

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF UTAH

3

Central Division

~~COUNTER COPY - DO NOT REMOVE - COPIES AVAILABLE AT \$1.50 PER PAGE~~

In re	:	
	:	
METAL TECH MFG., INC.,	:	Bankruptcy No. B-78-00655
a Utah Corporation	:	
	:	
Bankrupt	:	
	:	
HARRIET E. STYLER, Trustee	:	
	:	
Plaintiff	:	MEMORANDUM AND ORDER
	:	
vs	:	
	:	
K.J. Scharf	:	
d/b/a WESTERN LEASING	:	
	:	
Defendant	:	

On or about May 4, 1978, the defendant K.J. Scharf d/b/a Western Leasing, leased to the bankrupt, Metal Tech Mfg., Inc. (Metal Tech), the following personal property: One Shizuoka Model STN 2 Axis Level II Control Model with Contouring, and one Bausch & Lomb Readout with 16 x 30 scales. At the time of the transaction, the officers of Metal Tech represented that it was solvent and intended to pay the amounts due under the lease. They, at the time, gave to the defendant a balance sheet purporting to show the current assets and liabilities of the company. The bankrupt also traded in a Lagun FTV4 milling machine and a Burgmaster Six spindle drilling machine for an allowance against the amounts due under the lease. Although the bankrupt represented to the defendant that it was the owner of these machines, they were in fact owned by FMA Financial, Inc. (FMA), which had leased this equipment to the bankrupt and had filed a financing statement on the equipment with the Utah Secretary of State.

The equipment leased by the defendant to the bankrupt remained and was in the bankrupt's possession at the time of the filing in bankruptcy on July 21, 1978. Sometime following this petition in bankruptcy, FMA repossessed the two machines which were given to defendant as trade-ins. On January 8, 1979, the trustee filed a

1. The first part of the document is a list of names and titles.

(

(

(

complaint pursuant to §67c of the Bankruptcy Act, 11 U.S.C. §107 c, to have defendant's lien interest declared null and void. The trustee argued that the lease agreement constituted a sale and security agreement which required the filing of a financing statement with the secretary of state in order to perfect the lien as against the trustee. No financing statement had been filed. After consulting with her attorneys, the defendant, apparently, was advised that she had no chance of establishing any interest in the property leased to the bankrupt, even on the basis of fraud, so, in reliance on that advice, she entered into a stipulation conceding that she had no interest in the property and that all right, title and interest in and to it was vested in the trustee. The Court entered an order on that stipulation dated March 1, 1979. Upon obtaining new counsel, the defendant filed a Motion on April 9, 1979 to Vacate Order, Relieve Defendant from Stipulation, and Stay Sale of Property under Rule 60(b) of the Federal Rules of Civil Procedure so that she might pursue remedies of rescission under UTAH CODE ANN. §70A-2-702(2)(1953) and under the common law. For purposes of this motion, defendant accedes to the trustee's contention that the lease was in fact a sale which was not perfected under Article 9.

The order should only be vacated if justice requires. Thus, the trustee, in her supplemental memorandum, argues that the Court should only vacate the order if the defendant can demonstrate she has a meritorious claim or defense. Taking into consideration the fact that the costs of litigation on this issue will reduce the estate and hence affect the funds available to other creditors, the Court agrees that unless defendant's claim is meritorious, the order will not be vacated and defendant will not be relieved from her stipulation. Moving then to the merits of the claim, it appears to the Court that under the existing law the defendant would not be entitled to reclamation of the goods based on rescission either under UTAH CODE ANN. §70A-2-702(2)(1953) or the common law, and thus, the motion must be denied.

The Court first addresses the issue of whether there exists any common law right to reclaim property by a defrauded seller other

than that given in UTAH CODE ANN. §70A-2-702(2)(1953). This question was clearly answered in the negative in United States v. Wyoming National Bank, 505 F.2d 1064 (10th Cir. 1974). In that decision, the Court held that U.C.C. §2-702, codified in Utah in UTAH CODE ANN. §70A-2-702 (1953), eliminated any common law claim by a defrauded seller for reclamation. The Utah Court apparently has not spoken on the issue.

Confusion has arisen in this area, however, over the inter-relationship between U.C.C. §2-702(2) and U.C.C. §2-721. U.C.C. §2-702(2), codified in UTAH CODE ANN. §70A-2-702(2) (1953), after setting down specific elements entitling a seller to reclaim goods, says: "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." U.C.C. §2-721, codified in UTAH CODE ANN §70A-2-721 (1953), states:

Remedies for material misrepresentation or fraud include all remedies available under this chapter for nonfraudulent breach. Neither rescission or a claim for rescission of the contract for sale nor rejection or return of the goods shall bar or be deemed inconsistent with a claim for damages or other remedy.

These two sections taken together mean that the exclusive right to reclamation based on misrepresentation of solvency or intent to pay, either fraudulent or innocent, is found in U.C.C. §2-702(2) while other remedies for fraud, such as damages, are not affected by the rights given in U.C.C. §2-702(2). In the present case then, it is clear that defendant's claim for reclamation based on the misrepresentation of solvency on the part of the bankrupt must be based on rights, if any exist, under UTAH CODE ANN. §70A-2-702(2) (1953).

However, the effect of these code provisions on a reclamation right based on misrepresentations not concerning solvency or intent to pay is unclear. The Court in United States v. Wyoming National Bank, supra, was not faced with and did not decide this issue. It would appear, consistent with that opinion, that misrepresentations not dealing with solvency or intent to pay may give rise to a right of reclamation outside of the U.C.C. based on the common law of the state. It is, nevertheless, not necessary for this

Court to make a final determination on this legal issue as the facts of the instant case will not support a petition for reclamation based on a misrepresentation not dealing with solvency or intent to pay even if such a common law right still exists. Defendant's claim based on misrepresentations as to the ownership of the trade-in property could not establish common law fraud entitling her to rescission in this case because defendant did not reasonably rely on these misrepresentations. FMA, the owner of this leased equipment, had filed a financing statement as required under Article 9 of the Utah Uniform Commercial Code before plaintiff took these items as trade-ins. Therefore, the defendant had constructive notice that the bankrupt did not in fact own the property at the time of the trade in. It appears, therefore, that defendant has no right to reclamation based on common law on either ground. Thus, the Court now turns to UTAH CODE ANN. §70A-2-702(2) (1953) to assess defendant's rights.

The conflict respecting reclamation rights which exists between U.C.C. §2-702(2) and the Bankruptcy Act has been heavily debated. Many opinions have been written in the area reaching various conclusions. §546(c) of the new Bankruptcy Code, 11 U.S.C. §546(c), settles this long standing controversy by clearly defining the rights of a seller under U.C.C. §2-702(2) in the event of an intervening bankruptcy. It subjects the trustee to a seller's right of reclamation, whether statutory or common law in origin, if the seller demands in writing reclamation of the goods before 10 days after receipt of the goods by the bankrupt, and if the goods were sold to the bankrupt while insolvent in the ordinary course of the seller's business. This right of reclamation, however, is limited, for the Court may still deny reclamation if it protects the seller by either granting the claim priority status as an administrative expense or securing the claim by a lien. In light of these changes effected by §546(c) of the new Bankruptcy Code, this Court will omit an exhaustive discussion of the various cases and the interrelationship of the present laws.

The initial question that arises is whether the right of reclamation found in UTAH CODE ANN. §70A-2-702(2) (1953) is a

security interest which must be perfected under Article 9 of the Utah Uniform Commercial Code to prevail over the trustee in bankruptcy, or whether it is in the nature of some other kind of right. Although several courts have found this right of reclamation to be in the nature of some equitable right, this Court is persuaded that UTAH CODE ANN. §70A-2-702(2) (1953) gives the seller a right to reclamation subject to defeasance by an intervening lien creditor, including the trustee in bankruptcy, who is given this status under §70c of the Bankruptcy Act, 11 U.S.C. §110c, unless the seller files as if he were perfecting a security interest under Article 9 of the Uniform Commercial Code. See 4B Collier on Bankruptcy ¶70.62A[7.2] (1978). This interpretation makes sense in light of the specific language in UTAH CODE ANN. §70A-2-702 (1953) which states that the seller's right to reclaim is subject to the rights of a lien creditor, among others.¹ As the trustee in bankruptcy is made a hypothetical lien creditor under §70c of the Bankruptcy Act, the trustee, by the very terms of §2-702, takes a right in the property in question superior to that of the reclaiming seller. It is true that some courts, noting that this reference to a lien creditor in §2-702 does not cross-reference to Article 9, have reverted to state law outside of the U.C.C. to determine the rights of a lien creditor as against a reclaiming seller. See In Re Federal's Inc., 553 F.2d 509 (6th Cir. 1977); In Re Mel Golde Shoes, Inc., 403 F.2d 658 (6th Cir. 1968); In Re Kravitz, 278 F.2d 820 (3d Cir. 1960). This Court, however, feels that this reversion to pre-Code law violates the spirit and purpose of the Code which was drafted to create uniformity. Although not specifically cross-referenced to Article 9 of the Code, interpretation of a lien creditor's priority under Article 9 is reasonable when taking the U.C.C. as a whole. Treating this right as a security interest also creates

¹Some states have amended this section of U.C.C. to eliminate the lien creditor as one who can prevail over the reclaiming seller. The rights of a trustee in bankruptcy are naturally different under the amended section. See In Re Samuels & Co., Inc., 510 F.2d 153 (5th Cir. 1975).

an equitable result. It would be inequitable to let a seller, who has failed to protect his interest by filing, take precedence over other innocent creditors through a right of reclamation. Thus, the right of reclamation involved here, as nothing was filed on the underlying security interest, cannot stand as against the trustee.

Even if the Court had not found this right to be a security interest, there exist other conflicts between UTAH CODE ANN §70A-2-702(2) (1953) and the Bankruptcy Act. Under the present law, questions concerning the right of reclamation under §2-702(2) arise in the context of both sections 64 and 67 of the Bankruptcy Act, 11 U.S.C. §§104, 107.

§67c(1)(A) of the Bankruptcy Act states that "every statutory lien which first becomes effective upon the insolvency of the debtor" is invalid as against the trustee. Although there has been disagreement among courts as to whether the right to reclamation conferred under U.C.C. §2-702(2) falls into this category, this Court agrees with the reasoning which holds that this right does violate §67c(1)(A) and thus cannot stand as against the trustee.

By its own terms, UTAH CODE ANN. §70A-2-702(2) (1953) is of no effect unless the buyer is insolvent. The more debated issue is whether it is a statutory lien. Although some courts have held it is not, due to its common law roots, this Court feels that whether or not this lien as it now stands has common law roots is of no relevance to its present status, for the right created under UTAH CODE ANN. §70A-2-702(2) (1953) is a newly created statutory right whose elements differ from any common law right of reclamation. Even though it has superseded any common law right of reclamation, the fact still remains that the right conferred under this section is different from the common law right and as such is purely of statutory creation. For example, under UTAH CODE ANN. §70A-2-702(2) (1953), but not under the common law, even an innocent misrepresentation as to solvency will entitle the seller to reclamation. Our conclusion is further buttressed by the well-reasoned dissenting opinion of Judge Ross in In Re PFA

Farmers Market Association, 583 F.2d 992 (8th Cir. 1978). Judge Ross argued that the question of what is a statutory lien is asked to distinguish that lien from a consensual lien, and thus whether the lien has common law roots is of no consequence. Opinions supporting this Court's result include: In Re Good Deal Supermarkets, Inc., 384 F. Supp. 887 (D.N.J. 1974); In Re Neisner Brothers, Inc., 4 C.R.R. 865 (S.D.N.Y. 1978); In Re State Farm Garden Supply Co., Inc., 3 C.C.C. 1195 (D.N.J. 1978); In Re Ribgy Corp., 3 C.R.R. 1310 (D. Kan. 1977); In Re Kee Lox Manufacturing Co., 3 C.R.R. 1001 (E.D.Pa. 1977); In Re Giltex, Inc., 17 U.C.C. Rptg. Serv. 887 (S.D.N.Y. 1975). Those contra include: In Re Federal's Inc., supra; In Re Telemart Enterprises, Inc., 524 F.2d 761 (9th Cir. 1975), cert denied 424 U.S. 969 (1976).

Finally, this right of reclamation can be challenged as a state-created priority under §64 of the Bankruptcy Act. Although there has been wide disagreement on this issue as well, this Court finds that characterizing this lien as a state-created priority, which is invalid as against the trustee in bankruptcy, is supported not only by the statute itself, but also by the spirit behind the enactment of §64. §64 creates five classes of unsecured creditors which are to be satisfied before claims of general creditors. State-created priorities are included only to a limited extent. This section was passed to promote equality and uniformity of treatment as well as equitable distribution. UTAH CODE ANN. §70A-2-702(2) (1953) clearly seeks to establish a state created priority. It is created for the benefit of a particular class of creditors. It is not included in the list of priorities of §64, and as such, to allow it priority over other claims of creditors would violate the federally created order of priorities and the purpose behind the enactment of §64. Accord: In Re Neisner Brothers, Inc., supra. Contra: In Re PFA Farmers Market Association, supra; In Re Federal's Inc., supra; and In Re Telemart Enterprises, Inc., supra.

In conclusion, the Court must deny the Motion of defendant as it finds no meritorious claim for reclamation. The right conferred under UTAH CODE ANN. §70A-2-702(2) (1953) is a security


interest which, as it was not perfected, is subordinate to the rights of the trustee. Such right also violates §67c(1)(A) and §64 of the Bankruptcy Act and as such cannot be enforced against the trustee.

ORDER

Defendant's Motion to Vacate Order, Relieve Defendant from Stipulation, and Stay Sale of Property is denied.

DATED this 17 day of ^{September} ~~August~~, 1979.

BY THE COURT


Ralph R. Mabey
United States Bankruptcy Judge

b1