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## Bankruptcy--Reclamation and the Uniform Commercial Code

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## BANKRUPTCY—RECLAMATION AND THE UNIFORM COMMERCIAL CODE

### I. INTRODUCTION

Bankruptcy is the crucible which may ultimately test the rights of a party in any given commercial transaction. The various rights of an individual under the *Uniform Commercial Code*<sup>1</sup> must therefore be viewed in light of the practical results obtainable if bankruptcy should raise its head. This article will discuss reclamation of personal property from the trustee of the bankrupt's estate and its applicability under the *Uniform Commercial Code*. Reclamation is the process by which a claimant asserts his title or claim to property in the hands of the bankruptcy trustee and attempts thereby to obtain possession.<sup>2</sup> It is an important aspect of bankruptcy proceedings, occasionally resulting in almost complete exhaustion of the bankrupt's marketable assets.<sup>3</sup> Reclamation proceedings in bankruptcy and the *Uniform Commercial Code* interact in Article 2, when a vendor attempts to obtain possession of goods from a bankrupt vendee, and in Article 9, when a secured creditor attempts to assert a right to collateral in the possession of the bankrupt debtor.

### II. GENERAL ANALYSIS OF RECLAMATION PROCEEDINGS

Reclamation proceedings in bankruptcy do not have a definite statutory basis.<sup>4</sup> They developed out of attacks upon the trustee's title to property in his possession. The trustee of a bankrupt's estate is vested under section 70(a) of the Bankruptcy Act<sup>5</sup> with the bankrupt's title to property. The property of a third person, which is in the possession of the bankrupt, is not a part of the assets of the bankrupt's estate and should be restored to the true owner.<sup>6</sup> Reclamation may thus be based upon any number of claims to title; none of which are limited to bankruptcy proceedings.<sup>7</sup> The key fact is that property subject to reclamation is not the property of the bankrupt.

With the trustee in either actual or constructive possession, a claimant initiates a reclamation proceeding by filing a petition with the bankruptcy court for

1. Chapter 400, RSMo 1965 SUPP. The UNIFORM COMMERCIAL CODE has been adopted by 49 states and the District of Columbia. 1 COOGAN, HOGAN, & VAGTS, *SECURED TRANSACTIONS UNDER THE U.C.C.* vii (1967).

2. 2 COLLIER, *BANKRUPTCY* ¶ 23.11 (14th. ed. 1966) (hereinafter cited as COLLIER).

3. Blewett, *First Meeting of Creditors*, 14 REF. J. 11, 14 (1939).

4. MacLachlan, *Protection and Collection of Property of Bankrupt Estates*, 39 MINN. L. REV. 626, 647 n.67. The Canadian statute on bankruptcy explicitly sets forth reclamation procedure. Bankruptcy Act, 1 CAN. REV. STAT. c.14, 50 (1952).

5. 30 Stat. 544-66 (1898), as amended, 11 U. S. C. §§ 1-1255 (1964) (hereinafter cited as Bankruptcy Act).

6. *Thomas v. Taggart*, 209 U.S. 385, 389 (1908); 4A COLLIER, ¶ 70.39(1), at 467.

7. 9 AM. JUR. 2d, *Bankruptcy* § 1194 (1963).

the restoration of specific property.<sup>8</sup> If that property has been sold by the trustee, the claimant, if reclamation is granted, is entitled to the proceeds of such sale.<sup>9</sup> This remedy is exclusive, and a claimant may not institute a plenary suit to obtain possession unless the consent of the bankruptcy court is obtained.<sup>10</sup> The petition should conform with the requirements of FED. R. CIV. PRO. 8(a) and (e) by setting forth a concise statement of facts showing that the petitioner is entitled to the relief requested.<sup>11</sup>

There is no time limit specified in the Bankruptcy Act for filing a reclamation petition.<sup>12</sup> However, the petition should be filed as early as possible, because the court has the power to limit the time by setting a reasonable date and giving adequate notice thereof.<sup>13</sup>

The filing of a reclamation petition invokes the summary jurisdiction of the bankruptcy court. The court may therefore determine the claimant's rights or title in a summary fashion, and, in this manner, pass upon all defenses which the trustee may make to the petition.<sup>14</sup> The court may, upon a proper counterclaim, determine the rights of all parties connected with the transaction.<sup>15</sup> However, the summary jurisdiction does not extend to adjudication of the petitioner's rights on a totally unrelated matter.<sup>16</sup>

8. For the form of reclamation petitions see 5 COLLIER, Form 823 p. 3681, and Form 826 p. 3687.

9. *Thomas v. Taggart*, 209 U.S. 385, 389 (1908).

10. 2 COLLIER ¶ 23.11, at 587. A claimant may, however, bring suit against the trustee personally for conversion, *In re French*, 18 F.2d 792 (W.D. Mich. 1927) (sale of property during pendency of appeal as to question of title); *Dawson v. National Life Ins. Co.*, 156 Tenn. 306, 300 S.W. 567 (1927) (wrongful collection of cash surrender value of exempt insurance policies), or for negligence in losing the property, *In re National Molding Co.*, 230 F.2d 69 (3rd Cir. 1956).

11. General Order 37, 11 U.S.C. App., requires that the FEDERAL RULES OF CIVIL PROCEDURE be followed in proceedings under the Bankruptcy Act "in so far as they are not inconsistent with the Act. . . ."

12. The time limit prescribed by § 57(n) of the Bankruptcy Act does not apply. *Nauman Co. v. Bradshaw*, 193 Fed. 350 (8th Cir. 1912).

13. 4A COLLIER ¶ 70.39(2), at 472. Note that in the absence of knowledge or notice or laches a bar order will not foreclose a reclamation petitioner from asserting his right to the property in the trustee's possession. COLLIER, *op. cit. supra* at 472 n.20.

14. 9 AM. JUR. 2d *Bankruptcy*, § 1199, at 890. The trustee may defeat the reclamation petition by invoking, in a proper case, any of the powers or rights conferred upon him by the Bankruptcy Act, including §§ 60, 67(a), 67(c), 67(d), 70(c) or 70(e). 4A COLLIER ¶ 70.39(1), at 467. This comment will not discuss these avoiding powers. To do so would lead far beyond the scope of this article. We will assume that the petition would not be vulnerable on these grounds. Anyone interested in this particular aspect should refer to 4A COLLIER *op. cit. supra* at 468 n.8.

15. 2 COLLIER ¶ 23.08(5), at 549. However, the filing of a petition for reclamation by the United States does not operate as consent to the assertion of counterclaims upon the property. 2 COLLIER, *op. cit. supra* at 549 n.65. Nor may the court adjudicate the rights of a third person who might have a right in the property and who has not consented to the court's summary jurisdiction. 2 COLLIER, *op. cit. supra* at 550.

16. 2 COLLIER ¶ 23.08(5), at 550.

A reclamation petitioner may prevail only upon the strength of his own right to the property, and not on the weakness of the trustee's title.<sup>17</sup> The petitioner must be able to identify specifically the property sought to be reclaimed. If the property has been mingled with other assets of the estate and cannot be traced, then the petitioner's reclamation effort will fail.<sup>18</sup> The burden of proof is on the petitioner as to both the title to the property and its identity.<sup>19</sup>

In accordance with General Order in Bankruptcy number 22,<sup>20</sup> a proceeding before the referee is governed by the *Federal Rules of Civil Procedure*. Thus, in disposing of the reclamation petition, the referee is required to comply with FED. R. CIV. PRO. 52(a) and state separately the findings of fact and the conclusions of law thereon. The "clearly erroneous" rule is applicable in a review of the referee's decision by the district court,<sup>21</sup> and the referee's decision, based upon the credibility of the witness, will not be overturned unless there is clear evidence of a miscarriage of justice.<sup>22</sup> The reclamation proceeding has been held to give rise to issues appealable under section 24(a) of the Bankruptcy Act "as controversies arising in proceedings in bankruptcy" and not as "proceedings in bankruptcy."<sup>23</sup> Appeals from the judgment of the district court are also subject to the "clearly erroneous" rule.<sup>24</sup> FED. R. CIV. PRO. 62(a) provides for an automatic ten-day stay to allow time to appeal from the judgment of the district court. During this time, the trustee may refuse to deliver the property to the claimant, even though reclamation has been ordered.<sup>25</sup>

When the reclamation claimant is successful, the costs of the proceeding will be imposed upon the bankrupt's estate, and such expenses are considered part

17. *Robbins v. Bostian*, 138 F.2d 622 (8th Cir. 1943).

18. 4A COLLIER ¶ 70.39(3), at 478.

19. 9 AM. JUR. 2d, *Bankruptcy* § 1201 (1963). Once the petitioner has sustained this burden of proving ownership and identity of the property he is seeking to reclaim, then the trustee has the burden if reclamation is to be defeated on the basis of fraudulent transfer. *Trautwein v. Mandel*, 127 F.2d 567 (8th Cir. 1942).

20. 11 U.S.C. App.

21. General Order 47, 11 U.S.C. App.

22. When the case is submitted to the referee on an agreed statement of fact then the referee's findings do not carry as much weight, and the district judge has more leeway in drawing inferences and reaching contra conclusions. *In re Penn. Table Co.*, 26 F. Supp. 887 (S.D.W. Va. 1939).

23. 2 COLLIER ¶ 24.31. "Controversies arising in proceedings in bankruptcy" are appealable as a matter of right, but are only appealable as a final order. 2 COLLIER ¶ 24.27.

24. 2 COLLIER ¶ 25.30, at 966. In a case where the district judge has overruled the referee, the courts of appeal disagree as to the effect to be given the judge's decision. Some circuits hold that the question before the court in such a situation is whether the referee's findings are clearly erroneous, not whether the judge's findings are. *Phillips v. Baker*, 165 F.2d 578 (5th Cir. 1948); *Morris Plan Industrial Bank v. Henderson*, 131 F.2d 975 (2d Cir. 1942). The Eighth Circuit has held that the judge's findings will not be set aside unless it is clearly erroneous. *Katcher v. Wood*, 109 F.2d 751 (8th Cir. 1940); *In re Kansas City Journal-Post Co.*, 144 F.2d 791 (8th Cir. 1944). *But cf.* *Sanitary Farm Dairies Inc. v. Gammel*, 195 F.2d 106 (8th Cir. 1952) (following rule of *Morris Plan Industrial Bank v. Henderson*, *supra*).

25. *United States ex rel. Manufactures Equip. Co. v. Rugh*, 29 F. Supp. 40 (W.D. Pa. 1939).

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of the administrative expenses.<sup>26</sup> However, the storage charges paid to protect the property prior to filing of the reclamation petition and prior to its determination are taxable to the claimant where he is successful.<sup>27</sup> The claimant and the trustee may agree, prior to determination of the petition's merits, to sell the property and hold the funds subject to the reclamation determination. If this is done, the claimant, if successful, is chargeable with the costs incident to the sale.<sup>28</sup>

The filing of a proof of claim, either secured or unsecured, against the bankrupt's estate under section 57<sup>29</sup> is a distinct and separate process from filing a reclamation petition.<sup>30</sup> The issues are entirely different. A proof of claim is a request to share in either the bankrupt's general assets (unsecured claim) or in a specific asset of the bankrupt (secured claim). The reclamation petition is a demand that the claimant's own property be delivered to him. This distinction is an important one to bear in mind, because under some circumstances the filing of a proof of claim against the estate may be treated as a final election of remedies and a waiver of the right to reclaim.<sup>31</sup>

The filing of a proof of claim and entering into the selection of the trustee after the reclamation petition was filed has been held to constitute a bar to the continuance of the reclamation proceedings.<sup>32</sup> If this reclamation petition is denied, then it may be too late to file a proof of claim, because the statutory six-months period of section 57(n) of the Bankruptcy Act has passed. Although the court may treat a belated proof of claim as a reclamation petition,<sup>33</sup> a reclamation petition is not normally a sufficient basis for an amendment to a proof of claim after the statutory period.<sup>34</sup> If the proof of claim contains an express statement that it is intended only as an alternative to the right of restoration asserted under the reclamation petition, and that the property rights are retained, then such has been held not to be a waiver.<sup>35</sup> The safe practice in a doubtful reclamation case would be to file a reclamation petition and a timely proof of claim with an express statement that it is an alternative remedy only, and that the property rights claimed in the reclamation petition are reserved.

Reclamation, as discussed above, is an appropriate remedy when clearly identifiable property of the claimant is in the possession of the trustees in bankruptcy. A necessary element of the reclamation petition, at least until the adoption of the *Uniform Commercial Code*,<sup>36</sup> has been that title be in the claimant.

26. 4A COLLIER ¶ 70.39(5). Where the claimant is successful the claimant must pay the costs. 4A COLLIER, *op. cit. supra* at 480 n.54.

27. 4A COLLIER ¶ 70.39(5).

28. 4A COLLIER, *op. cit. supra* note 27.

29. Bankruptcy Act.

30. *Cf.*, *Hopkins v. National Shawmut Bank of Boston*, 293 Fed. 884 (5th Cir. 1923), *cert. denied*, 263 U.S. 722 (1923).

31. See 4A COLLIER ¶ 70.38(4).

32. *In re Myley Electrical Supply Co., Inc.*, 291 Fed. 775 (E.D. N.Y. 1923).

33. *Bowman v. MacPherson*, 93 F.2d 318 (10th Cir. 1937).

34. *In re Peck & Hills Furniture Co.*, 10 F. Supp. 403 (S.D.N.Y. 1935).

35. *Thomas v. Taggart*, 209 U.S. 385 (1908).

36. For the effect of the UNIFORM COMMERCIAL CODE on the title requirement, see Part IV *infra*.

Reclamation has been based upon a number of claims to title. It has been allowed in a straight bankruptcy proceeding in the following situations: (1) where personal property has been delivered to the bankrupt under a sales agreement which provided that title remain in the vendor until the entire purchase price had been paid; (2) where personal property has been delivered to the bankrupt for a sale or consignment; and (3) where personal property has been sold to the bankrupt under such circumstances as to amount to a fraudulent representation of solvency, and the vendor has been entitled to rescind the contract.<sup>37</sup> In corporate reorganization proceedings, under Chapter X of the Bankruptcy Act, reclamation has been allowed in the past only if title was reserved to the petitioning vendor under a conditional sales contract.<sup>38</sup>

The bankruptcy court is a court of equity, and it may impose various equitable requirements that must be satisfied before return of property will be ordered, even though the reclamation petition is approved. Courts have conditioned reclamation upon return of payments actually made, less a reasonable allowance for use, depreciation, and cost of repossession, where state law requires such as a condition of repossession from a defaulted vendee by a vendor under a title retaining sales agreement.<sup>39</sup> One court, however, has refused to condition a reclamation order upon the petitioner's payment to the bankrupt trustee of a sum due upon a matter unrelated to the reclamation petition.<sup>40</sup> The court, in another case, refused to extend the use of equitable powers to subordination of the petitioner's rights to those of general creditors.<sup>41</sup> One court also refused to create an equitable lien when a statutory lien had not been created due to failure to comply with statutory requirements.<sup>42</sup> The Eighth Circuit Court of Appeals in *In re Kansas City Journal Post Co.*<sup>43</sup> expressed doubts that equitable conditions could be imposed on a petitioner whose title was absolute. This statement was dicta, however, and has been criticized as inaccurate.<sup>44</sup>

### III. RECLAMATION AND ARTICLE 2 OF THE UNIFORM COMMERCIAL CODE

Prior to the adoption of the *Uniform Commercial Code*, the bankruptcy courts had allowed a vendor to reclaim goods from the estate of a bankrupt vendee when the sale was induced by fraud. The right to reclamation in this situation depended upon whether, under state law, the vendor was entitled to rescind the sales

37. *In re Broomhall, Killough & Co., Inc.*, 61 F.2d 760, 761 (2d Cir. 1932).

38. *In re Lake's Laundry*, 79 F.2d 326 (2d Cir. 1935), *cert. denied*, 296 U.S. 622 (1935).

39. *Wilkin v. Heywood-Wakefield Co.*, 7 F.2d 115 (6th Cir. 1925) (dictum), *cert. denied*, 271 U.S. 669 (1926); *In re Hooven-Owens-Rentschler Co.*, 195 Fed. 424 (6th Cir. 1912); *In re Price Drug Co.*, 19 F.2d 269 (E.D. Mo. 1927).

40. *In re C. A. Goldsmith Co.*, 122 F. Supp. 19 (D.N.J. 1954) (denying payment due for manufacturing of castins through use of reclaimed molds).

41. *In re Kansas City Journal-Post Co.*, 144 F.2d 791 (8th Cir. 1944).

42. *Colonial Trust Co. v. Goggin*, 230 F.2d 634 (9th Cir. 1955).

43. 144 F.2d 791 (8th Cir. 1944) (dictum).

44. 4A COLLIER 70:39(1), at 470 n.15; Oglebay, *Some Developments in Bankruptcy Law*, 19 REF. J. 78 (1945).

contract.<sup>45</sup> The bankruptcy trustee takes possession of the property subject to the retroactive divestment of title effected by the rescission, and the intervention of bankruptcy between the sale and the rescission had not been allowed to interfere with the right to reclaim.<sup>46</sup> The rescission reverted title to the vendor and was the basis for his reclamation petition.

The following types of conduct were grounds for reclamation after rescission of the contract for fraud:<sup>47</sup> 1) where the contract was induced by the bankrupt's actively or tacitly concealing insolvency known to himself, regardless of whether intent not to pay for the goods can be established; 2) where, although not insolvent, the bankrupt induced the contract by a bad faith, false and material representation of his financial status; 3) where the bankrupt made an innocent misrepresentation of his financial condition (this ground was extremely restricted in its operation by the bankruptcy court). The right to rescind was limited by defenses which avoided its exercise. In the absence of a duty to disclose, the absence of a representation as to financial condition would bar rescission and reclamation.<sup>48</sup>

The *Uniform Commercial Code* eliminates the necessity of proving the element of fraud. An objective standard for a conclusive right to reclaim the goods within a limited time is provided by section 2-702(2):<sup>49</sup>

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.

It has been held that the seller need not actually reclaim the goods within ten days following receipt, but only that demand be made within the time period.<sup>50</sup>

While the *Uniform Commercial Code* eliminates the element of fraud, it raises a question not normally present in the defrauded vendor situation under pre-code law.<sup>51</sup> This question is whether or not the trustee in bankruptcy has rights superior to those of the reclaiming vendor. The seller's right to reclaim under section 2-702(2) is subjected to the rights of a lien creditor under section 2-702(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)." The code provides in section 2-403(4) that "[t]he rights

45. O'Riely v. Endicott-Johnson Corp., 297 F.2d 1 (8th Cir. 1961).

46. 4A COLLIER ¶ 70.41(1), at 483. See cases cited in 4A COLLIER, *op. cit. supra* at 483 n.3.

47. 4A COLLIER ¶ 70.41(1), at 486-7.

48. 4A COLLIER ¶ 70.41(2).

49. RSMo 1965 Supp. (All subsequent citations to code sections will be to Chapter 400, RSMo 1965 Supp. unless otherwise noted.)

50. Metropolitan Distributors v. Eastern Supply Co., 21 Pa. D. & C.2d 128 (Pa. Ct. C.P. 1959).

51. 4A COLLIER ¶ 70.41(1), at 491.

... of lien creditors are governed by the Articles on Secured Transactions (Article 9). . . ." Article 9 provides in section 9-301(3), that a lien creditor includes a trustee in bankruptcy.

These provisions of the *Uniform Commercial Code* have been the subject of great controversy and speculation.<sup>52</sup> It has been suggested<sup>53</sup> that since the seller in section 2-702 would not have a security interest as defined in section 1-201(37),<sup>54</sup> there would be nothing to perfect under Article 9, and therefore a lien creditor would not have any rights. As Collier points out, however, such an interpretation would render unnecessary the cross referencing which ends up in Article 9.<sup>55</sup> The fear of the commentators that these cross references would result in the application of the strong-arm provision of 70(c) of the Bankruptcy Act to prevent reclamation by the defrauded seller was realized in the case of *In re Kravitz*.<sup>56</sup>

*Kravitz* was a Pennsylvania case which arose after the enactment of the *Uniform Commercial Code* in that state. A sale of radios on credit on January 16 was followed by delivery to the buyer on January 17. An involuntary petition in bankruptcy against the buyer was filed on January 20, and the seller took the necessary steps to rescind the sale on January 21. The court held that the seller could not prevail against the trustee in bankruptcy. The *Uniform Commercial Code's* according the trustee the position of a lien creditor in section 9-301(3) was a recognition of the trustee's power as created by federal law. It was held that the rights of a lien creditor depended upon state law. Pre-code Pennsylvania law, the court said, gave a lien creditor a higher claim than that of a defrauded seller, and the *Uniform Commercial Code* provisions did not change this.

The *Kravitz* case can be explained as based on peculiar pre-code Pennsylvania law and not as meaning that under the Code the seller's right to reclamation under section 2-702 is subject to the rights of a trustee in bankruptcy under section 9-301(3). At least one writer feels that such an interpretation would fly in the face of the intention of the provision of the section.<sup>57</sup> Indeed, Comment 3 to section 2-702 of the 1962 Official Edition of the *Uniform Commercial Code* indicates that such an interpretation would not be within the section's intention. Subsequent cases have also subjected the reclamation rights of a defrauded seller under this section to the rights of the bankruptcy trustee.<sup>58</sup>

52. See, e.g., Braucher, *Reclamation of Goods From a Fraudulent Buyer*, 65 MICH. L. REV. 1281 (1967); Kennedy, *The Trustee in Bankruptcy Under the Uniform Commercial Code: Some Problems Suggested by Articles 2 and 9*, 14 RUTGERS L. REV. 518 (1960); MacLachlan, *Two Wrongs Make a Right*, 37 TEXAS L. REV. 676 (1959); Williston, *The Law of Sales in the Proposed Uniform Commercial Code*, 63 HARV. L. REV. 561 (1950).

53. See 4A COLLIER ¶ 70.41(1), at 488 n.16, and article cited therein.

54. The seller in this situation would not be likely to have created a security interest because the transaction contemplated is essentially a sale on account and not one of financing.

55. 4A COLLIER ¶ 70.62A(7.1), at 721.

56. 278 F.2d 820 (3d Cir. 1960).

57. 1 U.C.C. REP. 160.

58. *In re Units, Inc.*, 3 U.C.C. REP. 46 (D. Conn. 1965) (opinion by referee); *In re Eastern Supply Co.*, 1 U.C.C. REP. 151 (W.D. Pa. 1963), *aff'd*, 331 F.2d 852 (3d Cir. 1964). The approach of the court in *In re Eastern Supply Co.*, *supra*,



The "lien creditor" of the *Uniform Commercial Code* appears to be a contractual lien creditor rather than a judicial lien creditor, i.e. an involuntary lien of judgment or levy. The contractual lien is what Article 9 is primarily concerned with. This is particularly relevant in this context, because the trustee's rights under section 70(c) of the Bankruptcy Act are those of a judicial lien creditor. If the trustee can defeat the vendor in reclamation, then it is only because state law, the *Uniform Commercial Code*, gives him this right, but not because of his powers under section 70(c) of the Bankruptcy Act.

The best solution to this problem would be to avoid it by deleting the phrase "or lien creditor" from section 2-702(3). Seven states have deleted this phrase from the section.<sup>59</sup> The Code's Permanent Editorial Board in 1966 recommended that the section be amended to eliminate the phrase and the cross reference.<sup>60</sup>

In Missouri section 400.2-702(3), RSMo 1965 Supp. includes the phrase "or lien creditor." This can only have the effect of giving the defrauded seller an illusory right. If bankruptcy should intervene, the phrase will prevent the sound operation of the section.<sup>61</sup> It would be desirable for the Missouri Legislature to amend the section and delete the phrase before the courts are faced with a case involving the problem.

In the absence of legislative action, it might be advisable to argue that pre-code Missouri law would not allow a subsequent lien creditor (trustee in bankruptcy) to cut off the rights of a defrauded seller to rescind the sale and reclaim his property, and that the enactment of the *Uniform Commercial Code* did not change this. The Missouri Supreme Court has held that when a trustee in bankruptcy takes possession of the bankrupt's property, he takes it subject to the equities to which the property is subject in the hands of the bankrupt.<sup>62</sup> There are no reported Missouri decisions on reclamation from the bankrupt's estate by a defrauded seller. The Missouri courts have held that a vendor may rescind the contract and reclaim his goods when they were purchased on credit by a vendee who knew at the time that he was insolvent and who did not intend to pay for them.<sup>63</sup> This indicates that Missouri does recognize the seller's right to rescind

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might also prevent the seller from stopping delivery of goods in transit under section 2-705. A receiver was appointed while the goods were still in the hands of the carrier, but the goods were later delivered to the bankrupt. Reclamation was denied under section 2-702(2) using the *Karvitz* approach. The court also said that according to section 2-401(2)(a) title passed to the receiver (whose title the trustee succeeded to) when the goods were delivered to the carrier. This reasoning, if applied to a section 2-705 situation, would give the trustee rights not contemplated by the Code.

59. Illinois, New York, New Mexico, California, Maine, New Jersey, and Connecticut. UNIFORM COMMERCIAL CODE (U.L.A.) § 2-702 (1962, SUPP. 1967).

60. U.C.C. PERMANENT EDITORIAL BOARD, 1966 OFFICIAL RECOMMENDATIONS FOR AMENDMENT OF THE U.C.C. 1 (1967).

61. See Duesenberg, *Title: Risk of Loss and Third Parties*, 30 Mo. L. REV. 191, 210 (1965).

62. *Blake v. Meadows*, 225 Mo. 1, 123 S.W. 868 (1909).

63. *Gratton & Knight Mfg. Co. v. Troll*, 77 Mo. App. 339 (St. L. Ct. App. 1898); *Moore & Bier v. Hinsdale*, 77 Mo. App. 217 (K.C. Ct. App. 1898); *Reid, Murdock & Co. v. Lloyd & Moorman*, 52 Mo. App. 278 (K.C. Ct. App. 1893); *Manheimer v. Harrington*, 20 Mo. App. 297 (St. L. Ct. App. 1886).

and reclaim when there is fraud on the part of the buyer. Missouri has also held that the rescission of a contract of sale after delivery of the goods is void as to the vendee's creditors, because there was no fraud on the part of the vendee.<sup>64</sup> Would it not follow, that had there been fraud in the inducement of the sale that rescission would not be void as against the vendee's creditors? The trustee in bankruptcy is accorded the status of a judicial lien creditor.

In summary, we see that section 2-702 gives a defrauded seller a right of reclamation, but that this right is perhaps illusory if bankruptcy intervenes. There is a possible argument that pre-code Missouri law would allow the defrauded vendor to succeed against a subsequent lien creditor. However, this is a weak argument when you consider the particular wording of the Code which gives rise to the problem. The ideal solution would be for section 400.2-702(3), RSMo 1965 Supp. to be amended to delete the phrase "or lien creditor."<sup>65</sup>

#### IV. RECLAMATION AND ARTICLE 9 OF UNIFORM COMMERCIAL CODE

The right of a secured creditor, not in possession of collateral, to enforce his security interest by reclamation from the bankrupt's estate depends upon the nature of the bankruptcy proceeding and the nature of the creditor's lien. It would be well to distinguish between two conceptually different methods by which a secured party may obtain his collateral from the bankrupt's estate. Reclamation is one of these methods; as discussed previously, it is essentially a court proceeding. The other method is abandonment by the trustee. Abandonment is largely within the discretion of the trustee. Neither abandonment nor reclamation depends upon the secured creditor filing a claim against the bankrupt's estate.<sup>66</sup> The necessity to distinguish between abandonment and reclamation is due to the different nature of the proof required to succeed under each. In reclamation the issue is whether or not the petitioner has title to the property. In abandonment the trustee must be convinced that the asset has no value or usefulness to the estate due to its nature and the bankrupt's equity in it. There is a tendency to blur these two methods, with resulting confusion as to the issues involved in a particular situation.<sup>67</sup>

The creditor seeking reclamation of his collateral, prior to the *Uniform Commercial Code*, had to prove that under state law title to the property remained

64. *Tuttle v. Bracey-Howard Const. Co.*, 136 Mo. App. 309, 117 S.W. 86 (K.C. Ct. App. 1909).

65. While not germane to the subject of the comment, there is an additional hazard which may confront the defrauded seller reclaiming under section 400.2-702. It has been held that a security agreement covering after acquired property will cut off the right to reclaim as against the secured party because he is a good faith purchaser given protection under section 400.2-702(3). *In re Hayward Wollen Co.*, 3 U.C.C. REP. 1107 (D. Mass. 1967); *Evans Products Co. v. Jorgensen*, 421 P.2d 978, 983 n.4 (Ore. 1966) (dictum).

66. "[L]ong established law that a secured creditor does not lose his security by failing to file a claim in bankruptcy within statutory time." *Clem v. Johnson*, 185 F.2d 1011, 1013 (8th Cir. 1950), cert. denied, 341 U.S. 909 (1951).

67. *E.g.*, MULDER & FOREMAN, A.L.I.-A.B.A. BANKRUPTCY AND ARRANGEMENT PROCEEDINGS (1964).

in him until the debtor's obligation was fulfilled.<sup>68</sup> The distinction, followed by some states, between a conditional sale, with title retained by the vendor, and a chattel mortgage, with title passing to the vendee, resulted in reclamation being denied chattel mortgagees in some states.<sup>69</sup> That reclamation turned upon where "title" was located in a security transaction was severely criticized by Judge Learned Hand as "a barren distinction."<sup>70</sup>

The *Uniform Commercial Code* presents a new dimension in this area by abolishing technical distinctions between various security devices. Section 9-202 provides that "[e]ach provision of this Article with regard to rights, obligations and remedies applies whether title to collateral is in the secured party or in the debtor." Although not enacted into positive law, Comment 1 to section 9-507<sup>71</sup> is very germane to our discussion. It provides that:

. . . since this Article adopts neither a "title" nor a "lien" theory of security interests . . . the granting or denying of, for example, petitions of reclamation in bankruptcy proceedings should not be influenced by speculations as to whether the secured party had "title" to the collateral or "merely a lien."<sup>72</sup>

Thus, under the *Uniform Commercial Code* it does not matter whether the security agreement is in the form of a conditional sale or a chattel mortgage. The secured party, in either case, has the right to take possession of the collateral upon default by the obligor<sup>73</sup> and dispose of it and apply the proceeds to the indebtedness.<sup>74</sup>

The old search for the location of "title" in a reclamation proceeding was abandoned by the Second Circuit in the case of *In re Yale Express System, Inc.*<sup>75</sup> This case involved a security interest in the form of a chattel mortgage executed according to the New York *Uniform Commercial Code*, securing payment for fifty trailers and sixty-two truck bodies purchased from the creditor, Fruehauf Corporation. The purchaser, Yale Express System, Inc., had filed a petition for reorganization under Chapter X of the Bankruptcy Act. The district court denied the petition for reclamation on the grounds that, irrespective of New York's adop-

68. *E.g., In re Voight-Pros't Brewing Co.*, 115 F.2d 733 (6th Cir. 1940).

69. *E.g., In re Lake's Laundry*, 79 F.2d 326 (2d Cir. 1935), *cert. denied* 296 U.S. 622 (1935).

70. *In re Lake's Laundry*, *supra* note 69, at 328 (L. Hand, J., dissenting).

71. A.L.I., UNIFORM COMMERCIAL CODE (1962 Official Text).

72. It should be remembered that the UNIFORM COMMERCIAL CODE is state law, and bankruptcy is governed by federal statute. It is only where the Bankruptcy Act allows the court to refer to state law that the UNIFORM COMMERCIAL CODE can affect the bankruptcy proceeding.

73. § 400.9-503. Query whether the secured party in the bankruptcy situation could recover the collateral from the bankrupt's estate by self help as allowed by this section. At least one case has held that a claimant may not acquire lawful possession by simply taking the collateral without permission of the court or the trustee. *Operators' Piano Co. v. First Wisconsin Trust Co.*, 283 Fed. 904 (7th Cir. 1922).

74. § 400.9-504(1).

75. 370 F.2d 433 (2d Cir. 1966).

tion of the *Uniform Commercial Code*, the distinction between a chattel mortgage and a conditional sale (and therefore the location of title) remained operative in the determination of what property belonged to the bankrupt and what property did not.<sup>76</sup>

The Second Circuit reversed, noting that the states, through the *Uniform Commercial Code*, had abolished the technical distinctions between various security devices, and then holding that the federal bankruptcy courts should no longer engage in a "theoretical exercise" of locating title. The court said that:

It would be incongruous for the federal courts, historically the leaders in the development of the law, to continue to employ anachronistic distinctions to determine whether a creditor is entitled to redeem property held by the trustee when the overwhelming number of states have succeeded in bringing their laws more into line with commercial reality.<sup>77</sup>

In the case of *In re United Thrift Stores, Inc.*,<sup>78</sup> the petitioner, in a proceeding under Chapter XI of the Bankruptcy Act, was allowed reclamation upon a finding of a valid security interest and agreement under the Code. In this latter case, however, there was no discussion of the title problem.

The second factor which has influenced whether a secured party is entitled to reclamation is whether the proceeding is one in straight bankruptcy, or whether it is a proceeding under Chapter X of the Bankruptcy Act. This factor is important because the power of the bankruptcy court to interfere with the enforcement of the security interest varies with respect to the nature of the proceeding. These equitable powers have been relatively limited in a straight bankruptcy proceeding.<sup>79</sup> The philosophy behind the straight bankruptcy proceeding is that of winding up and liquidating the debtor's estate. The philosophy behind Chapter X of the Bankruptcy Act is rehabilitation of the debtor; hence the court is given greater equitable powers in handling the debtor's property.<sup>80</sup> The provisions of straight bankruptcy are made applicable to corporate reorganization under Chapter X by section 102 of the Bankruptcy Act. The increased equitable powers available to the court in a corporate reorganization under Chapter X arise from the traditional powers available under common law equitable receivership, and from section 216 of the Bankruptcy Act which gives the court the power to change or modify the rights of creditors.

*Yale* was a reorganization proceeding under Chapter X of the Bankruptcy Act. The court, in discarding the importance of the title situs, specifically stated that "[e]quitable considerations and the *substance* of the transaction should

76. *In re Yale Express Systems, Inc.*, 250 F. Supp. 249 (S.D.N.Y. 1966).

77. *In re Yale Express Systems, Inc.*, 370 F.2d 433 (2d Cir. 1966).

78. 242 F. Supp. 714 (D.N.J. 1965), *aff'd* 363 F.2d 11 (3d Cir. 1966).

79. See notes 39 to 44 *supra*. See also King, *Bankruptcy—Equitable Power of Bankruptcy Court to Refuse Enforcement of Security Agreement Which it Finds Unconscionable*, 32 Mo. L. Rev. 284 (1967).

80. See 1 COOGAN, HOGAN & VAGTS, SECURED TRANSACTIONS UNDER U.C.C., § 9.02 (1967).

govern"<sup>81</sup> and remanded the case with directions for the lower court to examine the equities to determine whether the bankrupt should be allowed to retain possession of the trucks and trailers.<sup>82</sup>

The Second Circuit's acceptance of the *Uniform Commercial Code's* idea of a security interest which discards the concept of title, and its application to reclamation in a reorganization proceeding under Chapter X of the Bankruptcy Act, will probably be followed by federal courts in straight bankruptcy proceedings. The federal district court for the Eastern District of Missouri, in the case of *In re Jackson*,<sup>83</sup> allowed reclamation in a straight bankruptcy proceeding to a secured creditor who held a "chattel mortgage security agreement" executed six days after the *Uniform Commercial Code* became effective in Missouri. The court did not discuss the title requirement problem.

The cases of *Katcher v. Wood*<sup>84</sup> and *Trautwein v. Mandel*,<sup>85</sup> both of which arose under pre-code Missouri law, also concern reclamation by a creditor of his security from the bankruptcy trustee. The bankrupt in each case was an individual and the proceeding was in straight bankruptcy. The security device in each instance was a chattel mortgage. Reclamation was allowed without any discussion of the title problem. Under pre-code Missouri law, title to mortgaged property remained in the mortgagor prior to breach of conditions.<sup>86</sup> After breach of conditions, the mortgagee was regarded as the absolute owner of the property covered by the chattel mortgage.<sup>87</sup> However, whether the mortgagee was entitled to reclaim property upon which he held a chattel mortgage depended upon whether the requirements of section 443.460, RSMo 1949 (repealed effective 1 July 1965) as to filing had been properly complied with.<sup>88</sup>

A secured party should be able to draft his transactions in a manner such that he will know in advance the results if his debtor ends up in bankruptcy. The determination of reclamation by the application of equitable consideration, which can not be identified in advance, is unfortunate—particularly when viewed from the fact that most financing transactions which involve considerable sums will be with a corporation as debtor. A corporation may voluntarily seek reorganization under Chapter X of the Bankruptcy Act, which results in greater equitable powers in the court. In any event, it is to be hoped that the part of the *Yale* decision that makes equitable considerations increasingly important in the reorganization area will not transfer over to the straight bankruptcy situation. The practical result of the use of equitable determination to govern whether the secured

81. *In re Yale Express Systems, Inc.*, 370 F.2d 433, 438 (2d Cir. 1966).

82. *In re Yale Express Systems, Inc.*, *supra* note 81, at 439.

83. 268 F. Supp. 434 (E.D. Mo. 1967).

84. 109 F.2d 751 (8th Cir. 1940).

85. 127 F.2d 567 (8th Cir. 1942).

86. *Barnett v. Timberlake*, 57 Mo. 499 (1874); *Brandtjen & Kluge v. Hunter*, 235 Mo. App. 909, 145 S.W.2d 1009 (Spr. Ct. App. 1940); *Olean Milling Co. v. Tyler*, 208 Mo. App. 430, 235 S.W. 186 (K.C. Ct. App. 1921).

87. *Robinson v. Campbell*, 8 Mo. 365 (1843).

88. See *In re Patterson*, 139 F. Supp. 830 (W.D. Mo. 1956).

party will be allowed reclamation of his collateral is to make a question mark of his rights under section 9-503.

A secured creditor, after the *Yale* decision, can reclaim his collateral from the trustee's possession by proving a perfected security interest.<sup>89</sup> If the proceeding is in straight bankruptcy, then the equitable powers of the referee are rather limited. If the proceeding is one of reorganization, then after *Yale* the secured creditor might face greater equitable powers in the hands of the bankruptcy court.

#### V. CONCLUSION

The *Uniform Commercial Code* is an appropriate source of law in a proceeding to reclaim property from the bankrupt's estate. Section 2-702 gives a defrauded seller a right under state law to recover his goods. Until the phrase "or lien creditor" is removed from section 2-702(3), this right will be illusory if bankruptcy intervenes. The code's rejection of a title theory has been accepted by the federal courts in the *Yale* case. A secured creditor may recover his security from the bankruptcy trustee by proving his perfected security interest. He does not need to concern himself with the technical location of title. However, the uncertainties which may result from an application of greater equitable powers by the bankruptcy court may prove to be more troublesome than the "sterile" game of "locating title."

HUGH MCPHEETERS, JR.

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89. It should be noted that a security interest is subject to attack under all the varied powers of the bankruptcy trustee, this discussion has assumed that it would not be vulnerable.