Washington and Lee Law Review

Volume 34 | Issue 1 Article 9

Winter 1-1-1977

Ucc § 2-702(2): An Invalid State Priority In Bankruptcy

UCC § 2-702(2): AN INVALID STATE PRIORITY IN BANKRUPTCY

Section 67c(1)(A) of the Bankruptcy Act[1] empowers a trustee in bankruptcy to avoid every statutory lien which first becomes effective upon the debtor's insolvency. This provision qualifies the general validity accorded statutory liens under § 67b[2] by invalidating those liens which are essentially state priorities. Such liens do not confer any rights against property prior to insolvency of the debtor, but merely determine the order of distribution of the bankrupt's assets. Thus, these liens operate to confer priority status upon certain unsecured creditors.[3]

The priority of unsecured claims in the federal scheme of distribution is determined according to § 64 of the Bankruptcy Act.[4] That section has specifically excluded state-created priorities from favored treatment since passage of the Chandler Act in 1938.[5] Section 67c(1)(A) preserves the federal scheme of priorities as set out in § 64 by specifically invalidating priorities which would otherwise be upheld as statutory liens under the broad provisions of § 67b. Therefore, any statutory lien which is rendered invalid under § 67c(1)(A) is

---

[1] Bankruptcy Act § 67c(1)(A), 11 U.S.C. § 107(c)(1)(A)(1970), provides that "every statutory lien which first becomes effective upon the insolvency of the debtor, or upon distribution or liquidation of his property, or upon execution against his property levied at the instance of one other than the lienor" shall be invalid against the trustee.

[2] Bankruptcy Act § 67b, 11 U.S.C. § 107(b)(1970). The Chandler Act, ch. 575, §§ 1-703, 52 Stat. 840 (1938), eliminated the recognition originally given state priorities in bankruptcy, except for a limited priority for landlords. The change was made in the interests of national uniformity in the distribution of a bankrupt's assets. Nonetheless, in recognition of valid property interests created by state law, the Act gave explicit recognition for the first time to the general validity of statutory liens in § 67b. However, to meet situations in which states might express priorities in terms of liens and thus disrupt the new federal scheme of priorities as prescribed in § 64 of the Bankruptcy Act, 11 U.S.C. § 104 (1970), § 67c imposed limitations on the scope of § 67b. Section 67c was amended in 1952 and completely revised in 1966 to insure further the supremacy of the federal order of distribution. For a comprehensive discussion of the evolution of present § 67c, *see* 4 W. COLLIER, BANKRUPTCY § 67.20 (14th ed. 1975) [hereinafter cited as COLLIER].

[3] S. REP. No. 1159, 89th Cong., 2d Sess. 6, *reprinted in* [1966] U.S. CODE CONG. & AD. NEWS 2456, 2461.

[4] Bankruptcy Act § 64, 11 U.S.C. § 104 (1970), provides that certain general claims against the bankrupt estate and costs and expenses of bankruptcy proceedings are to receive priority in advance of payment to other general creditors. *See generally* 3A COLLIER, *supra* note 2, § 64.02 *et seq.*

[5] *See* note 2 *supra.*

likewise implicitly invalidated by § 64.[6]

Trustees in bankruptcy have invoked their powers under § 67c(1)(A)[7] to challenge the exercise of a seller's right to reclaim goods pursuant to § 2-702(2) of the Uniform Commercial Code (U.C.C.)[8] prior to distribution of a bankrupt buyer's assets among other unsecured creditors.[9] Section 2-702(2) accords the seller of goods on credit who discovers his buyer has received the goods while insolvent the right to reclaim those goods if he makes demand within ten days of the buyer's receipt.[10] The subsection also provides that reclamation is the seller's only remedy in cases involving the buyer's fraudulent or innocent misrepresentation of solvency or intent to pay.[11] Section 2-702(3) further provides that successful reclamation is an exclusive remedy and that the seller's right to reclaim is subject to the rights of buyers in the ordinary course of business and other good faith purchasers.[12]

---

[6] Either § 64 or § 67c(1)(A) may be used by a trustee in bankruptcy to invalidate statutory liens which are in essence state priorities. However, § 67c(1)(A) specifically addresses the situation in which a priority is expressed by a state in terms of a lien and explicitly provides that such a lien is invalid against the trustee. *See* notes 1 & 2 *supra.*

[7] *See* text accompanying note 1 *supra.*

[8] U.C.C. § 2-702(2) (1972 version) is state law in all United States jurisdictions except Louisiana and 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 intent to pay.

[9] The trustee has been successful in the following cases: Cohen & Sons, Inc. v. Perskey & Wolf, Inc., (*In re* Perskey & Wolf, Inc.), 19 U.C.C. REP. SERV. 812 (N.D. Ohio 1976); Carnation Plastic Mfg. Co. v. Giltex, Inc., (*In re* Giltex, Inc.), 17 U.C.C. REP. SERV. 887 (S.D.N.Y. 1975); Queensboro Farm Products v. Wetson's Corp., (*In re* Wetson's Corp.), 17 U.C.C. REP. SERV. 423 (S.D.N.Y. 1975); *In re* Good Deal Supermarkets, 384 F. Supp. 887 (D.N.J. 1974); *In re* Federal's, Inc., 12 U.C.C. REP. SERV. 1142 (E.D.Mich. 1973). The reclaiming seller has prevailed in Alfred M. Lewis, Inc. v. Holzman (*In re* Telemart Enterprises, Inc.), 524 F.2d 761 (9th Cir. 1975), *cert. denied,* 96 S. Ct. 1466 (1976) and *In re* National Bellas Hess, Inc., 17 U.C.C. REP. SERV. 430 (S.D.N.Y. 1975).

[10] The ten-day limitation is inapplicable if a written misrepresentation of solvency was made to the seller within three months before delivery. *See* note 8 *supra.*

[11] *See* note 8 *supra.*

[12] U.C.C. § 2-702(3) provides that "[t]he seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course and other good faith purchaser under this Article . . . . Successful reclamation of goods excludes all other

The Court of Appeals for the Ninth Circuit recently upheld the validity of § 2-702(2) against the trustee's challenge in *Alfred M.*

---

remedies with respect to them. As amended 1966." Prior to the 1966 amendment to the Official Text of the U.C.C., § 2-702(3) also made the seller's right to reclaim subject to the rights of lien creditors. Since a trustee in bankruptcy may claim the status of a lien creditor under Bankruptcy Act § 70c, 11 U.S.C. § 110(c)(1970) and U.C.C. § 9-301(3), cases arose in which trustees asserted their rights as lien creditors to defeat reclaiming sellers. In *In re* Kravitz, 278 F.2d 820 (3d Cir. 1960), the Court of Appeals for the Third Circuit held that § 2-702(3) required application of state common law in determining the respective rights of lien creditors and defrauded sellers. The Third Circuit assumed that a § 2-702(2) reclaiming seller is a defrauded seller entitled to the same rights accorded the defrauded seller at common law. Since Pennsylvania common law subordinates a defrauded seller's rights to those of a lien creditor, the court in *Kravitz* held for the trustee in bankruptcy. Following the *Kravitz* rationale, the Sixth Circuit in Johnson & Murphy Shoes, Inc. v. Meinhard Commercial Corp. (*In re* Mel Golde Shoes, Inc.), 403 F.2d 658 (6th Cir. 1968), reached the opposite result by applying Kentucky common law which favors a defrauded seller over a lien creditor. However, since § 2-702(2) requires no proof of fraud, state common law concerning the equities of defrauded sellers and lien creditors should not apply in favor of sellers who have not been defrauded and seek to reclaim under that subsection. *See* text accompanying notes 27-31 *infra*. *Cf. In re* Federal's, Inc., 12 U.C.C. REP. SERV. 1142, 1150 (E.D. Mich. 1973) (Michigan common law requires seller claiming status of a defrauded seller to establish that buyer did not intend to pay for the goods). *But see* Hawkland, *The Relative Rights of Lien Creditors and Defrauded Sellers—Amending the Uniform Commercial Code to Conform to the Kravitz Case*, 67 COM. L.J. 86 (1962). Furthermore, the reference in former § 2-702(3) to the rights of lien creditors apparently indicates that application of Article 9 priority rules in determining the seller's rights may be appropriate. As an unsecured creditor of the buyer, a § 2-702(2) reclaiming seller who has not been defrauded appears to have no greater rights with respect to lien creditors under former § 2-702(3) than a seller who has an unperfected security interest in goods. *See* U.C.C. § 9-301(1). Since § 9-301(1)(b) gives priority to a lien creditor over a creditor with an unperfected security interest, a lien creditor also should prevail over an unsecured seller. Therefore, by providing that a reclaiming seller is subject to the rights of a lien creditor, former § 2-702(3) allows the trustee in bankruptcy to prevail both under the U.C.C. priority scheme and at common law whenever the seller has not in fact been defrauded.

Subsequent to the *Kravitz* decision, however, six states, including California, amended § 2-702(3) by deleting the reference to lien creditors. The Permanent Editorial Board for the U.C.C. proposed the deletion as a uniform amendment in 1966, and 17 states have adopted the amendment to date. W. WILLIER & F. HART, 6 U.C.C. REP.—DIGEST § 2-702 at 1-172 (1975). Under the amended subsection, the seller's rights are subjected only to the rights of buyers in the ordinary course of business and other good faith purchasers. The deletion of the reference to lien creditors indicates that their rights as defined in § 9-301 no longer operate to give them priority over a § 2-702(2) reclaiming seller. Thus, amended § 2-702(3) precludes the trustee in bankruptcy from defeating reclaiming sellers by asserting his status as a lien creditor under § 70c of the Bankruptcy Act, and the trustee must look to other provisions of the Act to defeat the seller's claim. *See* text accompanying notes 48-53, 73-82, 90-97 and note 87 *infra*.

Lewis, Inc. v. Holzman (In re Telemart Enterprises, Inc.).[13] Telemart Enterprises, Inc., a California corporation formed to engage in the sale and delivery of retail merchandise, opened for business on September 13, 1970. The corporation immediately experienced operational difficulties and petitioned for a Chapter XI arrangement[14] on September 29. Alfred M. Lewis, Inc. had sold $61,587.43 worth of frozen foods and groceries to Telemart on credit, and had delivered the goods periodically from August 27 through September 25. Lewis learned of Telemart's petition on September 30 and demanded the return of the delivered goods pursuant to § 2-702(2).[15]

The Ninth Circuit rejected the trustee's claim that the subsection was invalid under § 67c(1)(A) and maintained that the subsection does not prevent the kind of abuse which § 67c was designed to prevent.[16] The court conceded that § 2-702(2) "evades the spirit" of § 64,[17] but upheld its validity by adopting the view that § 2-702(2) simply authorizes the "exact equivalent" of the common law remedy of rescission traditionally granted defrauded sellers.[18]

Prior to the adoption of the U.C.C. by state legislatures, courts recognized the common law rights of a seller of goods on credit who had been fraudulently induced to enter the sales contract to rescind that contract and reclaim his goods.[19] Only a defeasible or "voidable" title passed to the fraudulent buyer, and if no subsequent innocent

---

[13] 524 F.2d 761 (9th Cir. 1975), *cert. denied,* 96 S. Ct. 1466 (1976).

[14] 11 U.S.C. ch. 11, §§ 701-709 (1970). A Chapter XI arrangement is a supervised plan whereby the insolvent debtor devises the settlement, satisfaction or extension of time of payment of his debts with his unsecured creditors.

[15] The Ninth Circuit addressed itself only to the issue of the validity of § 2-702(2) in bankruptcy proceedings. Having determined that the subsection was valid, the court remanded the case for a new hearing on the question of whether Telemart was insolvent prior to September 29. Section 2-702(2) is operative only when a buyer receives goods while insolvent. *See* note 8 *supra.*

[16] 524 F.2d at 764. The court reasoned that the provisions of § 67c were designed to invalidate only those statutory liens which would have been invalid under § 60 of the Bankruptcy Act, 11 U.S.C. § 96 (1970), had they not been designated liens. *But see* text accompanying notes 83-93 *infra.*

[17] 524 F.2d at 766.

[18] *Id.* at 765.

[19] Donaldson v. Farwell, 93 U.S. 631 (1876); California Conserving Co. v. D'Avanzo, 62 F.2d 528 (2d Cir. 1933). *See also* Countryman, *Buyers and Sellers of Goods in Bankruptcy,* 1 N. MEX. L. REV. 435, 454 (1971). A party who had been fraudulently induced to enter a contract of sale could elect either to affirm the transaction and sue for damages or rescind the contract. Courts allowed rescission because permitting the contract to stand when the defrauded party would not have entered into it had he known the truth would have been inequitable. Similar grounds afforded contracting parties the right to rescind at common law when mistake or duress were involved in the inducement of the contract such that mutual assent to the transaction

purchasers were involved, title revested in the seller upon his showing that he had in fact been defrauded.[20] Since the trustee in bankruptcy acquired no better title than that of his bankrupt, his title to the goods was also subject to divestiture upon the seller's showing of fraud.[21]

The only support offered by the court in *Telemart* for its assertion that § 2-702(2) authorizes the "exact equivalent" of the common law remedy of rescission for fraud was a reference to an Official Comment to § 2-702.[22] The comment states that a buyer's receipt of goods while insolvent is "a tacit business misrepresentation of solvency" and therefore "fraudulent as against the particular seller."[23] A consideration of the grounds for rescission by a seller under the common law, however, indicates that § 2-702(2) clearly extends the common law.

The principal drafter of § 2-702(2) himself acknowledged that the subsection gives a reclaiming seller greater rights than he possessed

---

was improperly obtained. *See, e.g.*, Royal v. Goss, 154 Ala. 117, 45 So. 231 (1907); Neale v. Wright, 130 Ky. 146, 112 S.W. 1115 (1908); Fairbanks v. Snow, 145 Mass. 153, 13 N.E. 596 (1887); 3 S. WILLISTON, SALES, §§ 650, 656-658 (rev. ed. 1948) [hereinafter cited as WILLISTON].

[20] The concept of voidable title protects subsequent good faith purchasers for value and thus encourages the transferability of goods in commerce. Under the doctrine, the seller who has been fraudulently induced by a buyer to enter a contract of sale may avoid the transaction at his option and recover the goods as against the fraudulent buyer. However, a subsequent good faith purchaser for value acquires an indefeasible title from the fraudulent buyer which may not be disturbed by the seller. *See, e.g.*, Clark & White, Inc. v. Fitzgerald, 332 Mass. 603, 127 N.E.2d 172, 175 (1955); WILLISTON, *supra* note 19, § 650, at 503. The U.C.C. does not define the concept of voidable title, but recognizes its validity in § 2-403(1) which restates the rule that a person with voidable title can transfer a good title to a good faith purchaser for value. Furthermore, under U.C.C. § 1-103, this common law doctrine remains viable as a "supplementary general principle of law." *See generally* Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057 (1954).

[21] York Mfg. Co. v. Cassell, 201 U.S. 344 (1906); Hewit v. Berlin Mach. Works, 194 U.S. 296 (1904); Creel v. Birmingham Trust Nat'l Bank, 383 F. Supp. 871, *aff'd*, 510 F.2d 1363 (5th Cir. 1975); Sparrenberger v. National City Bank of Evansville (*In re* Woodruff), 272 F.2d 696 (7th Cir. 1959), *cert. denied*, 362 U.S. 940 (1960). Bankruptcy Act § 70a, 11 U.S.C. § 110(a) (1970), provides that the trustee is vested with the title of the bankrupt as of the date of the filing of the petition.

[22] 524 F.2d at 765.

[23] U.C.C. § 2-702, Comment 2 states that "[s]ubsection (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." The court's complete reliance on the comment is particularly troublesome since the official comments have not been adopted by the California legislature.

at common law.[24] Professor Llewellyn nonetheless contended that § 2-702(2) only "slightly enlarge[d]" the prior existing law of reclamation by standardizing the misrepresentation of solvency which would give rise to a right to rescind.[25] This standardization has also been characterized as having established a "conclusive presumption" that in every case in which a buyer has received goods while insolvent, he has in fact defrauded his seller.[26]

Section 2-702(2), however, does more than "slightly enlarge" the prior law. Under the common law, the reclaiming seller had the burden of proving that he had a superior title and right to possession of the goods in question as against the bankrupt or his trustee in bankruptcy.[27] Thus the seller would prevail only if he could affirmatively prove that he had been defrauded.[28] To establish fraud, various jurisdictions required the seller to show either that the buyer had not intended to pay for the goods when he ordered them on credit,[29] that

---

[24] K. LLEWELLYN, MEMORANDUM IN 1 N.Y. LAW REV. COMM'N, REPORT AND RECORD OF HEARINGS ON THE UNIFORM COMMERCIAL CODE, LEGIS. DOC. No. 65(b), 126 (1954).

[25] *Id.*

[26] Kennedy, *The Trustee in Bankruptcy Under the Uniform Commercial Code; Some Problems Suggested by Articles 2 and 9,* 14 RUTGERS L. REV. 518, 549 (1960); King, *Reclamation Petition Granted: In Defense of the Defrauded Seller,* 44 REF. J. 81, 82 (1970). To characterize § 2-702(2) as establishing a "conclusive presumption" of fraud is in effect to say that the subsection does not establish any evidentiary presumptions at all. As Professor Wigmore noted,

> Wherever from one fact another is said to be conclusively presumed, in the sense that the opponent is absolutely precluded from showing by any evidence that the second fact does not exist, the rule is really providing that, where the first fact is shown to exist, the second fact's existence is wholly immaterial for the purpose of the proponent's case; and to provide this is to make a rule of substantive law, and not a rule apportioning the burden of persuading as to certain propositions or varying the duty of coming forward with evidence.

9 J. WIGMORE ON EVIDENCE § 2492 at 292 (3d ed. 1940) (footnote omitted). *See also* C. MCCORMICK, EVIDENCE, § 342, at 804 (2d ed. 1972).

[27] *See, e.g.,* National Silver Co. v. Nicholas, 205 F.2d 52, 55 (5th Cir. 1953) (seller has "burden of adducing facts sufficient to establish that its claim to possession is superior to the *prima facie* right of the trustee"); Rochford v. New York Fruit Auction Corp., 116 F.2d 584, 585 (2d Cir. 1940) (charge of fraud must be "thoroughly proven"); Manly v. Ohio Shoe Co., 25 F.2d 384, 385 (4th Cir. 1928)("in every case the fraud must be established to the satisfaction of the court by evidence clear, unequivocal, and convincing").

[28] *See* cases cited in note 27 *supra.*

[29] Donaldson v. Farwell, 93 U.S. 631 (1876)(agent who had made purchase for bankrupt defendant testified that at the time of purchase he did not expect that he or the defendant would pay for the goods); United Constr. Co. v. Milam, 124 F.2d 670 (6th Cir.), *cert. denied,* 317 U.S. 642 (1942)(seller's demonstration that buyer was

the buyer had induced the sale by knowingly concealing his hopeless insolvency when he ordered the goods,[30] or that he had induced the sale by false material misrepresentations of his financial status.[31]

In every case, the "true ground" for rescission was the buyer's fraudulent intent which induced the contract of sale.[32] Since that intent was most difficult for the seller to demonstrate, courts sought to alleviate the seller's burden in the situation where the buyer had simply concealed his hopeless insolvency by inferring intent from facts which established the buyer's knowledge of his condition when he ordered the goods.[33] The courts inferred that one who ordered goods while hopelessly insolvent could not reasonably have intended to pay for them. The requirement remained, however, that the seller present sufficient facts regarding the buyer's situation from which the inference of fraudulent intent could be drawn.[34] Courts clearly emphasized that the mere fact that a buyer was insolvent when he ordered the goods was insufficient to support a finding of fraud.[35]

The event which entitles a seller to rescind and reclaim under § 2-702(2), the buyer's receipt of goods while insolvent,[36] differs significantly from events which supported inferences of fraudulent intent in pre-Code cases. In those cases, intent not to pay was inferred from

---

insolvent at the time of purchase was insufficient without further proof to support a finding that buyer had no intention of paying for the goods).

[30] Rochford v. New York Fruit Auction Corp., 116 F.2d 584, 585 (2d Cir. 1940)(seller's showing that buyer was insolvent at the time of purchase was insufficient without further proof to support a finding of "absence of hope" on the part of buyer); California Conserving Co. v. D'Avanzo, 62 F.2d 528, 530 (2d Cir. 1933)(buyer knew at the time of purchase that his affairs had become so precarious that his ability to pay was clearly compromised); Manly v. Ohio Shoe Co., 25 F.2d 384, 385 (4th Cir. 1928) (officers in control of bankrupt corporation knew at the time of purchase that the corporation was "hopelessly insolvent"); Gillespie v. J. C. Piles & Co., 178 F. 886 (8th Cir. 1910)(buyer knew at the time of purchase that he had and could obtain no money or credit with which to pay for hogs ordered).

[31] Sternberg v. American Snuff Co., 69 F.2d 307 (8th Cir. 1934)(seller relied upon false financial statements submitted by buyer to commercial agency); *In re* Indiana Concrete Pipe Co., 33 F.2d 594 (N.D.Ind. 1929)(false financial statement furnished to seller); *In re* Bendall, 183 F. 816 (N.D.Ala. 1910)(buyer made false statements in writing concerning his assets and liabilities and the condition of his bank account).

[32] WILLISTON, *supra* note 19, § 637 at 457.

[33] *See* cases cited in note 30 *supra.*

[34] *See* cases cited in note 27 *supra.*

[35] Thus, one court noted that "[m]any an insolvent obtains goods on credit with the honest intent to pay for them and many times he succeeds in doing so." Gillespie v. J. C. Piles Co., 178 F. 886, 890 (8th Cir. 1910). *See also* United Constr. Co. v. Milam, 124 F.2d 670 (6th Cir.), *cert. denied,* 317 U.S. 642 (1942); WILLISTON, *supra* note 19, § 637 at 457.

[36] U.C.C. § 2-702(2).

facts which existed at the time the buyer ordered the goods.[37] The fraud involved was fraud in the inducement, and rescission was allowed on the basis that the seller would not have entered the contract of sale had he known the buyer did not intend to pay.[38] Section 2-702(2), however, wholly disregards any consideration of fraud in the inducement.[39] The buyer's intent at the time the contract of sale was made has no relevance in determining its applicability.[40] Instead, rescission is automatically granted when the buyer receives goods while insolvent. If the buyer does not inform the seller before delivery, the seller may exercise his right to reclaim and recover the goods. Arguably, a buyer's failure to inform his seller that he has become insolvent prior to delivery and can no longer pay for the goods may indicate a lack of good faith on the part of the buyer. Indeed, his silent acceptance of the goods may be interpreted as a "tacit business misrepresentation of solvency" at that point.[41] Nevertheless, such silence does not constitute fraud in the inducement because it did not induce the seller to enter the contract of sale.[42] Thus the seller would not be entitled to rescind under traditional common law principles.[43] Section 2-702(2), therefore, discards those principles by which fraud in the inducement entitled the seller to rescission[44] and instead establishes the buyer's insolvency upon receipt of the goods as a new and different ground for rescission. Moreover, since actual fraud is not required, rescission cannot be based on the concept of "voidable

---

[37] *See* cases cited in note 30 *supra.*

[38] *See* note 19 *supra.*

[39] *See* note 42 *infra.*

[40] Professor Honnold noted that the apparent assumption of fraudulent intent made in Official Comment 2 to § 2-702(2) "is particularly hazardous since the agreement to buy may have been well in advance of the date for delivery and at a time when buyer had grounds for believing that he could pay." 1 N.Y. LAW REV. COMM'N, STUDY OF THE UNIFORM COMMERCIAL CODE, LEGIS. DOC. NO. 65(c), 548-49 (1955).

[41] U.C.C. § 2-702, Comment 2.

[42] Non-disclosure of changed circumstances generally is considered fraudulent only when it concerns circumstances that actually induce the contract of sale. WILLISTON, *supra* note 19, § 631, at 430. Section 2-702(2), however, allows rescission for changed circumstances which occur after the contract is made, regardless of the intent of the parties when they entered the contract.

[43] *See* note 42 *supra.*

[44] The subsection explicitly provides that it is the seller's only remedy in cases based on the buyer's fraudulent or innocent misrepresentation of solvency or intent to pay. Thus, § 2-702(2) simultaneously extends the seller's common law right to reclaim and limits the remedy available to sellers who have in fact been defrauded by requiring that they demand reclamation within ten days of the buyer's receipt of the goods. *See* note 8 *supra.*

title."[45] Thus, the seller is allowed to recover goods when full title has passed to the buyer[46] and subsequently has vested in the trustee in bankruptcy.[47]

The court in *In re Telemart*[48] asserted that "[n]othing in the Bankruptcy Act prevents a state from authorizing rescission for grounds other than those recognized at common law."[49] However, both § 67c(1)(A) and § 64 prohibit such state authorization when the result operates to disrupt the federal scheme of distribution of a bankrupt's assets.[50] Section 2-702(2) clearly accords the seller his statutory right to reclaim only in the event of the buyer's insolvency.[51] Furthermore, while the Bankruptcy Act offers no guidance with regard to what constitutes a lien thereunder,[52] § 2-702(2) in effect gives the seller a lien on the goods he seeks to reclaim and therefore may be invalidated by the trustee under § 67c(1)(A).[53]

---

[45] *See* note 20 *supra.*

[46] Under U.C.C. § 2-401(2), title passed to the buyer upon delivery of the goods. *See, e.g.,* Lawrence v. Graham, 29 Md. App. 422, 349 A.2d 271 (Ct. Spec. App. 1975); A. M. Knitwear Corp. v. All-America Export-Import Corp., 50 App. Div.2d 574, 375 N.Y.S.2d 23 (1975).

[47] *See* note 21 *supra.*

[48] 524 F.2d 761, *cert. denied,* 96 S. Ct. 1466 (1976).

[49] *Id.* at 766.

[50] *See* text accompanying notes 1-5 *supra.*

[51] Although the seller may not exercise his right unless he complies with the requirements of the subsection, the right itself is operative only upon insolvency and has no meaning prior to insolvency. 4A COLLIER, *supra* note 2, § 70.41 at 492. Furthermore, while the U.C.C. definition of insolvency in § 1-201(23) is broader than the Bankruptcy Act definition in § 1(19), 11 U.S.C. § 1(19)(1970), one court has noted that the event which generally triggers the demand for reclamation is the filing of a petition in bankruptcy. *In re* Federal's, Inc., 12 U.C.C. REP. SERV. 1142, 1152 n.22 (E.D.Mich. 1973).

[52] Bankruptcy Act § 1 (29a), 11 U.S.C. § 1 (29a)(1970), provides:

> Statutory lien shall mean a lien arising solely by force of statute upon specified circumstances or conditions, but shall not include any lien provided by or dependent upon an agreement to give security, whether or not such lien is also provided by or is also dependent upon statute and whether or not the agreement or lien is made fully effective by statute.

The Act thus distinguishes between statutory and consensual liens, yet fails to define the term "lien."

[53] *See* text accompanying notes 66-71 *infra.* Section 2-502 of the U.C.C. confers upon the buyer a right similar in some respects to that given the seller under § 2-702(2). Section 2-502(1) allows a buyer who has paid part or all of the price of goods in which he has a "special property" (obtained under § 2-501 by identification of existing goods) and who makes and keeps good a tender of any unpaid portion of the price, to recover the goods from a seller who becomes insolvent within ten days after receipt of the first installment on the price. The section thus operates in bankruptcy to prevent the goods

At common law, the unpaid seller of goods was accorded a possessory lien[54] for the duration of the period in which he retained possession of the goods sold. The seller's lien essentially allowed him to keep the goods and rescind the contract of sale whenever the buyer failed to pay.[55] In the case of the buyer's supervening insolvency and as long as the goods remained in the possession of a carrier in transit, the lien continued under the seller's right of "stoppage *in transitu.*"[56] This right to stop during transit was based on the fiction that the seller remained in "possession" of the goods during that period.[57] The seller's lien, then, ended with delivery to the buyer unless the parties

---

from being valued and distributed among general creditors as assets of the bankrupt's estate. It also allows the buyer to recover the goods regardless of the fact that their value may exceed the contract price and that the result in such a case would be a diminution of available assets for distribution in bankruptcy.

While it has been contended that § 2-502 is also premised on a fraud theory, 1 P. COOGAN, W. HOGAN & D. VAGTS, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE, § 10.04[2][b] (1963), the section does not require any proof of fraud. Rather, recovery of the goods is allowed whenever the seller becomes insolvent within ten days after receipt of the first installment of the price. Furthermore, unlike § 2-702(2), § 2-502 does not provide for rescission of the contract of sale, but entitles the buyer to specific performance. At common law, the defrauded buyer who had not acquired title to the goods was allowed to rescind the contract of sale and recover any traceable payments he had made thereunder. Hirsch v. Morton, 13 F.2d 701 (3rd Cir. 1926); *In re* Thompson, 4 F. Supp. 921 (W.D.Wash. 1933); 5 S. WILLISTON & G. THOMPSON, CONTRACTS, §§ 1373, 1525 (rev. ed. 1937).

The impracticability of tracing payments, particularly when the seller was insolvent, led some common law courts to grant the buyer an "equitable lien" on the goods in the seller's possession when the buyer's prepayment was made to finance the seller's production. Hurley v. Atchison T. & S. F. Ry. Co., 213 U.S. 126 (1909); Grief Bros. Cooperage Co. v. Mullinix, 264 F. 391 (8th Cir. 1920). Arguably, § 2-502 codifies the concept of the buyer's "equitable lien," applying it whenever the buyer has made an advance payment on goods in which he has a special property. Section 2-502, however, should be invalid against the trustee in bankruptcy under § 67c(1)(A) for, like § 2-702(2), it is a statutory lien which first becomes effective upon the debtor's insolvency. *See* note 52 *supra* and text accompanying notes 68-73 *infra;* Countryman, *Buyers and Sellers of Goods in Bankruptcy,* 1 N. MEX. L. REV. 435 (1971).

[54] The common law possessory lien was simply a right to retain possession of the property of another to secure payment of a debt. During the nineteenth century, legislatures began to recognize non-possessory lien interests as well and to allow foreclosure on liened property. Some statutes also provided that certain lienors had rights to recover deficiency judgments when the proceeds of the sale did not satisfy the full debt. In its broadest sense, however, a lien is simply a hold on property to secure performance of a duty or obligation. *See generally* R. BROWN, PERSONAL PROPERTY § 107 (2d ed. 1955); 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 33.2 (1965).

[55] WILLISTON, *supra* note 19, § 503 at 99.

[56] *See generally* WILLISTON, *supra* note 19, § 517 *et seq.*

[57] *Id.*

agreed that the lien should continue after delivery.[58]

The common law lienor had no right to sell the subject matter of his lien.[59] Thus the liened property was forced to carry the full debt or obligation.[60] The Uniform Sales Act gave statutory recognition to the unpaid seller's lien[61] and further provided for resale and additional recovery if the seller did not realize the full contract price.[62] Under both the common law and the Uniform Sales Act, the seller had a "specific lien" on the goods sold.[63] His lien secured the sales price of all goods sold pursuant to a single contract, but he could not have refused delivery to secure other contract obligations of the buyer.[64]

Statutory recognition of the unpaid seller's specific lien was carried over into the U.C.C., which also allows for resale and recovery by the seller of the difference between contract and resale price.[65] Section 2-702(1) specifically provides that in the case of the buyer's insolvency, the seller "may refuse delivery except for cash including payment for all goods theretofore delivered under the contract."[66] Furthermore, § 2-702(2) provides that when goods are sold on credit, the seller's lien continues even after delivery. In particular, the seller is accorded a specific lien as security for payment of the price if the buyer is insolvent upon receipt of the goods.[67] Indeed, § 2-702(2) simply extends the unpaid seller's lien recognized at common law and

---

[58] Gregory v. Morris, 96 U.S. 619 (1877). *See generally* WILLISTON, *supra* note 19, § 511 *et seq.*

[59] Since the common law lienor was allowed to keep the goods under the lien, he naturally could sell or otherwise dispose of them as he pleased. However, his right to sell the goods arose out of the fact that they were once again his property and did not inhere in his status as a lienor.

[60] Knapp, Stout & Co. v. McCaffrey, 177 U.S. 638, 645 (1900). A seller would exercise his rights under his seller's lien simply by retaining possession of the goods and thereby rescinding the contract of sale. Any later resale of the goods would be unrelated to the exercise of those rights. *See* note 59 *supra.*

[61] UNIFORM SALES ACT §§ 60-62 (act withdrawn). The Uniform Sales Act was the predecessor of Article 2 of the U.C.C. and is specifically repealed by U.C.C. § 10-102.

[62] UNIFORM SALES ACT § 60(1)(act withdrawn).

[63] The specific lien extends only to indebtedness due the lienor with respect to the specific property in which the lien is claimed. The common law general lien, however, relates not only to the indebtedness on specific property but also to the general account between the parties. *See generally* R. BROWN, PERSONAL PROPERTY §§ 107-109 (2d ed. 1955).

[64] *Id.*, § 108 at 523-25.

[65] U.C.C. §§ 2-702(1), 2-703, 2-705, 2-706.

[66] U.C.C. § 2-702(1).

[67] *See* text accompanying notes 59-62 *supra* and note 68 *infra. But see* Braucher, *Reclamation of Goods from a Fraudulent Buyer,* 65 MICH. L. REV. 1281 (1967).

under the Uniform Sales Act. The lien, rather than expiring with delivery of the goods, continues for ten days thereafter when the goods are received by an insolvent buyer.[68] The fiction underlying the seller's right to stoppage *in transitu*[69] is thus extended so that the seller remains in "possession" not only during the period of transport, but also for ten days following delivery. His rights under the lien are essentially the same rights accorded the unpaid seller under the original common law possessory lien; he may keep the goods and rescind the contract of sale.[70]

The seller must meet the requirement of § 2-702(2) in order to exercise his rights, which are subject under § 2-702(3) to the rights of buyers in the ordinary course of business and other good faith purchasers.[71] Subsection (3) also provides that successful reclamation is an exclusive remedy, so that the reclaiming seller does not have the additional right to recover the difference between contract and resale price that is granted a seller who has not yet delivered under § 2-702(1) and § 2-706.[72]

Several federal district courts[73] have held that § 2-702(2) is a statutory lien which is invalid against a trustee in bankruptcy under § 67c(1)(A) of the Bankruptcy Act. In *Carnation Plastic Mfg. Co. v. Giltex, Inc. (In re Giltex),*[74] the District Court for the Southern District of New York maintained that § 2-702(2) secures payment of the

---

[68] U.C.C. § 2-702(2). While § 2-702(2) does not expressly provide for termination of the lien upon payment of the debt, the subsection apparently requires that if the buyer tenders a cash payment for the goods concerned, including all goods previously delivered under the contract, within the ten-day period, the seller must accept the payment and cannot reclaim. If under § 2-702(1) the seller must accept cash payment for goods still in his possession and deliver such goods, it follows that he must also accept cash payment for goods already delivered. *See* text accompanying note 66 *supra*. *See also* U.C.C. § 2-511(1).

[69] *See* text accompanying notes 56-57 *supra*.

[70] *See* note 60 *supra*.

[71] U.C.C. § 2-702(3).

[72] *See* text accompanying note 65 *supra*. Comment 3 to § 2-702 indicates that a policy judgment underlies the denial to a reclaiming seller of any additional remedies. The comment provides that all other remedies are barred because the seller's right to reclaim under § 2-702(2) "constitutes preferential treatment as against the buyer's other creditors."

The fact that the seller is denied these remedies should not prevent the subsection from being characterized as a lien. Rights of foreclosure and allowance of deficiency judgments are created by state legislatures and are not inherent lien rights. Carnation Plastic Mfg. Co. v. Giltex, Inc. (*In re* Giltex, Inc.), 17 U.C.C. REP. SERV. 887 (S.D.N.Y. 1975); *see* note 54 *supra* and text accompanying notes 74-77 *infra*.

[73] *See* cases cited in note 9 *supra*.

[74] 17 U.C.C. REP. SERV. 887 (S.D.N.Y. 1975).

price by the buyer and thus constitutes a lien.[75] The court noted that since the seller's interest "in respect of the goods" is determinative of his status as a lienor,[76] it is irrelevant that he is not granted additional rights against the buyer over and above his interest in the goods.[77] The court held that § 2-702(2) was invalid against the trustee under § 67c(1)(A) as a statutory lien that, by its own terms, takes effect only when the buyer is insolvent.[78] The court also determined that § 2-702(2) confers favored treatment upon a particular class of creditors, unsecured sellers of goods, thereby disrupting the federally created order of priorities in bankruptcy.[79] The district court in *In re Federal's,*[80] held that § 2-702(2) was invalid against the trustee under § 67c(1)(A) because the practical effect of the subsection is to grant the seller lien rights which attach only upon the insolvency of the buyer.[81] That court also noted that § 2-702(2) gives the reclaiming seller a priority over the bankrupt's other general creditors.[82]

The Ninth Circuit in *Telemart,* however, refused to characterize § 2-702(2) as a statutory lien that first becomes effective upon the debtor's insolvency.[83] The court correctly noted that § 67c is a "remedial trimming back" of the general validity accorded statutory liens by § 67b,[84] but failed to consider the full scope of § 67c and its relationship to § 64.[85] The court of appeals contended that § 67c is

---

[75] *Id.* at 891. *But see In re* National Bellas Hess, Inc., 17 U.C.C. REP. SERV. 430 (S.D.N.Y. 1975).

[76] 17 U.C.C. REP. SERV. 887, 891 n.7 (S.D.N.Y. 1975).

[77] *Id. See* note 72 *supra.*

[78] *Id.* at 889. *See* note 51 *supra.*

[79] *Id.* at 893. *Accord, In re* Good Deal Supermarkets, Inc., 384 F. Supp. 887 (D.N.J. 1974). The Chandler Act, *see* note 2 *supra,* eliminated the recognition of state priorities in § 64 to assure national uniformity in the distribution of a bankrupt's assets. Arguably, a priority created under the U.C.C. does not undermine national uniformity because the U.C.C. has been adopted in all United States jurisdictions except Louisiana. Nevertheless, the priority accorded the unsecured seller is clearly not recognized by § 64 which specifically lists those claims which Congress has determined are to receive favored treatment. Furthermore, by placing the reclaiming seller ahead of other general creditors of the bankrupt, § 2-702(2) upsets a fundamental policy of the Bankruptcy Act which is to assure an equitable distribution of a bankrupt's estate. *See* S. REP. No. 1159, 89th Cong., 2d Sess. 6, *reprinted in* [1966] U.S. CODE CONG. & AD. NEWS 2456, 2461.

[80] 12 U.C.C. REP. SERV. 1142 (E.D.Mich. 1973), *noted in* Henson, *Reclamation Rights of Sellers Under Section 2-702,* 21 N.Y.L.F. 41 (1975).

[81] 12 U.C.C. REP. SERV. at 1153.

[82] *Id.* at 1151.

[83] 524 F.2d at 764.

[84] *Id.*

[85] *See* text accompanying notes 1-5 *supra.*

designed to invalidate only those statutory liens that were created in an attempt to escape the effects of § 60 of the Bankruptcy Act through validation under § 67b.[86] The court concluded that § 2-702(2) does not constitute a voidable preference under § 60,[87] and that the

---

[86] 524 F.2d at 764. Bankruptcy Act § 67b provides:

> The provisions of section 60 of this Act to the contrary notwithstanding and except as otherwise provided in subdivision (c) of this section, statutory liens . . . created or recognized by the laws of the United States or any State, may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition initiating a proceeding under this Act by or against him.

Section 67b gives expression to the policy of the Bankruptcy Act to recognize statutory liens which are valid property rights created by state law. Section 67c(1)(A), however, invalidates those statutory liens which arise only upon the debtor's insolvency and which are in essence priorities created by state legislatures. *See* 4 COLLIER, *supra* note 2, § 67.281[2.1] at 419-22.

[87] 524 F.2d at 764. Bankruptcy Act § 60a(1) provides:

> A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

The court in *Telemart* reasoned that no transfer is made on account of an antecedent debt under § 2-702(2) because the seller's right to reclaim attaches at the instant the debt is created. However, the transfer of the goods is not effectuated unless the seller in fact exercises that right, which is necessarily subsequent to the creation of the debt. Furthermore, Bankruptcy Act § 1(30), 11 U.S.C. § 1(30)(1970), defines a transfer to include all modes of "disposing of or . . . parting with property." Thus, reclamation does involve transfer of the bankrupt's property on account of an antecedent debt.

Under § 60a(2),

> a transfer of property other than real property shall be deemed to have been made or suffered [for purposes of § 60a(1)] at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee . . . .

The reclaiming seller's interest is perfected against lien creditors under amended § 2-702(3) by demand made within ten days after the buyer's receipt of the goods. *See* note 12 *supra*. In *Telemart*, the seller made demand after the petition was filed to initiate the Chapter XI arrangement. Section 60a(2) further provides that when perfection is not made prior to the filing of the petition "it shall be deemed to have been made immediately before the filing of the petition." Thus the transfer in *Telemart* was made within four months prior to the filing for purposes of § 60a(1).

Since the effect of the transfer was to enable the seller to obtain a greater percentage of his debt than other general creditors, a preference under § 60a is established. Nevertheless, for the preference to be voidable under § 60b, the seller must have had "reasonable cause" to know the buyer was insolvent when the transfer was made. If

subsection thus "[does] not present the abuse which section 67c was designed to combat."[88] The court maintained that even if § 2-702(2) were "conceived" as a lien,[89] § 67c(1)(A) was nonetheless inapplicable.

Section 67c(1)(A), however, invalidates without qualification every statutory lien which first becomes effective upon the debtor's insolvency.[90] The provision strikes at liens that are essentially state priorities, regardless of whether they would have violated § 60 had they not been designated as liens.[91] Although the court in *Telemart* acknowledged the function of § 67c(1)(A) to invalidate state-created priorities,[92] it did not recognize that § 2-702(2) is such a priority. Section 2-702(2) clearly determines distribution of a bankrupt buyer's assets upon his insolvency, placing the reclaiming seller ahead of other general creditors. Indeed, the priority status accorded the seller under § 2-702(2) is recognized even in the Official Comment to § 2-702. Comment 3 states that "the right of the seller to reclaim goods under this section constitutes preferential treatment, as against the buyer's other creditors. . . ."[93] By allowing the trustee to invalidate § 2-702(2), a statutory lien which operates as a state-created priority, § 67c(1)(A) preserves the federal scheme of priorities as set out in § 64 of the Bankruptcy Act. Furthermore, the exclusion of state priorities from favored treatment in § 64 itself implicitly invalidates § 2-702(2) because the subsection does accord the reclaiming seller priority status in the scheme of bankruptcy distribution.

The court in *Telemart* upheld the validity of § 2-702(2) in bankruptcy by incorrectly equating the seller's remedy under that section with the defrauded seller's right to rescind at common law.[94] Section 2-702(2) does not codify the prior law, but rather establishes a new ground for rescission—the buyer's insolvency upon receipt of the goods.[95] Both § 67c(1)(A) and § 64 of the Bankruptcy Act provide for the invalidation of state-created priorities in bankruptcy. These sec-

---

the time of the transfer under § 2-702(2) is deemed to be prior to the filing of the petition in bankruptcy, the trustee must always establish that the seller had reason to know of the buyer's insolvency at that time.

[88] 524 F.2d at 764.

[89] *Id.*

[90] *See* note 1 *supra.*

[91] *See* text accompanying notes 1-5 *supra.*

[92] 524 F.2d at 764.

[93] U.C.C. § 2-702, Comment 3.

[94] *See* text accompanying notes 22-44 *supra.*

[95] *Id.*

tions limit the powers of state legislatures to establish additional grounds for rescission when such action disrupts the federal scheme of distribution.[96] Section 2-702(2) confers a distinct priority upon the unsecured seller of goods on credit in the event of the buyer's insolvency. Moreover, it does so by according the seller lien rights similar to those given the unpaid seller of goods in possession at common law.[97] The subsection is therefore rendered invalid in bankruptcy proceedings under both § 67c(1)(A) and § 64. While the court in *Telemart* correctly noted that only congressional legislation may limit the powers of states to create additional grounds for rescission,[98] it failed to recognize that § 67c(1)(A) and § 64 are just such limitations.[99] Congress clearly has the power to validate § 2-702(2) through further federal legislation.[100] In the absence of such congressional sanction, however, the subsection should be inoperative in federal bankruptcy proceedings.

EMILIA M. DEMEO

---

[96] *See* text accompanying notes 1-5 *supra.*

[97] *See* text accompanying notes 67-72 *supra.*

[98] 524 F.2d at 766. U.S. CONST. art. I § 8 cl. 4 gives Congress sole authority to make "uniform Laws on the subject of Bankruptcies throughout the United States." State law which conflicts with the Bankruptcy Act must succumb to the provisions of the Act. International Shoe Co. v. Pinkus, 278 U.S. 261 (1929).

[99] *See* note 2 *supra.*

[100] *See* note 98 *supra.*