reclamation was often treated as a matter of general law without reference to state court decisions.[19]

Until 1910, the trustee's right to property in such cases depended on section 70a(5) of the Bankruptcy Act of 1898, vesting in the trustee "the title of the bankrupt" to all property "which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him . . . ." Where an adverse claim could have been defeated by a purchaser from the bankrupt or by a levying creditor of the bankrupt but there had been no purchase or levy, the trustee was held to take only the bankrupt's title.[20] In 1910, to change this rule, Congress enacted the "strong-arm clause," section 47a(2), which later

13. 278 F.2d at 822 citing Schwartz v. McCloskey, 156 Pa. 258, 27 Atl. 300 (1893); Mann v. Salsberg, 17 Pa. Super. 280 (1901).

14. See McAuliffe & Burke Co. v. Gallagher, 258 Mass. 215, 218, 154 N.E. 755, 756 (1927) (creditor attaching "for a preexisting debt" is not a purchaser for value); Hurd v. Bickford, 85 Me. 217, 218, 27 Atl. 107, 108 (1892) ("This distinction between the rights of prior and subsequent creditors does not seem to have been always recognized."); Bradley v. Obear, 10 N.H. 477, 480 (1839).

15. See Van Duzor v. Allen, 90 Ill. 499 (1878), criticized in East St. Louis Lumber Co. v. Schnipper, 310 Ill. 150, 159, 141 N.E. 542, 545 (1923).

16. Liquid Carbonic Co. v. Whitehead, 115 Va. 586, 80 S.E. 104 (1913).

17. Donaldson v. Farwell, 93 U.S. 631 (1876); Montgomery v. Bucyrus Mach. Works, 92 U.S. 257 (1875); *cf.* Turner v. Ward, 154 U.S. 618 (1876).

18. See 4 COLLIER, BANKRUPTCY § 70.41 (1964); Annot., 59 A.L.R. 418 (1929).

19. *Cf.* Annot., 16 A.L.R.2d 839 (1951).

20. York Mfg. Co. v. Cassell, 201 U.S. 344 (1906); Hewit v. Berlin Mach. Works, 194 U.S. 296 (1904); *cf.* Knapp v. Milwaukee Trust Co., 216 U.S. 545 (1910); Security Warehousing Co. v. Hand, 206 U.S. 415 (1907).

became section 70c.[21] As to property coming into the custody of the bankruptcy court, the new provision vested in the trustee "all the rights, remedies, and powers of a creditor holding a lien by legal or equitable proceedings thereon . . . ."

The effect of the 1910 provision was considered in a few cases of reclamation from a fraudulent buyer, and the statute stimulated attention to the relevant state law. In one case, in which the fraudulent buyer had contracted many other debts after receiving the goods in question, the court analogized the trustee in bankruptcy to an innocent party who has taken a mortgage for a valuable consideration, and denied reclamation.[22] In the others, reclamation was granted on the ground that under the relevant state law a defrauded seller would prevail over a levying creditor of the buyer.[23]

If goods held by a fraudulent buyer are subject to reclamation from his trustee in bankruptcy, a return or retaking of the goods shortly before bankruptcy should not be a preference voidable by the trustee, even though the other elements of a voidable preference are present, since there is no diminution of the assets of the estate. Numerous cases have so held.[24] If the identity of the property has been lost, a transfer of other assets may be preferential; but if the fraudulent buyer still has possession of the property fraudulently obtained, compensation of the seller with other property is to that extent a transfer for new value and hence not a preference.[25]

III. The History of Section 2-702

Prior to 1951, no reference to the rights of lien creditors appeared in the drafts of the provisions which became section 2-702 of the Code. In the 1941 draft, there were provisions that "[a] buyer by buying or contracting to buy on credit warrants that he is and will remain solvent," that "[a] buyer by taking delivery of goods on credit represents that at the time of taking delivery he is solvent,"

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21. 36 Stat. 838 (1910); see 4 Collier, *op. cit. supra* note 18, at § 70.47.

22. *In re* Whatley Bros., 199 Fed. 326 (N.D. Ga. 1912) (Georgia law).

23. *In re* Perelstine, 19 F.2d 408 (W.D. Pa. 1927) (Pennsylvania law); Jones v. H. M. Hobbie Grocery Co., 246 Fed. 431 (5th Cir. 1917) (Alabama law); *In re* Gold, 210 Fed. 410 (7th Cir. 1913) (Illinois law); *In re* J. S. Appel Suit & Cloak Co., 198 Fed. 322 (D. Colo. 1912) (Colorado law).

24. Cunningham v. Brown, 265 U.S. 1 (1924); Kamberg v. Springfield Nat'l Bank, 293 Mass. 24, 199 N.E. 339 (1935); see 3 Collier, *op. cit. supra* note 18, at § 60.18; Annot., 103 A.L.R. 310 (1936).

25. Hough v. Atchison, T. & S. F. Ry., 34 F.2d 238 (10th Cir. 1929); Illinois Parlor Frame Co. v. Goldman, 257 Fed. 300 (7th Cir. 1919); *cf.* Engstrom v. Wiley, 191 F.2d 684 (9th Cir. 1951).

and that bankruptcy within ten days after taking delivery "raises a presumption that the buyer's procurement of delivery was in breach of this representation."[26] The accompanying comment discussed the "conflict in present case-law on what amounts to a sufficient misrepresentation" and strongly recommended that "presumptions" be removed and that "flat legal effect" be substituted.[27] The 1944 draft adopted that recommendation:

> (1) If the seller discovers the buyer to be insolvent or a petition in bankruptcy or for receivership is filed by or against the buyer or he makes an assignment for the benefit of creditors, the seller may
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> . . .
>
> (b) reclaim any goods received by the buyer on credit and still held by him if any of the above-described events occurs within ten days after such receipt. No misrepresentation of solvency made by the buyer enlarges this period for reclamation unless made in writing to the particular seller within three months before delivery of the goods.[28]

Drafts published in the years 1948-1951 changed the wording somewhat. In 1948, the preamble was simplified: references to bankruptcy, receivership, and assignment for creditors were deleted, so that the subsection (1) applied "[w]here the seller discovers the buyer to be insolvent."[29] Subsection (1)(b) was made "subject to the rights of a good faith purchaser under Section 57" (later section 2-403). What is now the last sentence of subsection (3) was added: "Successful reclamation of goods excludes all other remedies with respect to them." In 1949, the section was given its present number.[30] In 1950, the section on good faith purchase was changed to refer to "a buyer in the ordinary course of business" and a provision was added that "the extent to which other purchasers take free of the rights of a secured lender is governed by the Article on Secured Lenders (Article 9)."[31] The cross-reference in section 2-702 was conformed; making the seller's right to reclaim "subject to the rights of a buyer in ordinary course or other good faith purchaser under

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26. REVISED UNIFORM SALES ACT § 16-C (Report and Second Draft 1941); see Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798 (1958).

27. REVISED UNIFORM SALES ACT § 16-C, comment (Report and Second Draft 1941).

28. REVISED UNIFORM SALES ACT § 104 (Proposed Final Draft No. 1, 1944).

29. CODE OF COMMERCIAL LAW art. II, § 103 (1948).

30. U.C.C. §§ 2-405, 2-702 (May 1949 Draft). At the same time, the cross-reference was changed to rights of a good faith purchaser "under this Article (Section 2-405)."

31. U.C.C. §§ 2-403, 2-702 (Spring 1950 Draft). The section was also renumbered to its present number, § 2-403.

this Article (Section 2-403)." The reclamation provisions of section 2-702 were not amended further until after the Code was approved by the sponsoring organizations and the House of Delegates of the American Bar Association in 1951.[32]

After those approvals, references to a "lien creditor" were inserted in sections 2-403 and 2-702.[33] No explanation of the insertion seems ever to have been published; it appears highly probable that it was regarded as an insubstantial editorial change, simply making cross-reference to Articles Six, Seven, and Nine for rules which might prevent reclamation in cases of bulk transfers, documents of title, or secured transactions. The early drafts confirm what one would have inferred—that is, that the draftsmen from the beginning had bankruptcy in mind and intended to authorize reclamation in bankruptcy in the circumstances defined in section 2-702. Nothing in the history of that section through its promulgation and enactment in Pennsylvania in 1953 suggests any weakening of that intention.

The next phase of the history is the consideration of the Code by the New York Law Revision Commission and the response of the sponsors' Editorial Board, culminating in the 1956 Recommendations of the Board and the enactment of the revised Code in Massachusetts in 1957.[34] Again there is no indication of any shift in the intentions of the draftsmen. The first reaction of the Editorial Board was the publication in January 1955 of Supplement Number 1 to the 1952 text of the Code. The supplement included a report of a subcommittee of which the present writer was chairman; that report dealt with sections 2-403 and 2-702 under the heading "Answers to Criticisms of Certain Sections."[35] The report responded to criticism that reclamation under section 2-702 "might conflict with the Bankruptcy Law as a preference" by pointing out that "Comment 2 sets up a fraud theory which might well be followed under the Federal Bankruptcy Act to preserve the right of reclamation granted by this section," citing *California Conserving Co. v. D'Avanzo*,[36] a bankruptcy decision. Later, the two sections were revised, following suggestions of the New York Commission, but only for clarification of such subsidiary matters as the sufficiency of a de-

32. U.C.C. at v (Proposed Final Draft No. 2, 1951); U.C.C. at v (Final Text Edition, 1951).

33. U.C.C. §§ 2-403, 2-702 (Official Draft, 1952).

34. See Braucher, *The 1956 Revision of the UCC*, 2 VILL. L. REV. 3 (1956).

35. See ENLARGED EDITORIAL BOARD, *supra* note 2, at 102, 106.

36. 62 F.2d 528 (2d Cir. 1933).

mand within ten days to support later repossession and the non-exclusion of reclamation for misrepresentation of facts other than solvency or intent to pay.[37]

IV. Related Code Provisions

Although *Kravitz* dealt with facts which occurred in 1958, the 1953 version of the Code was applied since the 1956 revision was not effective in Pennsylvania until January 1, 1960. But there is nothing to indicate that the revision would have affected the court's reasoning or decision. Accordingly, the following discussion refers to relevant Code sections as they were revised in 1956. None of these sections was the subject of any amendment promulgated by the Board before 1966.

As has been indicated, section 2-702 on reclamation refers to section 2-403 for the rights of lien creditors to which the right of reclamation is subject. Section 2-403 in turn states that those rights "are governed by the Articles on Secured Transactions (Article 9), Bulk Transfers (Article 6) and Documents of Title (Article 7)." Examination of Articles Six, Seven, and Nine leads to only one section which seems relevant to the facts of *Kravitz*: section 9-301(3), defining "lien creditor" to mean a levying creditor and to include a trustee in bankruptcy. Judge Goodrich, who wrote for the Court of Appeals in *Kravitz*, was also Director of the American Law Institute, one of the organizations which sponsored the Code. He followed the two-step cross-reference this far, and it is hard to see how he could have followed it further. He then fell back on section 1-103, which makes supplementary general principles of law applicable "unless displaced by the particular provisions of this Act." The pre-existing Pennsylvania law subordinating the reclamation seller's interest to that of a lien creditor who extended credit subsequent to the sale, he held, was not so "displaced" by section 2-702.

A contrary holding could have been based on a plausible reading of these sections. In view of the policy of uniformity expressed in section 1-102(2)(c), and the conflicting pre-Code decisions in the various states, it would have been possible to read section 2-702 as occupying the field of reclamation for a buyer's misrepresentation of solvency or of intent to pay. A lien creditor of the buyer could then prevail over a reclaiming seller only if his rights were rights "under this Article (Section 2-403)." The reference to section 2-403 need not

37. 1956 Recommendations of the Editorial Board for the U.C.C. 52, 72.

be exclusive of other sections; thus, given a different factual situation, a levying creditor might be permitted to take advantage of section 2-326, under which goods held on consignment are in some circumstances "deemed to be on sale or return" and thus subject to claims of the buyer's creditors while in the seller's possession.[38] The reference to section 2-403 and the further reference to Articles Six, Seven, and Nine could be given meaning with respect to lien creditors by, for example, section 9-301(1)(b), which subordinates a seller's unperfected security interest to the rights of a levying creditor of the buyer; a seller with such an interest would then not be permitted to mend his hold by reclaiming under section 2-702. *Kravitz* went beyond such references and subjected the right of reclamation also to any rights that levying creditors of the buyer might have under pre-Code law.

Several other sections have been brought into the discussion of section 2-702 in the legal literature. One is section 2-507(2), which provides: "Where payment is due and demanded on the delivery to the buyer of goods or documents of title, his right as against the seller to retain or dispose of them is conditional upon his making the payment due." The comment to that section states that the words "right as against the seller" are used as words of limitation to conform with Code policy on bona fide purchase; the comment refers to the possibility of waiver and adds that the ten day limitation of section 2-702 "is also applicable here." Sections 2-507 and 2-702 may overlap in a case of payment for goods by a check which is later dishonored. The Kentucky Supreme Court in one such case relied on section 2-702 in allowing the aggrieved seller to reclaim proceeds of the goods from a third person who was neither a bona fide purchaser nor a lien creditor.[39] Bankruptcy courts in Pennsylvania have permitted reclamation under section 2-507 in two bad-check cases subsequent to the *Kravitz* case.[40] In both Pennsylvania cases, section 2-507 was treated as providing an independent basis for reclamation, not subject under Pennsylvania law to the claims of lien creditors. In the first case, the court pointed out that the petition for reclamation was filed within ten days; in the second it was not, but the court held applicable the presumption of section

38. See General Elec. Co. v. Pettingell Supply Co., 347 Mass. 631, 199 N.E.2d 326 (1964), applying § 2-326 in a case not involving misrepresentation.

39. Greater Louisville Auto Auction, Inc. v. Ogle Buick, Inc., 387 S.W.2d 17 (Ky. Ct. of Appeals 1965).

40. *In re* Lindenbaum's, Inc., 2 U.C.C. Rep. 495 (E.D. Pa. 1964); *In re* Mort, 208 F. Supp. 309 (E.D. Pa. 1962).

3-503(2) that thirty days is a reasonable time for presentment of a check.

Reclamation could conceivably also be based on section 2-703(f), which permits a seller to "cancel" in the event of certain types of default by the buyer, but the definition of "cancellation" in section 2-106 in terms of "termination" seems to limit its effect to discharge of "obligations which are still executory on both sides."

However based, it has also been suggested that a right of reclamation might fall within the definition of "security interest" in section 1-201(37). In one of the Pennsylvania cases on reclamation under section 2-507,[41] one of the conclusions of law was that the petitioner was entitled to the amount of the check "as a secured creditor." But one of the consequences of a holding that a right to rescind for fraud is a security interest fully subject to Article Nine would be that, under section 9-203, the right could not be enforced even against the fraudulent party unless the fraudulent party signed a written agreement providing for such a right. Such an absurd conclusion can be avoided in any one of three ways. First, a right to rescind is a right to undo the transaction—to reclaim the goods as a substitute for the price—not a right to "secure" payment of the price as required by the definition of "security interest";[42] under section 2-702(3), successful reclamation "excludes all other remedies." Second, any such security interest is not the result of a transaction "intended to create a security interest" and is not "created by contract" within the meaning of section 9-102, which defines the scope of Article Nine on secured transactions. Third, even if the right is deemed to be a security interest, such a security interest is exempted by section 9-113 from the requirement of a written security agreement and from any requirement of filing, since it arises solely under Article Two on sales and since a buyer who obtains goods by fraud or the equivalent does not "lawfully obtain possession."[43]

Finally, there is a question whether the lien creditor, actual or hypothetical, who is to prevail against a reclaiming seller must have extended credit, or levied, or both, without knowledge of the buyer's misrepresentation, or without notice of it, or in "good faith." Only a creditor who becomes a lien creditor "without knowledge" of a security interest is covered by section 9-301(1)(b); section 9-301(3),

41. *In re* Lindenbaum's, Inc., *supra* note 40.

42. *Cf.* Bloch v. Mill Factors Corp., 119 F.2d 536 (2d Cir. 1941) ("proceeds" does not include rights on rescission). See generally 1 GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 11.1 (1965).

43. McAuliffe & Burke Co. v. Gallagher, 258 Mass. 215, 154 N.E. 755 (1927).

defining "lien creditor," declares that a trustee in bankruptcy is a "lien creditor without knowledge," regardless of his personal knowledge, "unless all the creditors represented had knowledge of the security interest . . . ." None of the other sections referred to above as relevant to the rights of a lien creditor makes any reference to notice or knowledge as a factor limiting or otherwise affecting the lien creditor's rights.

If a pre-Code rule gives a lien creditor of the buyer a right to prevent reclamation and is not "displaced" by section 2-702, but rather is preserved by section 1-103, presumably the effect of knowledge or notice is left to the pre-Code law. Under what is called above the orthodox rule, notice of the seller's claim would apparently prevent a levying creditor from becoming a bona fide purchaser at his execution sale, and knowledge of the claim would seem to negate the reliance element essential to an estoppel.[44] The Pennsylvania rule protecting subsequent creditors is less clear on this point, but it seems fairly arguable that only creditors who extended credit without knowledge should be permitted to prevail over the defrauded seller. The *Kravitz* opinion did not consider the question, perhaps because the trustee in bankruptcy was thought to be "the ideal creditor, irreproachable and without notice, armed cap-a-pie with every right and power which is conferred by the state upon its most favored creditor who has acquired a lien by legal and equitable proceedings."[45]

V. Bankruptcy Developments

Although there was much concern over developments in bankruptcy law as they affected secured transactions, there is no indication that the sponsors of the Code were greatly concerned as to the impact of the Bankruptcy Act on rights under section 2-702. Since 1949, the comment to section 2-702 has contained a statement that reclamation is "preferential treatment," and in 1950 Professor Williston raised the question of preference in bankruptcy.[46] But others were concerned only that reclamation grounded on insolvency in the absence of fraud might be disallowed in bankruptcy.[47] Before

44. See notes 11 & 12 *supra.*

45. 278 F.2d at 822, quoting *In re* Waynesboro Motor Co., 60 F.2d 668, 669 (S.D. Miss. 1932).

46. See Williston, *The Law of Sales in the Proposed Uniform Commercial Code*, 63 Harv. L. Rev. 561, 585 (1950).

47. See Malcolm, *supra* note 2, at 161-62; *cf.* Enlarged Editorial Board, *supra* note 2.

the *Kravitz* decision there seems to have been no published discussion of the relevant sections of the Bankruptcy Act.

Where state law permits reclamation as against a buyer of goods but not as against third parties claiming under the buyer, the trustee in bankruptcy might conceivably assert rights based on (a) the rights of an actual creditor of the buyer, under sections 67a or 70e of the Bankruptcy Act; (b) the rights of a hypothetical creditor, under section 70c; (c) the invalidity of statutory liens under section 67c; (d) the right to avoid preferences under section 60; or (e) the invalidity of state-created priorities conflicting with the federal priorities established by section 64.

A. *Actual Creditors*

Section 67a(1) renders void a lien obtained by levy within four months before bankruptcy if the debtor was then insolvent. If an actual creditor of a fraudulent buyer levied on the goods shortly before bankruptcy, his lien could thus be set aside by the trustee. Section 67a(3) provides that in such a case the court may on due notice order the lien preserved for the benefit of the estate. If the seller's right to reclaim is subject to the levy under state law, the trustee could thus assert whatever rights the levying creditor could have asserted against the seller. Those rights would include not only priority under the Pennsylvania rule applied in the *Kravitz* case, but also any estoppel arising under the orthodox rules.[48]

Section 70e(1) renders void a "transfer" which is "fraudulent as against or voidable for any other reason by any creditor" of the bankrupt. The definition in section 1(30) treats retention of a security title as a "transfer" from buyer to seller and may well be broad enough to cover a seller's right to reclaim for fraud. If such a "transfer" is subject to the rights of an actual creditor of the buyer, it would be no great strain on the words "fraudulent" or "voidable" to apply section 70e. Under section 70e (2), the transfer can be preserved for the benefit of the estate, but the trustee can also recover the property for the estate, entirely free of the seller's interest, even though the actual creditor could only insist on prior payment of a comparatively small claim.[49]

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48. See notes 11–14, *supra*.

49. See MACLACHLAN, BANKRUPTCY §§ 284-85 (1956); *cf., e.g.*, Friedman v. Sterling Refrigerator Co., 104 F.2d 837 (4th Cir. 1939) (actual claim of $14.23 invalidated security for $534.25).

B. *Hypothetical Creditors*

Section 70c has, since 1910, conferred on the trustee in bankruptcy the rights of a creditor holding a legal lien on property of the bankrupt, whether or not such a creditor actually exists; amendments to the provision in 1938, 1950, 1952, and 1966 seem not to have changed its application for present purposes.[50] Section 70c has been held to give the trustee the status not merely of a lien creditor but of a lien creditor "without notice," and that status has sometimes been extravagently characterized as that of an "ideal" lien creditor.[51]

The concept of an "ideal" lien creditor was applied in *Kravitz* to give the trustee the status of a lien creditor without notice who extended credit after the buyer received the goods. In 1954, the same concept had been applied in the Second Circuit to give the trustee the rights under New York law of a hypothetical lien creditor without notice who had extended credit during a period of delay in recording, although the period had ended more than a year before bankruptcy.[52] Fears were expressed that the trustee would be allowed "to take advantage of all sorts of hypothetical actions by a hypothetical lien holder to improve his position,"[53] but in 1961 the Supreme Court rejected the Second Circuit decision, stating that "the trustee acquires the status of a creditor as of the time when the petition in bankruptcy is filed."[54] The Court also said: "The construction of § 70c which petitioner urges would give the trustee power to set aside transactions which no creditor could void and which injured no creditor."[55]

The result is to cast in doubt the concept of the "ideal lien creditor" applied in *Kravitz.* Since 1961, it has been held in the Ninth Circuit that section 70c gives the trustee the status of a hypothetical levying creditor only if at the date of bankruptcy there was an actual creditor who could have obtained a lien by levy; the result was to deny the trustee the status of a creditor who extended credit after the date of the transaction under attack, because no actual creditor had so extended credit.[56] On the other hand, it has been held in the

50. See note 21 *supra*; MACLACHLAN, *op. cit. supra* note 49, at § 183.

51. Hoffman v. Cream-O-Products, 180 F.2d 649 (2d Cir.), *cert. denied,* 340 U.S. 815 (1950); see note 45 *supra.*

52. Constance v. Harvey, 215 F.2d 571 (2d Cir.), *cert. denied,* 348 U.S. 913 (1954).

53. See MACLACHLAN, *op. cit. supra* note 49, at § 183.

54. Lewis v. Manufacturers Nat'l Bank, 364 U.S. 603, 607 (1961).

55. *Id.* at 608.

56. Pacific Fin. Corp. v. Edwards, 304 F.2d 224 (9th Cir. 1962), 76 HARV. L. REV. 1296 (1963).

Third Circuit that section 70c continues to grant the trustee the status of a lien creditor without notice, apparently without regard to whether there was an actual creditor without notice.[57] For the time being, it seems unlikely that section 70c will bring into play a hypothetical estoppel of a defrauded seller to assert his rights against a hypothetical creditor of the fraudulent buyer.

C. *Statutory Liens*

Statutory liens on personal property are sometimes more like priorities than like true liens.[58] The Chandler Act of 1938 eliminated state-created priorities from section 64 of the Bankruptcy Act, and section 67c subordinated state statutory liens on personal property not accompanied by possession to certain claims which were given federal priority. A 1952 amendment invalidated such statutory liens as against the trustee. If the right to reclaim under section 2-702 of the Code were treated as a statutory lien, it would thus be invalid in bankruptcy.

In 1956, a decision in the Third Circuit held that a consensual security interest provided for by statute was a "statutory lien."[59] The opinion was withdrawn and the question left open on rehearing,[60] and a contrary rule was made explicit in the statute by a 1966 amendment.[61] Nevertheless, reclamation by a defrauded seller seems not to be affected by these developments, since reclamation is not consensual. Moreover, it is to be hoped that a right to rescind, excluding all other remedies, will not be regarded as a "lien," just as it should not be regarded as a "security interest" under the Code.[62]

D. *Preferences*

At the time section 2-702 first took shape, section 60 of the Bankruptcy Act, as amended by the Chandler Act of 1938, had the effect in some circumstances of conferring on the trustee in bankruptcy

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57. *In re* Dee's, Inc., 311 F.2d 619 (1962).

58. See 4 COLLIER, *op. cit. supra* note 18, at § 67.20; MACLACHLAN, *op. cit. supra* note 49, at §§ 155 & 213.

59. *In re* Quaker City Uniform Co., [1956-1959 Transfer Binder] BANKR. L. REP. ¶ 58778 (3d Cir. 1956). *Contra, In re* Tele-Tone Radio Corp., 133 F. Supp. 739 (D.N.J. 1955).

60. *In re* Quaker City Uniform Co., 238 F.2d 155 (3d Cir. 1956), *cert. denied*, 352 U.S. 1030 (1957); 70 HARV. L. REV. 1296 (1957).

61. Bankruptcy Act § 1(29a), added by 80 Stat. 268, 11 U.S.C.A. § 1 (1966); see H.R. REP. No. 686, 89th Cong., 1st Sess. (1965).

62. See note 42 *supra* and accompanying text.

rights given by state law to bona fide purchasers from the debtor.[63] In 1950, shortly before promulgation of the Code, amendments to section 60 abolished the "bona fide purchaser test" with reference to personalty and substituted a test of perfection against lien creditors.[64] The result is to suggest the possibility that, if a reclaiming seller could be defeated by a hypothetical lien creditor of the fraudulent buyer, the "transfer" to the seller is not perfected, constitutes a "preference," and can be set aside by the trustee if the seller has reasonable cause to believe that the debtor is insolvent at the time the transfer is perfected. If the transfer is not perfected before bankruptcy, section 60a(2) deems it to be perfected "immediately before the filing of the petition."

If reclamation is not accomplished before bankruptcy and, as noted above, the trustee can defeat it under sections 70c or 70e of the Bankruptcy Act, there is no need for him to rely on section 60. On the other hand, if the reclaiming seller has improved his position by taking possession shortly before bankruptcy, it seems entirely proper to use section 60 to deprive him of any preferential advantage thus obtained. But if reclamation from the trustee would be proper, reclamation from the buyer shortly before bankruptcy seems not to satisfy the language of section 60a(1), which limits preferences to transfers the effect of which "will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class." Thus the transfer to the seller would not constitute a voidable preference and could not be set aside by the trustee. Recent developments do not seem to have undermined the reasoning of earlier cases to this effect.[65]

E. *State Priorities*

Section 64a of the Bankruptcy Act specifies five classes of debts entitled to priority. Before 1938, fifth priority was accorded to debts entitled to priority by state law, but the Chandler Act eliminated state-created priorities except for landlords. In a number of situations, claims of statutory rights to property arising upon insolvency have been held ineffective in bankruptcy as state-created priorities.[66]

63. Corn Exch. Nat'l Bank & Trust Co. v. Klauder, 318 U.S. 434 (1943); see MACLACHLAN, *op. cit. supra* note 49, at §§ 257-61.

64. See MACLACHLAN, *op. cit. supra* note 49, at §§ 262-66.

65. See note 24 *supra*.

66. Elliott v. Bumb, 356 F.2d 749 (9th Cir. 1966); N. W. Day Supply Co. v. Valenti, 343 F.2d 756 (1st Cir. 1965); Crosstown Motors, Inc. v. Allen, 272 F.2d 224 (7th Cir. 1959), *cert. denied*, 363 U.S. 811 (1960).

It is this principle which provides whatever justification there is for the fear that reclamation grounded on insolvency without fraud might be contrary to the Bankruptcy Act.[67] But if reclamation for fraud is something other than a priority, it is hard to see why reclamation for innocent misrepresentation, mistake, or breach of warranty should stand on any different footing. There is a common-law basis for rescission on such grounds, and section 2-702 of the Code can easily be read, not as conferring a right arising on the buyer's insolvency, but rather as putting short time limits on the right which might exist without the statute. So read, it does not create a priority but rather a beneficial interest in specific property. In any event, section 2-702 is not limited in its effect to insolvency proceedings: it authorizes reclamation without regard to whether or when such proceedings are begun.

VI. The Sponsors' Response to *Kravitz*

The *Kravitz* decision in 1960 seems to have come as a surprise to the draftsmen of the Code. There was general agreement that a right to reclaim from a fraudulent buyer would lose most of its utility if it was ineffective in bankruptcy and that the insertion of the words "or lien creditor" had been a mistake. The bill to enact the Code in Illinois was then in process; with Professor Llewellyn, the chief draftsman of the Code, participating, the offending words were deleted from the bill. New Mexico and New York followed the Illinois example, and a subcommittee of which the writer was chairman recommended approval of the Illinois solution, but a vigorous argument against the amendment by Professor Shanker[68] led to its rejection by the Permanent Editorial Board. The Board's report stated the *Kravitz* case, added that "in most states the pre-Code law was otherwise," noted the amendment in three states, and concluded: "The Board is not convinced that the decision in *In re Kravitz* requires an amendment of this section."[69] The comment to section 2-702 was then rewritten to make appropriate cross-references to other sections of the Code that are relevant to rights of lien creditors.[70]

Four years later, California, Maine, and New Jersey had also fol-

67. See note 47 *supra*; 79 Harv. L. Rev. 598, 612 (1966).

68. See note 2 *supra*.

69. U.C.C. Permanent Editorial Board, Report No. 1, at 70 (1962), reprinted in Report No. 2, at 48 (1964).

70. U.C.C. Permanent Editorial Board, Report No. 1, at 137; *cf.* part IV *supra*.

lowed the Illinois example. The subcommittee was still of the same opinion. Only three states remained who had not enacted the Code,[71] and the Permanent Editorial Board was less reluctant than before to re-examine Code provisions. On a renewed recommendation of the subcommittee, the Board promulgated the Illinois amendment for uniform adoption.[72] The "Reason for Change" states that the cross-reference is confusing, summarizes the *Kravitz* case, adds that "the result in Pennsylvania is to make the right of reclamation granted by this section almost entirely illusory," repeats the statement that pre-Code law was otherwise in most states, notes a subsequent decision contrary to *Kravitz* on the scope of section 70c of the Bankruptcy Act, and concludes: "Six states have resolved the problem by deleting the words 'or lien creditor' from this section, and there seems to be no other practicable route to uniformity among the states."[73]

VII. The Result

For the time being, the law is something less than uniform. But the hope of the Code sponsors obviously is that general adoption of the Illinois solution will produce uniformity. This requires us to consider the horrid possibility that the deletion of the words "or lien creditor" from section 2-702 still leaves the rights of lien creditors to pre-Code law under section 1-103. The presence of those words was not sufficient to "displace" pre-Code law in *Kravitz;* can their absence be more effective? The answer given by a literal reading of the text of the Code is clear: the seller has a right to reclaim under stated conditions. That right is "subject to the rights of a buyer in ordinary course or other good faith purchaser under this Article (Section 2-403)." There is no similar exception for lien creditors, and the legislative history recounted here makes it clear that the omission was not inadvertent.

What if the seller has represented to a creditor of the buyer that the buyer paid cash for the goods and the creditor has so relied that, as against him, the seller is estopped to claim that the sale was on credit? How does this affect the right to reclaim which the seller would otherwise have? Deletion of the words "or lien creditor" may be sufficient to "displace" a general rule preferring lien creditors, but it seems very doubtful that it displaces the doctrine of estoppel.

71. Arizona, Idaho and Louisiana. Enactment in Arizona and Idaho came in 1967.

72. U.C.C. Permanent Editorial Board, 1966 Official Recommendations for Amendment of the U.C.C. 1 (1967).

73. *Ibid.*

Therefore, if the creditor levies before the seller reclaims, he should be able to assert the estoppel to defeat reclamation. If bankruptcy follows, the trustee can set aside the levy under section 67a of the Bankruptcy Act or he can preserve it for the benefit of the estate. Even if there is no levy, if the right to reclaim is treated as a "transfer" and is "fraudulent" or "voidable," the trustee under section 70e can assert the rights of the particular creditor, including any estoppel.

On the other hand, if there is no estoppel available to any actual creditor, it now seems unlikely that the trustee can use section 70c to assert a hypothetical estoppel available to a hypothetical creditor, regardless of the outcome of pending disputes as to the scope of that section. It should follow that reclamation before bankruptcy is not a voidable preference even if there is an actual creditor who could defeat reclamation. And nothing in the Code amendment gives color to the treatment of a right to reclaim as a statutory lien or a state-created priority.

Hopefully, therefore, uniform adoption of the Code amendment will generally validate the right to reclaim stated in section 2-702 according to the terms of that section, in bankruptcy as well as out. The law will then be, as it was in the beginning, the way most of us thought it should be. After a troubled and perilous voyage, we will have returned safely to the port from which we embarked.