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Transfer of Movable Property under U.S. Law

Discussed from a Functional Perspective

PL ACADEMIC RESEARCH

I. Introduction

A. Coverage and approach

This book discusses legal rules for **three "functional" commercial "conflict situations"** under the laws of the U.S.A. The term “conflict situation”, here, is meant to address a certain type of conflict arising between certain parties (e.g., buyer, seller, creditors of buyer or seller, or other types of third parties, like former title-holders to the goods) having certain colliding interests in the same property. The three conflict situations addressed in this book are **(1)** the protection of a buyer in the seller's insolvency; **(2)** the protection of a seller in the buyer's insolvency; and **(3)** the conflict between a person formerly entitled to the goods (the original owner) and a good faith acquirer buying these goods from a non-owner who has no right to dispose of the goods. The aim is to clarify the rules comprehensively and rather exhaustively.

This requires a couple of clarifications.

A first, brief, clarification relates to the **types of assets** the transfer of which is covered by this study. The discussion of the three conflict situations listed above is limited to the law of **corporeal movable property** (“goods”). Excluded from the discussion, therefore, are all movable assets which are not corporeal, such as receivables and intellectual property rights, and different types of rights to use property under lease contracts, as well as all law related to immovable property, with reference to real property, such as land, including not only the earth but everything of a permanent nature over or under it.

A second clarification concerns the three “conflict situations” named above: Who are the parties to these types of conflicts, and which interests collide? The first conflict, referred to as the **buyer’s protection** in the seller’s insolvency, addresses the following type of situation: A buyer and a seller have concluded a contract for the sale of goods. Since the seller’s financial means do not suffice to discharge all of the seller’s debts, there is a conflict between the buyer and the seller’s other creditors about who will “get” the goods. The buyer has an interest in separating them from the seller’s estate (in order to do with them whatever he or she intended to do when entering the contract). The other creditors’ interest will be keeping the goods as a part of the seller’s estate, in order to get their own claims against the insolvent debtor satisfied at a higher percentage. A comparable conflict may also arise where the seller is not insolvent, but another creditor seeks to seize the goods in execution of a claim that creditor has against the seller. But if the seller’s funds are sufficient, he may either satisfy that other creditor’s claim, or procure substitute goods for the buyer or pay damages to the buy-

er for not performing the contract. The conflict becomes more vital where the seller's funds are insufficient. Therefore, we will henceforth use "protection of a buyer in the seller's insolvency" as a short-hand description of this kind of conflict.

The issue addressed in the second type of conflict, described as the **seller's protection** in the buyer's insolvency, relates to the reverse situation: A contract for sale has been concluded and the buyer does not have sufficient funds to discharge all of his obligations. The seller's interest is in receiving the full purchase price from the buyer. The other creditors of the buyer, however, will have an interest in maximizing the percentage to which their claims can be discharged. The optimal result for these creditors would, evidently, be to both "get" the goods and keep the money, in order to distribute the proceeds of these (and all other) assets amongst each other.

Finally, the third conflict stands between **an original owner and a buyer from a non-owner.** This conflict involves a situation with three parties: One party (later referred to as "A") originally owns certain goods. These goods, however, are later sold by a second party ("B") lacking any right or authority to dispose of the goods. The third party buying from "B" is "C". In this triangle, "A" typically has an interest in having the goods returned. "C", on the other hand, will be interested in keeping the goods. Alternatively, "A" and "C" may be interested in receiving compensation for their loss if they have to relinquish the goods to the other party. The solution to these issues usually depends on whether the relevant legal system provides rules on good faith acquisition.

A third clarification concerns the reference to the term **"functional"**. This term is commonly used to denote a specific way of structuring legal problems – in particular, problems related to transfers of movable property – in the **Scandinavian countries**. The basic idea of this "functional approach" is to discuss, and solve, the different conflict situations (as referred to above) independently from each other, each on its own merits, taking into account (only) those interests and arguments that are actually relevant for the particular type of conflict.[5] As a con-

5 See, in English, Martin Lilja, *National Report on the Transfer of Movables in Sweden*, at 13-27, and, Jan-Ove Færstad (with contributions from Martin Lilja), *National Report on the Transfer of Movables in Norway and Denmark*, at 215 ff, *both in* NATIONAL REPORTS ON THE TRANSFER OF MOVABLES IN EUROPE: SWEDEN, NORWAY AND DENMARK, FINLAND, SPAIN (Wolfgang Faber & Brigitta Lurger eds., 2011); Martin Lilja, *The Relevance of Concepts for a Transfer of Movables under the Uniform Commercial Code – With a Focus on the Buyer's Protection against the Seller's Creditors*, (forthcoming, 2014); CLAES MARTINSON, TRANSFER OF TITLE CONCERNING MOVABLES PART III, NATIONAL REPORT: SWEDEN (Johannes Michael Rainer ed., 2006), in particular 13 ff.

sequence, there may exist different solutions for different conflict situations. It should be noted that there are potentially an unlimited number of possible conflict situations; the three conflicts picked for this study, however, are the most common and prevalently discussed ones in Scandinavia and also of significant importance in other legal systems. It is also important to note that each conflict situation involves two, and only two, incompatible claims: If more parties are involved, the issue is solved by splitting the problem into several conflict situations. This means that one party may have a "better right", or priority, against one adverse claimant, but not against another.

This Scandinavian "functional" approach to matters of law is based upon a fiery criticism of legal formalism and the use of concepts:[6] Under functional approach-thinking, concepts such as "ownership" or "title" are considered too comprehensive to provide a clear look at the "real problems", as they imply too many consequences resting on the location of ownership or title, while the concept of ownership, in turn, is resting on too many legal facts. Instead, particular legal facts triggering certain legal consequences should be connected directly, making it possible to better adjust the legal facts to the desired legal consequence: One party should not have priority to the property over another party based on examination of where "title" or "ownership" is located, but rather by linking certain relevant facts with legal consequences directly.

The approach taken in the USA reveals **significant parallels** with the approach taken by the Scandinavian legal systems with respect to fundamental starting points: Article 2 of the Uniform Commercial Code (U.C.C.), which regulates sales of goods, including most of the issues related to the transfer of movable property, deliberately abandons the idea of linking a large number of aspects to the passing of "title".

> Each provision of this Article with regard to the rights, obligations and remedies of the seller, the buyer, purchasers or other third parties applies irrespective of title to the goods except where the provision refers to such title.[7]

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6 This criticism is part of the movement usually described as Scandinavian realism, beginning sometime in the late 19th century. Scandinavian realism has parallels with American realism, even if both movements rarely had any contact with each other, see, for instance, MICHAEL MARTIN, LEGAL REALISM – AMERICAN AND SCANDINAVIAN (1997), 125 f. For a short comparative overview, see Lilja, *The Relevance of Concepts*, note 5.

7 U.C.C. § 2-401, opening sentence. The para. (1) of the same section however also states: "Title to goods cannot pass under a contract for sale…", followed by a number of legal facts that need to be fulfilled for the title to pass. This confusion is explained by LARY LAWRENCE, LAWRENCE'S ANDERSON ON THE UNIFORM COMMERCIAL CODE (3rd

When Karl Llewellyn, the main draftsman of the U.C.C., called for a realistic jurisprudence on these matters of law, he did so with a very critical attitude towards the use of concepts, calling title a "mythical" or "mystical something" and comparing it to a "halo", which is hung over the buyer's or the seller's head.[8] In fact, Llewellyn did this by ridiculing the prior law (the Uniform Sales Act), where the concept of title practically governed every available consequence.[9] In the words of Llewellyn, sales law issues were traditionally solved in a "silly" manner: "To a silly issue no sane answer is possible. This one we currently pose thus: Has Title passed?" And since "[n]obody ever saw a chattel's Title", the question is considered simply irrational.[10] His suggestion was therefore to abolish the "lump" or "title" concept in favor of what he called a **"narrow-issue approach"**.[11] This meant to structure the problems, or conflicts between adverse claims concerning the same property, by addressing quite narrowly defined situations from the angle of, for example, events occurring during performance, or the remedies available in various instances of breach. In Article 2 of the U.C.C., the "narrow-issue approach" is used, for instance, to determine the risk of loss,[12]

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ed. 2013), § 2-401:6: "Although most issues as to the parties' respective rights arising in a sale of goods are determined by Article 2 without regard to which party has "title" to the goods, there will be situations in which the question will arise as to which party is the owner of the goods. U.C.C. § 2-401 deals with this issue by its protection on the effect of a transfer of title under an express agreement of the parties; under contracts calling for physical delivery of the goods, or not calling for their physical delivery; the effect of the identification of goods and of a reservation by the seller of a property or security interest; and the revesting of title in the seller. When it is stated that title passes, it is meant that title passes to the buyer who is the person dealing with the seller, even though another person, such as the buyer's husband, pays for the goods." Transfer of title, it is said, has little significance in determining the rights of the parties as between themselves, Lawrence, (cited above), § 2-401:7. But while the role of title is diminished under the U.C.C., the title concept is used, for instance, for determining who should be liable for taxes. Ibid., § 2-401:15. This is also mentioned in Official Comment 1 to that section: "The basic policy of this Article [Article 2 U.C.C.] that known purpose and reason should govern interpretation cannot extend beyond the scope of its own provisions." It is considered to be important to determine when title passes, but just for the case that the courts consider this concept of "private law" decisive for the application of legal rules outside the U.C.C., such as for public regulation purposes.

8 Karl Llewellyn, *Through Title to Contract and a Bit Beyond*, 15 N.Y.U. L.Q. Rev. (New York University Law Quaterly Review), 159 (1938), at 169.

9 Llewellyn, note 8, at 169.

10 Llewellyn, note 8, at 165.

11 See, for instance, Llewellyn, note 8, at 163.

12 U.C.C. §§ 2-509 and 2-510.

to provide the buyer with a right to "recover" goods in the seller's insolvency in certain narrow circumstances,[13] and to determine the right to sue third parties for injury to the goods.[14] The approach is also visible in one of the opening comments to Article 2:

> The legal consequences are stated as following directly from the contract and action taken under it without resorting to the idea of when property or title passes or was to pass as being the determining factor. The purpose is to avoid making practical issues between practical men turn upon the location of an intangible something, the passing of which no man can prove by evidence and to substitute for such abstractions proof of words and actions of a tangible nature.[15]

Llewellyn's aversion to concepts such as ownership has certainly made its impact on the Code. However, the rhetoric does not exactly correspond to the actual situation. While title does play a much diminished role in the Code of today, other concepts have taken the role of "title", but with more limited scope, such as in the case of "special property"[16] (which is nothing other than "identification") and "replevin".[17] These are as "mythical" or "mystical" as title – and can only be understood by studying the requirements to acquire the position addressed by one or the other concept.[18]

In addition to the use of other concepts as replacements for the despised title, ownership and title still play a role in deciding matters within the areas that the U.C.C. covers. This is, for instance, reflected by the bankruptcy courts which use the location of title in U.C.C. section 2-401 in determing whether certain property should belong to the estate.[19]

As will become evident in the course of this study, the "narrow issue approach" applied in Article 2 U.C.C. implies working with a much narrower focus than the one applied when structuring problems according to relatively broad conflict situations, defined according to the colliding interests between certain categories of parties, as suggested by the Scandinavian "functional approach". The structure chosen in this book to present the relevant American

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13 U.C.C. § 2-502.

14 U.C.C. § 2-722.

15 Official Comment to U.C.C. § 2-101. Considering the distinctive writing style of this comment, it was probably drafted by Karl Llewellyn himself.

16 See U.C.C. §§ 2-501 and 2-502.

17 See U.C.C. § 2-716(3).

18 This topic is dealt with in Lilja, *The Relevance of Concepts*, note 5.

19 See chapter II.B.3. below.

rules follows the latter approach for a number of reasons. First, employing broadly defined conflict situations in a "functional approach" fashion makes it easier for parties to get a full overview of when, and under what circumstances, legal protection can be expected if a particular type of problem (e.g., the other contracting party becoming insolvent) is envisaged. If it turns out that the requirements imposed for one particular rule cannot be met, one might still be able to resort to some other provision potentially granting protection in the same type of conflict. There are also methodological reasons pointing in the same direction: The functional approach structure fits perfectly with conducting comparative legal research employing the classic "functional method of comparative law", as well as for conducting analytical research employing a method of argumentation analysis designed for transfer issues, as briefly referred to in the subsequent chapter I.B.[20] Ultimately, this structural approach is more easily understandable for lawyers with a European background, certainly where the background is a Scandinavian one, but also for lawyers from continental Europe, and perhaps even for lawyers from a common law jurisdiction.

Consequently, the relevant rules found in U.S. law are placed into this "functional" context and scheme – no matter whether the particular rule(s) are meant to be applied only to the relevant "functional" problem, or whether the rule's scope is smaller or broader than the relevant "conflict situation". In fact, it will turn out that when it comes to the first two conflict situations addressed above; the U.S. rules governing these situations are not targeting these problems exclusively. It may even happen that some rules are not even explicitly intended to apply in the context of insolvency, but are also not excluded from being applied in this context.

Finally, apart from a difference in structuring problems, there is another distinctive difference between the approaches taken in the U.S. and Scandinavia: While the Scandinavians solve these situations almost entirely without the use of concepts, the U.C.C. has not done away with concepts, but to a large extent only replaced the title-concept with the use of smaller concepts, such as "special property".[21]

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20 On both issues, see Wolfgang Faber, *Functional Method of Comparative Law and Argumentation Analysis in the Field of Transfers of Movables: Can they Contribute to Each Other?* 2 EPLJ (European Property Law Journal) 22 (2013).

21 "Special property" is found in U.C.C. § 2-501 and equals "identification". See, Lilja, *The Relevance of Concepts*, note 5.

In the following discussion, references to specific statutory provisions will be references to **sections of the U.C.C.**, unless otherwise indicated. Also, the U.C.C. will often be addressed simply as "the Code", following broadly applied U.S. terminology.

B. Purposes pursued with this study, including argumentation analysis

As already indicated above, this volume intends to provide rather comprehensive information on certain practically and dogmatically important aspects of U.S. law, in a way presumably useful for commercial actors as well as for academic purposes. Presenting the U.S. rules under the present perspective also has the purpose of filling a gap that American literature usually does not address: American scholars tend to be very focused on the study and presentation of either the Uniform Commercial Code or Bankruptcy – but they very rarely combine these areas of laws, even if the areas do tend to overlap with each other from a practical point of view.[22] This has the effect that when reading about the U.C.C., one may easily be misled without taking into account additional bankruptcy literature in order to determine the effects of these (state law) provisions in the other party's insolvency.[23] Since bankruptcy is governed by the federal Bankruptcy Code, and since these provisions often take precedence over state-enacted laws such as those adopting the U.C.C.,[24] it is advisable to look at the relevant rules for the whole functionally-framed broad conflict situation, taking into account both of these areas of law.[25]

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22 The distinction between these subjects is perhaps aggravated by the fact that "bankruptcy" as a subject in law school is often not mandatory, and does not appear on bar exams.

23 See, in relation to Article 9, U.C.C. § 9-109(c)(1): "A statute, regulation, or treaty of the United States preempts this article."

24 However, also other state law may override state-enacted U.C.C. provisions: A security interest under Article 9 of the U.C.C. is enforceable in bankruptcy – but other state law may override this right. The debtor may, for instance, rescind for fraud, for mutual mistake, for duress or for undue influence, see RESTATEMENT (SECOND) OF CONTRACTS, § 7. The right of the debtor is succeeded to the trustee in bankruptcy, see § 558 Bankruptcy Code.

25 It may also be worth pointing out that matters resolved under the U.C.C. are usually brought forward in state courts, while bankruptcy cases are filed in Bankruptcy Courts, which are tied to the federal trial courts, called United States District Courts. There are 94 District Courts in the federal system. Cases from the District Courts can be appealed to one of the 13 intermediate appellate courts (United Courts of Appeals), depending on