Boston College Law Review

Volume 10
Issue 3 *A Symposium Federal Rule 23 - The Class Action*

Article 13

4-1-1969

Section 2-702(2): A Seller's Prima Facie Case and the Obligation of Good Faith

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UNIFORM COMMERCIAL CODE COMMENTARY

SECTION 2-702(2): A SELLER'S PRIMA FACIE CASE AND THE OBLIGATION OF GOOD FAITH

Under pre-Code case law a seller was entitled to rescind a contract and recover goods sold if he could prove that the buyer had made a fraudulent misrepresentation of solvency inducing him to extend credit that he would not have granted had he been aware of the buyer's true financial condition.[1] Section 2-702(2) of the Uniform Commercial Code[2] is the first attempt to codify the seller's right to reclaim goods from an insolvent buyer. The statute sets forth two factors as conditions precedent to the right of reclamation: (a) the transaction must be for credit; and (b) the buyer must be insolvent[3] at the time he receives[4] the goods. If these two conditions are met and the seller makes a demand for the goods[5] within ten days of the buyer's receipt, the seller has an absolute right of reclamation

[1] See, e.g., Rochford v. New York Fruit Auction Corp., 116 F.2d 584 (2d Cir. 1940); Sternberg v. American Snuff Co., 69 F.2d 307 (8th Cir. 1934); Annot., 59 A.L.R. 418 (1929).

[2] U.C.C. § 2-702(2) states:

> 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.

Unless otherwise indicated, all Uniform Commercial Code citations are to the 1962 Official Text.

[3] U.C.C. § 1-201(23) states:

> A person is "insolvent" who either has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due or is insolvent within the meaning of the federal bankruptcy law.

Bankruptcy Act § 1(19), 11 U.S.C. § 1(19) (1964), states:

> A person shall be deemed insolvent within the provisions of this Act whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts.

[4] U.C.C. § 2-103(1)(c) states: "'Receipt' of goods means taking physical possession of them."

[5] The phrase "reclaim the goods upon demand," found in § 2-702(2), supra note 2, means that the seller need merely make a demand for the goods within ten days of receipt by the buyer. He need not actually obtain possession within that period. Metropolitan Distribs. v. Eastern Supply Co., 21 Pa. D. & C.2d 128, 134 (Allegheny County Ct. 1959); Cf. In re Helms Veneer Corp., 287 F. Supp. 840, 844 (W.D. Va. 1968).

Delivery by the seller need not coincide with receipt by the buyer. Under § 2-319 (1)(a) a seller may deliver goods to a carrier, but no receipt occurs until the buyer takes physical possession. See § 2-103(1)(c), supra note 4. The ten-day limitation period runs from the time when the buyer takes possession. See note 58 infra for a reference to the proper way to measure the limitations period.

against the buyer. However, if there has been a written misrepresentation of solvency within three months prior to delivery, the ten day period within which goods must be demanded does not apply.

The purpose of this comment is to examine each element of a seller's prima facie case under section 2-702(2). The proper resolution of situations likely to arise under this section will be suggested. The comment will consider also recent litigation concerning the interrelation of section 2-702(2) with the Code's overriding requirement that all contracts and duties within the Act be performed or enforced in good faith.[6]

I. Requisite Conditions for the Application of Section 2-702(2)

A. *Credit Transaction*

If the goods are in the possession of the buyer or of a person without priority under section 2-702(3), the first fact which a seller must allege and prove in order to prevail under the section is that the sale was on credit. This burden should be easily met in most instances. A sale is either a cash or credit transaction, depending upon the intent of the parties.[7] A seller must consent to some extension of credit to establish something other than a cash transaction.[8] Thus the consent of the seller,[9] his permission to the buyer to possess and use the goods without simultaneous payment, is the essence of the credit transaction.

The cash or credit nature of a sale has been examined in only two Code cases,[10] both of which have held that the seller's delivery of goods and the simultaneous acceptance of a check did not establish a credit transaction. Such a result is essential from the viewpoint of commercial practicality, the only alternative being to require a buyer to keep large amounts of cash on hand. As long as due diligence is exercised in collection, the transaction will be treated as a cash sale.[11] The transaction being for cash, immediate recourse to section 2-702(2) is precluded.[12]

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[6] U.C.C. § 1-203 states: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."

[7] Sandoz v. Knippers, 241 F. Supp. 640 (W.D. La. 1965).

[8] National City Bank v. Hotchkiss, 231 U.S. 50, 58 (1913). See § 2-511, Comment 6.

[9] In re Helms Veneer Corp., 287 F. Supp. 840, 844 (W.D. Va. 1968).

[10] In re Helms Veneer Corp., 287 F. Supp. 840 (W.D. Va. 1968); In re Mort Co., 208 F. Supp. 309 (E.D. Pa. 1962).

[11] U.C.C. § 2-511, Comment 4. However, if the parties agree that the instrument will not be presented with due diligence, the sale will be held a credit transaction. Sandoz v. Knippers, 241 F. Supp. 640 (W.D. La. 1965).

[12] A seller who has engaged in a cash transaction by accepting a demand item which is later dishonored may still reclaim goods from the buyer. Section 2-507(2) provides that a buyer's right to retain goods in a cash sale is conditioned upon his making the payment due. Payment by check is made conditional by § 2-511(3). The payment and right to retain the goods is defeated, as between the parties, by dishonor of the check upon due presentment. U.C.C. § 2-511(3). In re Mort Co., 208 F. Supp. 309 (E.D. Pa. 1962). However, the seller must demand the goods within ten days of delivery or he will be held to have waived his right to reclaim. If waiver occurs, the seller will be relegated to the status of a general creditor with an action on the item and for breach of contract. See In re Helms Veneer Corp., 287 F. Supp. 840, 846 (W.D. Va. 1968), reading Comment 3 to § 2-507 into the body of that statute.

The Code cases mentioned do not establish a new precedent, but rather they follow along a line of pre-Code cases holding that when a seller accepts a demand instrument at the time of the buyer's receipt of the goods the transaction is a cash sale.[13] It is also settled that the proper test for determining whether the sale is for cash or credit is the intent of the parties, which may be evidenced by a course of dealing or usage of trade.[14]

B. *Insolvency*

The second condition which the seller must allege and prove to establish a prima facie case under section 2-702(2) is that the buyer was insolvent[15] when he received the goods. The Code defines three situations which constitute insolvency.[16]

The first two tests establish insolvency in the equity sense. They are based on a person's failure to pay his debts in the ordinary course of business or as they become due. This type of insolvency rests on a dynamic theory which equates insolvency with a lack of liquidity, an inability to pay one's debts as they mature. A buyer's failure to have sufficient funds on hand to pay his seller on demand or when the debt is due clearly establishes equitable insolvency.

Insolvency under the Bankruptcy Act is in the nature of a status at a particular moment in time.[17] It is a mechanical balance sheet test wherein liabilities exceed assets on a given date.

In the extreme situation, where bankruptcy proceedings are instituted shortly after delivery, the burden of proof should not be difficult to overcome. Because equitable insolvency usually precedes insolvency in the bankruptcy sense, one commentator has stated that "[i]t would not be illogical to hold that if [the buyer] was insolvent [in the bankruptcy sense] at the time he receives the goods or shortly thereafter, that he was insolvent [in the equity sense] . . . three months prior to the filing of the petition in bankruptcy. . . ."[18] Furthermore, the frequency with which equitable insolvency precedes bankruptcy may give rise to a presumption of equitable insolvency at the time of delivery.[19]

In the less extreme situation, where only equitable insolvency is sought to be proved, the reclaiming seller may have a somewhat more difficult task. He may have to rely on such evidence as the opinion of persons

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[13] See, e.g., Sears Roebuck & Co. v. Harris, 22 N.J. Misc. 84, 36 A.2d 135 (Cumberland County Ct. 1944).

[14] U.C.C. § 1-205 defines a course of dealing and usage of trade. These factors, particularly a course of dealing, may be of great importance in the interpretation of the conduct of the parties. See Sandoz v. Knippers, 241 F. Supp. 640 (W.D. La. 1965), where acceptance of a demand item but failure to exercise diligence in presentment showed the intent to extend credit. This holding exemplifies a precise application of a course of dealing to prove intent.

[15] See U.C.C. § 1-201(23), supra note 3.

[16] U.C.C. § 1-201, Comment 23.

[17] See note 3 supra. See also 1 W. Collier, Bankruptcy ¶ 1.19[1] (14th ed. 1968).

[18] R. Duesenberg & L. King, Sales & Bulk Transfers Under the Uniform Commercial Code § 13.03[4][c] (1968).

[19] Id.

familiar with the alleged insolvent's property and affairs, admissions against interest, prior insolvency and the individual's general reputation for solvency.[20] Because of the numerous difficulties surrounding any proof of the above factors, it appears that the seller would have more difficulty in proving equitable insolvency when no bankruptcy proceedings are instituted. However, because the extreme situation may well be the ordinary one,[21] it is likely that the seller will in most cases be able to carry his burden.

If the seller can establish that the transaction was for credit and that the buyer was insolvent when he received the goods, he has an absolute right of reclamation against the buyer. These factors conclusively establish a tacit representation of solvency which the Code treats as tortious.[22] This constructive fraud, however, creates a very limited right of recovery under section 2-702(2) because the seller must demand the goods within ten days of delivery or lose the benefit of the conclusively presumed fraud.

II. Misrepresentation of Solvency: A Prima Facie Case

In the event that the seller does not make a demand for the goods within ten days of receipt by the buyer, he, as the moving party, must allege and prove five factors in order to reclaim the goods. He must establish: (a) that there has been a misrepresentation; (b) that the misrepresentation was of solvency; (c) that the misrepresentation was made to him; (d) that the misrepresentation was made in writing; and (e) that the misrepresentation was made within three months prior to delivery of the goods. The Code does not explicitly require the seller to prove that the buyer or his agent made the misrepresentation, nor does it explicitly require proof of a demand for the goods within any particular time period if all elements of a prima facie case are proved. These omissions and other ambiguities require an examination of each portion of the subsection to determine precisely what is encompassed by the elements of a seller's case for reclamation.

A. *Misrepresentation*

Under the Uniform Sales Act no right of reclamation existed and the seller lost his lien on the goods upon receipt of possession by the buyer.[23] Although the seller was entitled to an action for the price, it was of little benefit when the buyer was insolvent. He would have preferred to secure possession of the goods to minimize losses and thereby to neutralize, at least partially, the effects of the buyer's insolvency. In response to this need, three lines of case law developed establishing a right to reclaim goods under three different tests, each of which was sufficient to establish fraud and a consequent right to rescind the contract and reclaim the goods. Under the common law theories a seller could reclaim goods from an insolvent buyer who had received them as the result of the well recognized principles

[20] 6 Am. Jur., Proof of Facts 393-99 (1960).

[21] R. Duesenberg & L. King, supra note 18, § 13.03[4][c].

[22] See U.C.C. § 2-702, Comment 2.

[23] Uniform Sales Act § 56(b).

of traditional common law fraud,[24] or constructive (innocent) fraud;[25] or, in a few instances, the seller could reclaim by demonstrating a mere inability to pay after a showing of intent to pay.[26] The final sentence of section 2-702(2) abolishes all common law claims for recovery, making the statutory remedy provided in the second clause of the first sentence exclusive.

It has been stated that because this legislation establishes an entirely new statutory right and purports to supplant entirely common law rights, the theories underlying pre-Code decisions are no longer relevant.[27] Such a view should not apply in the construction of section 2-702(2).

While it may be accepted that the statute creates a new and exclusive right, the meaning of the terms of the statute must have a foundation either in definitions provided by the legislation creating that right, or in some pre-statutory case law upon which the particular statute is based. Absent such reference to earlier uses of words in similar or analogous circumstances, it would be impossible to determine the meaning of each term and the statute would be incomprehensible. Furthermore, it is unlikely that the Code's draftsmen would seek to abrogate entirely the diverse pre-Code standards for reclamation by establishing a single new standard without providing a meaningful guide to a proper understanding of the new standard.[28] Where the Code does not define its terms, pre-Code case law retains

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[24] See, e.g., Mulroney Mfg. Co. v. Weeks, 185 Iowa 714, 171 N.W. 36 (1919). In *Mulroney* the defendant merchant was indebted to his supplier for past sales of goods on credit. The supplier refused to extend further credit unless payment was made on the account. The court held that the supplier had established his claim when he proved that the merchant had presented a check to him with knowledge that there were insufficient funds to honor the item, and that he immediately relied thereon to his detriment.

[25] See, e.g., Sternberg v. American Snuff Co., 69 F.2d 307 (8th Cir. 1934). In *Sternberg* the buyer had furnished a false financial statement to a mercantile agency which in turn supplied to the plaintiff seller a statement based on the buyer's statement. The report received by the seller indicated that the buyer was in a sufficiently strong financial condition to merit credit. The seller relied on the statement and delivered goods to the buyer who was in fact insolvent. The court granted reclamation, stating that "*whether* [the errors were] *intentional or not*," they were materially false and resulted in plaintiff's reliance to his detriment. Id. at 309 (emphasis added). The *Sternberg* court granted relief, accepting the misrepresentation as unintentional, the type of "innocent" misrepresentation referred to in § 2-702(2).

[26] See, e.g., Haywood Co. v. Pittsburgh Indus. Iron Works, 163 F. 799 (W.D. Pa. 1908). In *Haywood* the defendant buyer placed an order for goods and was solvent at that time, but became insolvent prior to the time of delivery. The court treated the buyer's silence, coupled with insolvency, as a constructive fraud. But see In re Sherman, 13 F.2d 121 (2d Cir. 1926), where mere silence was insufficient to establish a right to rescind the contract and recover the goods.

[27] R. Duesenberg & L. King, supra note 18, § 13.03[4][b].

[28] In instances where the draftsmen substantially depart from pre-Code law, the departure is clear in both the statute and the Comments thereto. Pre-Code law was vitally interested in the concept of title. See, e.g., In re Stridacchio, 107 F. Supp. 486 (D. N.J. 1952). The Code changed the point of concentration to that of an interest in the goods, title in most cases being immaterial. See U.C.C. § 2-401. This change was effected with great care and consideration of its ramifications. Section 2-401 includes a preamble and covers explicitly the step-by-step performance or non-performance under the contract. Ramifications concerning identification to the contract, insurable interests and risk of loss are carefully treated. See §§ 2-501, 2-509, 2-510. It is submitted

some vitality and must be consulted for the proper construction and application of a section.

Many pre-Code cases stand for the proposition that a seller may reclaim goods delivered to a buyer after reliance on the buyer's fraudulent representation of solvency.[29] Section 2-702(2) does not use that familiar phrase, but rather refers to "misrepresentation of solvency." The Comment to section 2-702(2) uses the same phrase and therefore provides little clarification of the intended meaning. However, the history of the subsection and a report of the Permanent Editorial Board are enlightening. The subsection[30] was substantially redrafted by the Board prior to promulgation in its present form. The changes were made at the behest of the New York Law Revision Commission.[31] One of the questions most troublesome to the Commission was the uncertainty as to whether the right of reclamation had to be based on a misrepresentation within the traditional concept of fraud or merely on an innocently incorrect statement.[32] When the Board redrafted the section, it commented that "[t]he changes were made to make it clear that . . . the section applies to innocent as well as fraudulent misrepresentation of solvency or intent to pay. . . ."[33] The draftsmen apparently intended the newly codified right to reflect closely pre-Code law. Unfortunately this intent has not been made explicit in the Comments to section 2-702 and can only be inferred from the history of the statute. In any event, it is apparent that courts will have to consult pre-Code law to determine the meaning of misrepresentation. It is submitted that this consultation will effectuate the draftsmen's intention but in all likelihood will promote non-uniformity of law by causing courts to reaffirm at least a substantial part of their pre-Code decisional law.[34]

B. *"Of Solvency"*

A seller called upon to extend short term credit is primarily interested in the liquidity of the prospective debtor, as demonstrated by his ability

that this policy of care in making substantial changes from pre-Code law was not abandoned in the drafting of § 2-702(2).

29 See, e.g., Annot., 59 A.L.R. 418 (1929).

30 In 1952 § 2-702(1)(b) read:

> Where the seller discovers the buyer to be insolvent he may . . . (b) subject to the rights of a buyer in the ordinary course or other good faith purchaser or lien creditor under this Article (Section 2-403), and within ten days after receipt, reclaim any goods received by the buyer on credit, 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.

This section was redrafted and became the present § 2-702(2).

31 1 New York Law Revision Commission Report, Study of the Uniform Commercial Code 549 (1955).

32 Id.

33 1956 Recommendations of the Editorial Board for the Uniform Commercial Code 72 (1957).

34 The draftsmen have not promoted uniformity of law in all cases. In an effort to have some legislation passed, the Code was often drawn to avoid strongly conflicting policies among the various states. See, e.g., § 2-318, Comment 3. The use of this technique in drafting uniform legislation has resulted in conflicting decisions. Compare Delta Oxygen Co. v. Scott, 238 Ark. 534, 383 S.W.2d 885 (1964), with Haley v. Allied Chem. Corp., 1967 Mass. Adv. Sh. 1501, 231 N.E.2d 549.

to pay his debts as they mature in the ordinary course of business. Liquidity may be best determined by a study of the buyer's balance sheet. The buyer's current ratio, the ratio of current assets to current liabilities, is ordinarily an accurate indicium of liquidity. A buyer may be solvent in the bankruptcy sense (the fair market value of all his assets exceeds his liabilities), but if the assets are of such a nature that they cannot be easily converted into cash an equitable insolvency will result when current liabilities become due and exceed current assets. Inasmuch as a disadvantageous current ratio is often indicative of impending financial disaster, a seller will usually require a 2 to 1 ratio before consenting to extend short term credit.[35]

The Code refers to a buyer receiving goods while insolvent, but does not refer to his state of solvency at the time of misrepresentation. However, the section explicitly states that a seller's extended right of reclamation is based on a misrepresentation "of solvency." It seems clear that a balance sheet indicating a current ratio of 2.5 to 1, when in fact it should indicate a ratio of 1.5 to 1, is an erroneous representation of liquidity upon which a seller may be expected to rely to his detriment. It is submitted that the term "misrepresentation of solvency" properly includes any erroneous representation of liquidity and that actual insolvency is not a prerequisite at the time of misrepresentation.[36] Thus, where a buyer is solvent at the time he misrepresents his liquidity but is insolvent at the time of delivery, reclamation should be available. Such construction is clearly within the purview of a statute designed to permit a seller to reclaim goods from a buyer who is unable to pay for them at the time of receipt. Furthermore, the stated reasons for change in the 1962 Comments show that the section applies to a situation in which goods have been delivered to a buyer "immediately preceding his insolvency . . . ."[37] This is an explicit indication that

[35] W. Fletcher, Cyclopedia of the Law of Private Corporations § 9248 (J. Tracy ed. 1959).

[36] But see R. Duesenberg & L. King, supra note 18, § 13.03[4][c]. The commentators appear to take the position that there is no misrepresentation unless the buyer was in fact insolvent at the time the representation was made. The authors make no distinction among the varying degrees of solvency which may influence a seller's decision to extend credit.

If a court requires that the buyer be insolvent at the time of the representation, then, depending upon what constitutes a misrepresentation in a particular jurisdiction, a seller may or may not have to prove that the buyer was insolvent at the time when he placed his order. The clear and easily decided case occurs where the insolvent buyer encloses with his order a materially erroneous balance sheet indicating solvency and where the seller immediately relies thereon and delivers goods on credit. (For a pre-Code case granting reclamation on similar facts, see O'Rieley v. Endicott-Johnson Corp., 297 F.2d 1 (8th Cir. 1961)). Such a case is clearly within any reasonable construction of the statute. On the same facts, but with delivery three months and one day after the misrepresentation is made, the seller may still not be barred from recovery. If either delivery of a postdated check or the signing of an invoice acknowledging receipt of goods and indicating an intent to pay will constitute misrepresentation in the particular jurisdiction, the seller's action will be revived if there is simultaneous insolvency of the buyer.

[37] See U.C.C. § 2-702, Comment, Changes. The draftsmen are referring to insolvency in the bankruptcy sense. A prerequisite to the statute's application is that the buyer be insolvent when he receives the goods. If the draftsmen were referring to equitable insolvency their statement would be inconsistent with the clear language of the statute.

the purpose of the statute is to strengthen a seller's reclamation right, and the statute should be construed to do so.[38]

C. *Misrepresentation Made to the Particular Seller*

The next element essential for reclamation is proof that the misrepresentation was made to the *particular* reclaiming seller. The Comment to section 2-702(2) states that the writing must be "addressed" to the reclaiming seller.[39] If the term addressed means that the writing must be sent directly to the seller, then the Comment presents an overly narrow interpretation of the statute. This narrow interpretation is contrary to many pre-Code cases holding that a right of reclamation exists when the buyer sends a materially erroneous financial statement to a mercantile agency or trade association which the supplier may be expected to consult for information regarding the financial status of the purchaser.[40] However, the Comment is subject to such a narrow construction, and one writer has so interpreted it.[41] It is submitted that, since the object of the subsection is to protect the seller who has relied on the apparent solvency of the buyer, no justification exists for distinguishing the buyer who sends false financial statements directly to his suppliers from the buyer who sends such statements to a trade association to which the suppliers belong or may be expected to consult. In *Sternberg v. American Snuff Co.*[42] a bankrupt buyer had made a materially erroneous financial statement available to a mercantile agency which based its evaluation of the buyer's financial condition at least in part on the statement. The reclaiming seller had extended credit in reliance on the mercantile agency's evaluation. The *Sternberg* court stated that "a false financial statement made to such an agency and used by it as a basis or one of the bases of its reports to its cor-

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However, in most cases a business will suffer equitable insolvency for many weeks or months prior to insolvency in the bankruptcy sense. Therefore, the logical and consistent construction of the draftsmen's Comment and of the subsection is that the statute is designed to protect one who sells goods to a buyer who is equitably insolvent and who is about to become insolvent in the bankruptcy sense. Further, this construction is consistent with the 1962 version of subsection (3), which subordinates the seller's rights to those of a trustee in bankruptcy. The seller was protected only until the date of bankruptcy, as this Comment infers. See In re Kravitz, 278 F.2d 820 (3d Cir. 1960). In 1966 the Board recommended deletion of this subordination clause, but the lack of attention given to the "Changes" section of the Comments by many commentators seems to have resulted in an oversight by the Board. With the 1966 recommendation, the reference to insolvency is no longer correct; the reclaiming seller is protected even from the trustee in bankruptcy. Comment, The Reclaiming Seller and the Lien Creditor: The End of an Unnecessary Controversy, 8 B.C. Ind. & Com. L. Rev. 593 (1967).

38 U.C.C. § 1-102(1) states: "This Act shall be liberally construed and applied to promote its underlying purposes and policies." This mandate is directed to the courts. Once the policy of a section is understood, the statute must be construed to promote that policy.

39 U.C.C. § 2-702, Comment 2.

40 See, e.g., Sternberg v. American Snuff Co., 69 F.2d 307 (8th Cir. 1934).

41 Note, Bankruptcy and Article Two of the Uniform Commercial Code: The Right to Recover the Goods Upon Insolvency, 79 Harv. L. Rev. 598, 609 (1966).

42 69 F.2d 307 (8th Cir. 1934).

respondents is, effectively, a statement made direct[ly] to any of such correspondents as act in reliance thereon. . . ."[43] In this case, as in most cases where the misrepresentation is an erroneous financial statement submitted to a mercantile agency, the misrepresentation is not in fact made by the buyer to the seller, but is made by the agency to the seller.[44] The theory underlying the cases exemplified by *Sternberg* is that the buyer is the tortfeasor, the agency being merely a conduit for false information. Section 2-702(2) encompasses this theory since it does not explicitly require that the misrepresentation be made by the buyer, but merely that it be made to the particular seller. Section 2-702 closely reflects the theory underlying the mercantile misrepresentation cases, and there is no justification for distinguishing between false financial statements received by a seller from a mercantile agency or directly from a buyer. Therefore, the term "addressed" in the Comment, and the statute itself should be construed to include a written misrepresentation of solvency issued to a mercantile agency by a buyer who could reasonably foresee that the reclaiming seller might consult and rely upon the representation. This construction will promote the stated purpose of strengthening a seller's right of reclamation. Such a construction is both reasonable and well precedented.[45]

D. *The Misrepresentation Must Be in Writing*

The requirement that the representation be in writing[46] is easily understood. The Code's definition of a writing is broad enough to include writings not signed by the buyer or anyone on his behalf.[47] Any type of writing would be sufficient so long as it contained a misrepresentation of solvency.

The Comments do not indicate the draftsmen's motives in the requirement that the misrepresentation be written. However, the reason may be inferred from the traditional judicial attitude and that of the draftsmen toward the right of reclamation. It has been noted that reclamation is not a favored remedy[48] and that a seller has a heavy burden of proof to over-

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[43] Id. at 308.

[44] Mercantile agencies are not liable to customers who rely on their financial reports when the subscription contract with the customer states that the agency does not guarantee the validity of the information in the agency reports and that the agency shall not be liable for its own negligence. Serino v. Dun & Bradstreet, Inc., 267 F. Supp. 396 (D.S.C. 1967); Annot., 102 A.L.R. 1070 (1936). However, the disclaimer clauses are ineffective if malice or gross negligence amounting to fraud occurs. Munro v. Bradstreet Co., 170 App. Div. 294, 155 N.Y.S. 833 (1915).

[45] It has frequently been stated that creditors of a bankrupt who do not rely on misrepresentations have no right to benefit from the bankrupt's tortious conduct. See, e.g., In re Stridacchio, 107 F. Supp. 486, 487 (D.N.J. 1952). Furthermore, the substantive elements of the right of reclamation are determined by state law. O'Rieley v. Endicott-Johnson Corp., 297 F.2d 1, 5 (8th Cir. 1961). Therefore it is clear that the Bankruptcy Act condones a construction of § 2-702(2) which would protect the seller who has suffered from the insolvent's tortious conduct.

[46] U.C.C. § 1-201(46) states: "'Written' or 'writing' includes printing, typing or any other intentional reduction to tangible form."

[47] See R. Duesenberg & L. King, supra note 18, § 13.03[4][c].

[48] O'Rieley v. Endicott-Johnson Corp., 297 F.2d 1, 4 (8th Cir. 1961).

come.[49] This same heavy burden is imposed in bankruptcy cases.[50] Thus it appears that in the attempt to codify a right of reclamation for the first time and to have this right uniformly enacted, the draftsmen adopted a conservative position regarding the evidentiary requirements for proof of misrepresentation.[51] The action for oral misrepresentation is now supplanted by the exclusive requirement of a writing.[52]

E. *Time of Misrepresentation*

The final element of a seller's prima facie case for reclamation is proof that the misrepresentation was made within three months prior to delivery. The critical date from which the time period is measured is the date of delivery, which should be distinguished from the date of receipt, the critical point for the per se rule, which requires that a demand be made within ten days of receipt.[53] Delivery is made when the seller tenders the goods to the buyer or a carrier. Tender occurs when the seller puts and holds conforming goods at the buyer's disposal and gives any notification reasonably necessary to enable him to take the goods.[54] Depending upon the agreement of the parties, delivery may occur at the seller's place of business[55] or before[56] or after[57] shipment.

After the seller has determined the date of delivery, in most cases it will be very easy to establish the time period between the misrepresentation and the delivery.[58] However, the Code and Comments seem to treat inconsistently one situation which may be expected to arise often. Such a situation would occur if a buyer were to send a fraudulent balance sheet to

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49 Id.

50 Id. at 5.

51 Though most pre-Code reclamation cases were based on some sort of writing, oral misrepresentation was recognized as an act giving rise to rescission if clearly proven. National Silver Co. v. Nicholas, 205 F.2d 52 (5th Cir. 1953).

The New York Law Revision Commission, in its study of § 2-702(2), was of the opinion that the requirement that the misrepresentation be in writing has little meaning if traditional rules allowing reclamation for fraud, whether oral or written, were to continue unchanged by the Code. The Commission was perplexed by the apparent inconsistency in distinguishing oral from written fraud, and hypothesized that the dilemma was avoidable through construction of this limitation as applying only to innocent misrepresentations. However, the Commission refused to suggest such construction and inferred that it was in fact implausible in light of both an honest reading of the statute and the Comments thereto. 1 New York Law Revision Commission Report, Study of the Uniform Commercial Code 549 (1955).

52 R. Duesenberg & L. King, supra note 18, § 13.03[4][c].

53 See note 5 supra and accompanying text.

54 U.C.C. § 2-503(1).

55 U.C.C. § 2-308.

56 U.C.C. § 2-319(1)(a).

57 U.C.C. § 2-319(1)(b).

58 The Code does not provide any guidance for measuring either the ten-day or three-month time periods. In one instance where the exact end of a limitation period was vital, a referee in bankruptcy applied to the Code the rule of § 31 of the Bankruptcy Act, 11 U.S.C. § 54 (1964), holding that the first day of the period is to be excluded and the last day included. In re Behring & Behring, 5 U.C.C. Rep. Serv. 600 (1968). Although the right to reclaim goods from a bankrupt is in most cases determined by state law, it seems reasonable to apply the rule of the Bankruptcy Act where local law is silent.

a mercantile agency on January 1, and if on April 1 a seller were to request and be given by the agency an evaluation of the buyer which was at least partially based on the buyer's false balance sheet, and if the seller were immediately to rely thereon. In such a case a misrepresentation would have been made to the particular seller within three months prior to delivery. The situation seems to fall clearly within the statute, but the explanation of the subsection by the draftsmen casts the suggested conclusion into doubt. The Comment states that the misrepresentation must be "dated" within three months of delivery.[59] A balance sheet is a statement of the assets and liabilities of a business enterprise on a particular date and is so dated.[60] In the hypothetical, the balance sheet is not dated within three months of the seller's reliance, but the report given to the seller is so dated. The consistent and simple solution to the apparent conflict is to require that the bases of the agency's analysis be less than three months old. Though such solution is easily arrived at, it is not supported by the statute and is highly undesirable from a commercial viewpoint.[61] The central problem is to determine whether the law seeks to nullify the effects of fraud after three months or whether it is designed to encourage sellers to investigate the credit standing of their buyers. A policy nullifying the effects of fraud after ninety days would not comport with another policy clearly expressed in the section. If a seller qualifies under the statute, he need not make a demand for the goods for months or even years in appropriate cases.[62] The extended reclamation period indicates a policy to prefer and to protect creditors who rely on a misrepresentation of solvency to the exclusion of those who do not so rely. The effects of the fraud are not treated as terminated after three months. The better policy is to require reliance within three months of a credit investigation. This requirement encourages sellers to investigate their purchaser's credit and provides strong justification for

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59 U.C.C. § 2-702, Comment 2.

60 W. Fletcher, supra note 35, § 9237.

61 It is important to examine the commercial impracticality of requiring such recent information. A Dun & Bradstreet report typically indicates a buyer's financial history in terms of gross sales for the past several years. It includes an evaluation by creditors of the buyer's traditional ability or inability to pay his debts as they mature, and it includes a rough estimate of the buyer's bank account. Not only is it commercially impossible to maintain this information in very updated fashion, but sellers in general are interested not only in his current position but also in the long-time performance of the prospective debtor.

62 Section 2-702(2) states only that the ten-day limitation is inapplicable if a written misrepresentation of solvency is made to the seller within three months of delivery. Though the subsection removes this time limitation, it establishes no other period within which a demand for the goods must be asserted. If a seller qualifies under this subsection and under the exception to the ten-day time limit, it appears that he may demand payment for some undefined length of time before demanding the goods. It is submitted that, in cases where the goods can be identified months or years later and no party with a priority has superseded the seller's rights, four years is the time limit within which a seller must make a demand for the goods and institute litigation if he so desires. The immediate right of reclamation indicates that the buyer has in effect repudiated the contract. This breach of his duty to pay for the goods should initiate the running of the Code's statute of limitations. See U.C.C. § 2-725(2). An action for breach of contract must be brought within four years. See U.C.C. § 2-725(1).

preferring the defrauded supplier over creditors generally in insolvency proceedings. Further, the seller can do little more to protect himself than to carry out this private form of investigation. The realities of commercial practice and good public relations prevent sellers from making quarterly requests for statements of solvency.[63]

It is submitted that because section 1-102 mandates a liberal construction of the Code to promote sound commercial practices and because the statute itself does not require that the buyer be the party making the misrepresentation of solvency, subsection (2) of section 2-702 should be construed to permit reclamation by a seller who has relied on a mercantile agency report within three months of his receipt of the report.

III. THE OVERRIDING DUTY OF GOOD FAITH

On only one occasion has an appellate court had an opportunity to consider the meaning of misrepresentation of solvency under the Code. In *Theo. Hamm Brewing Co. v. First Trust & Savings Bank*,[64] the plaintiff sold and delivered beer to a distributor buyer whose inventory was subject to a properly perfected security interest in after-acquired property held by the defendant bank. Plaintiff and the buyer had dealt together for over two years and both parties were well aware of the buyer's precarious financial condition. Over a ten-day period plaintiff made four deliveries to the buyer and received a check for each delivery. All the checks were dishonored for insufficient funds. The defendant took possession and sold the beer. In what was apparently an action for conversion, the plaintiff relied solely on his right of reclamation[65] without regard to the ten-day limitation, his

[63] A solution to this problem has been suggested. A seller may include in his order forms the following statement: "[T]he buyer by acknowledging this order warrants that he is able to pay the purchase price for the goods described on the reverse side and that he is solvent." R. Duesenberg & L. King, supra note 18, § 13.03[4][c]. The authors recognize that though this may provide a legal answer to the problem, it is quite unlikely that such an approach will be taken in many instances. From a business viewpoint, the form would be in bad taste.

[64] — Ill. App. 2d —, 242 N.E.2d 911 (1968).

[65] Neither the court nor the parties raised the threshold question whether this was a cash or credit transaction. It was apparently conceded by all concerned that § 2-702(2) controlled. However, unless the seller took the checks without an intent to present the items for immediate payment, the transaction should properly have been treated as a cash sale. See text beginning at page 635 supra. Because the checks were immediately presented for payment, it is submitted that the case was decided on the wrong grounds. Had this threshold question been raised, the proper approach would entail an evaluation of priorities between third parties and a reclaiming seller where a buyer's conditional payment and right to the goods is defeated. It has been argued that a good faith purchaser, referred to in § 2-702(3), includes a secured party holding a perfected security interest in goods arising under an after-acquired property clause, and that such secured party has a prior right to the goods. Note, Selected Priority Problems in Secured Financing Under the Uniform Commercial Code, 68 Yale L.J. 751, 758 (1959). If this analysis is valid, the result in the *Hamm Brewing* case is correct, but for the wrong reason. The seller would not need to have waived his right of reclamation, and this right would in any event be inferior to the interest of the defendant secured party. But see In re Mort Co., 208 F. Supp. 309, 310 (E.D. Pa. 1962), where it was stated

theory being that the checks received at each delivery constituted a misrepresentation of solvency. Whether the checks constituted a written misrepresentation of solvency was viewed as a question of fact, but the court decided as a matter of law that the facts could not establish a right of reclamation.[66] The court concluded further that the seller's knowledge that the buyer was in a poor financial condition precluded the *right to rely* on the checks as true representations of solvency. The court denied the right to rely on the checks on the ground that such conduct was not in "good faith" or in the exercise of "ordinary prudence." The question whether the facts did constitute a misrepresentation of solvency was never reached; the decision was based on the court's concept of good faith which either included or was confused with ordinary prudence. Because this case establishes the only Code precedent concerning the interrelation of sections 1-203 and 2-702 as applied to a course of dealing between a seller and a buyer, the decision should be examined as precedent for treatment of the same or similar fact patterns.

Section 1-203 requires that parties act in good faith in performing or enforcing any contract or duty under the Act.[67] This obligation of good faith applies throughout the entire Code. Significantly, the meaning of good faith depends upon the status of the party and is defined differently for the merchant[68] and the non-merchant.[69] The duty imposed upon a merchant by sections 1-203 and 2-103 is *not* one of ordinary care or commercial reasonableness. Any purely objective standard of due care has been rejected by the draftsmen.[70] The section 2-103 definition of good faith is objective but is *not* a standard of due care.[71] The current Comments do not attempt to explain the meaning within section 2-103(b) of the words "reasonable commercial standards of fair dealing in the trade." In 1952 good faith was

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in relation to a cash transaction that "if the seller has a right to reclaim the goods he stands in a position superior to any creditor. . . ."

66 — Ill. App. 2d —, 242 N.E.2d 911, 914 (1968).

67 U.C.C. § 1-203, supra note 6.

68 U.C.C. § 2-103(1)(b) states:

> "Good faith" in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.

Merchant is defined in § 2-104(1):

> "Merchant" means a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.

69 As used here the term non-merchants includes all persons who do not qualify as merchants under § 2-104(1), supra note 68. These persons also have a duty under § 1-203, but it is defined in § 1-201(19), which states that "good faith means honesty in fact in the conduct or transaction concerned."

70 1956 Recommendations of the Editorial Board for the Uniform Commercial Code 21 (1957). The 1957 version of § 2-103 is incorporated without change into the 1962 version of the Code.

71 In contrast, where the draftsmen wished to impose a strict standard of commercial reasonableness, they did so in explicit terms. See § 2-311(1), which specifically refers to commercial reasonableness. This standard is supplemental to the duty of good faith.

defined as "includ[ing] observance of reasonable commercial standards."[72] This definition seemed to establish as a minimum a general standard of due care, the objective standard termed ordinary prudence by the *Hamm Brewing* court. The 1952 definition was unacceptable to the Commissioners in New York[73] and to the American Bar Association[74] because they disapproved of a strict objective standard which would be applied in such a manner as to hinder development of desirable commercial practices. As now drafted, the section is designed to foster and require commercial "decency and fairness" in performance or enforcement of a contract or duty.[75] It seeks to assure the cooperation of the parties to a contract so that neither will be deprived of his reasonable expectations of profit from the transaction.[76] After the formation[77] of the contract the parties are no longer to be viewed as at arm's length but as partners to a venture involving and requiring commercial fair play. They must cooperate for mutual benefit. In light of this understanding of good faith, the *Hamm Brewing* decision must be closely scrutinized.

The opinion of the court fails to appreciate the Code's definition of good faith for a merchant. Without examining the meaning or history of this definition, the court applied its own understanding of good faith, something interchangeable with ordinary care. This purely objective standard was used as a basis for affirming a lower court's judgment on the pleadings. The court did not consider the standards of the trade or whether the seller was in fact trying to cooperate with and assist the buyer to overcome his financial difficulties. The facts indicate such cooperation. Eight months prior to the deliveries which gave rise to the litigation, the seller had established a system of operations for the buyer in an attempt to prevent the buyer's financial collapse. Occasionally during the intervening eight months, checks were dishonored, but the opinion indicates that these were later paid prior to the events in controversy.[78] Had the seller had the opportunity he may have been able to show that he was acting "fairly and decently" in accordance with trade practices. This essential finding was denied consideration when the court imposed a good faith duty of ordinary prudence.

The *Hamm Brewing* court stated that the seller, had he been acting in good faith, would have known that an honest financial statement would show that the buyer was insolvent. The duty of good faith for a merchant does require honesty in fact.[79] However, it is submitted that nowhere does

[72] U.C.C., 1952 Official Text, § 2-103(1)(b).

[73] New York Law Revision Commission Report, Study of the Uniform Commercial Code 27 (1956).

[74] Braucher, The Legislative History of the Uniform Commercial Code, 58 Colum. L. Rev. 798, 812 (1958).

[75] See Farnsworth, Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code, 30 U. Chi. L. Rev. 666, 668 (1962).

[76] Id. at 669.

[77] Section 1-203 applies only to the performance and enforcement of contracts and duties under the Code; it does not apply to formation of contracts. A contract which is unreasonable may be unconscionable under U.C.C. § 2-302. R. Duesenberg & L. King, supra note 18, § 4.08[3][a].

[78] — Ill. App. 2d —, 242 N.E.2d 911, 915 (1968).

[79] U.C.C. § 2-103(1)(b), supra note 68.

this duty or any trade practice make the act of accepting a check on delivery to an insolvent an act *per se* in bad faith[80] even if the seller does have knowledge of the insolvency. On similar facts it has been held that delivery of the check was a representation that it was good and would be paid on presentment.[81] The seller could justifiably rely on such representation. It is to be noted that to deliver knowingly a bad check in an attempt to gain possession of goods constitutes the crime of false pretenses.[82] The *Hamm Brewing* court would have the supplier assume that his buyer was a criminal.

If the seller in *Hamm Brewing* had been able to present his case and had been able to overcome the court's understanding of good faith, the court would have confronted the question whether a check presented on delivery could constitute a misrepresentation of solvency.[83] In Illinois, it has been held that receipt of goods with knowledge of an inability to pay is enough to establish a seller's right of reclamation.[84] This is controlling authority upholding the position of the seller in *Hamm Brewing*.

It is submitted that the *Hamm Brewing* court was incorrect in the application of the standard determining the right to rely,[85] and in its concept of good faith. It is submitted further that had the question been reached, reliance on a check as a misrepresentation of solvency may be justified as an act performed in good faith. If it is so justified and if the parties concede the application of section 2-702(2),[86] a bad check may qualify within the Code as a misrepresentation of solvency.[87]

CONCLUSION

Section 2-702(2) codifies and makes exclusive a seller's right to reclaim goods from an insolvent buyer or a person without priority under sec-

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80 The phrase per se bad faith is used because the *Hamm Brewing* court ruled as a matter of law that this conduct was not good faith.

81 Mulroney Mfg. Co. v. Weeks, 185 Iowa 714, 171 N.W. 36 (1919).

82 See, e.g., N.J. Stat. Ann. § 2A:111-8 (1953). See also Commonwealth v. Kelinson, 199 Pa. Super. 135 (1962).

83 But see note 65 supra.

84 Farwell v. Hanchett, 120 Ill. 573, 11 N.E. 875 (1887). This case is not mentioned in the *Hamm Brewing* decision.

85 Reliance is an act in performance of a contract. One has a right to rely on a representation if the reliance is in good faith. Both the Code and decisions under it recognize the commercial practicality and trade practice of accepting a check in payment for a delivery of goods. See In re Mort Co., 208 F. Supp. 309 (E.D. Pa. 1962). Unless the seller has actual knowledge that the check is bad, he will be acting in good faith.

86 U.C.C. § 2-702(2) is properly applicable in a situation such as postdating where the transaction is not for cash because the check is not a "demand item." See §§ 3-108; 2-511, Comment 6. Thus a check which is postdated by even one day is a credit instrument which clearly qualifies under § 2-702(2).

87 It is not suggested that whenever payment is proferred by a bad check there is a misrepresentation of solvency and the ten-day limitation will not apply. Such result will obtain only if the parties and the court concede a credit transaction or if the check is postdated. See the discussion of the cash or credit nature of a sale, supra pp. 635-36, and notes 65 and 86 supra.

tion 2-702(3). If the transaction is for credit and the buyer is insolvent at the time he receives the goods, a seller must allege and prove five facts to establish a prima facie case. The Code does not define four of the factors and the Comments are in several instances deceptive or overly narrow in their explanation of the subsection. The proper meaning and application of this subsection emerges only from a study of pre-Code case law and commercial practices as they exist today. As a consequence, non-uniformity is likely to result because of the diversity of pre-Code decisions and a judicial tendency to adhere to established law.

Good faith, although a nebulous term that will vary in meaning according to the trade to which it is applied, clearly requires an affirmative duty of cooperation to facilitate each party's receipt of reasonable benefits from the performance of the contract. The duty is not an objective standard of due care.

The bar and the judiciary should recognize the *Hamm Brewing* decision as an improper interpretation of the obligation of good faith. With this recognition the case should be rejected in any further consideration of a seller's right to reclaim goods. Section 2-702(2) was originally drafted to strengthen a seller's right of reclamation. It has twice been redrafted to further that end. Only if the judiciary follows the Code mandate for a liberal construction to promote the policy of the section and sound commercial practices will the newly redrafted section fulfill its purpose.

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