1975

Kentucky Law Survey: Commercial Law

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Notes/Citation Information
Kentucky Law Journal, Vol. 63, No. 3 (1974-1975), pp. 727-737

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In *Mitchell v. W. T. Grant Co.*,[1] decided during 1974, the United States Supreme Court announced a significant change in the manner in which it would determine whether creditors' statutory prejudgment remedies which involve an application of state authority are constitutional under the due process clause of the fourteenth amendment.[2] This portion of the Survey will consider this change in judicial attitude.

To fully appreciate the significance of *Mitchell* it is necessary to consider two prior decisions of the Court, decided in 1969 and 1972, which suggested that the provisional remedies in many jurisdictions, including Kentucky,[3] were not constitutional under federal due process standards. The earliest of these decisions was *Sniadach v. Family Finance Corp.*[4]

In *Sniadach*, the petitioner's wages were frozen pursuant

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[1] 416 U.S. 600 (1974).

[2] Statutory prejudgment remedies which involve an exercise of state power include garnishment, attachment, and replevin. They are often referred to as "provisional" remedies. Since these remedies involve the use of court process and state power there is normally no problem with respect to their meeting the state action requirement of the fourteenth amendment: "No State shall . . . deprive any person of life, liberty, or property without due process of law." U.S. CONST. amend. XIV, § 1. Thus, provisional remedies may be constitutionally distinguishable from creditors' "self-help" remedies which are validated by state statute but which do not involve an exercise of state power. *See* note 16 and accompanying text *infra*.

[3] There are several Kentucky and federal opinions dealing with the constitutionality of Kentucky provisional and "self-help" remedies. *See* Gary v. Darnell, 505 F.2d 741 (6th Cir. 1974) (KY. REV. STAT. 355.9-503 [hereinafter cited as KRS] constitutional); Cockeral v. Caldwell, 378 F. Supp. 491 (W.D. Ky. 1974) (KRS 376.280(1) unconstitutional but KRS 376.270 constitutional); Thompson v. Keesee, 375 F. Supp. 195 (E.D. Ky. 1974) (KRS 425.129 unconstitutional); Holt v. Brown, 336 F. Supp. 2 (W.D. Ky. 1971) (KRS 383.040, .050 unconstitutional); Dresser Indus., Inc. v. K-Service, Inc., No. 73-2363 (Fayette Cir. Ct. 6th Div., June 18, 1974) (KRS 425.185 constitutional); OP. ATT'Y GEN. 74-865 (Ky. 1974) (KRS 376.280(1) unconstitutional but KRS 370.275 constitutional); OP. ATT'Y GEN. 73-24 (Ky. 1973) (KRS 383.040, .050 unconstitutional); OP. ATT'Y GEN. 70-40, 70-47 (Ky. 1970) (KRS 425.185 constitutional). *See also* Duo-Therm Div., Motor Wheel Corp. v. Sheargrain, Inc., 504 S.W.2d 689 (Ky. 1974).

[4] 395 U.S. 337 (1969).

to a Wisconsin statutory procedure which permitted a creditor, without notice to the debtor and without a pre-or postseizure hearing, to obtain an in rem prejudgment seizure of a debtor's wages. Under the procedure, a clerk of court would issue a summons on the garnishee at the request of the creditor. The creditor had ten days to serve a summons on the debtor after service of the summons on the garnishee.[5] The debtor's wages could be unfrozen if a court ultimately determined in the main action that the creditor's claim was without merit. But until such a determination the debtor would be deprived of the use of his wages with no opportunity to be heard. The petitioner challenged the procedure on the grounds that it did not satisfy the due process requirements of the fourteenth amendment.

Mr. Justice Douglas, writing for the majority, held for the petitioner. The Court acknowledged that such a summary procedure might meet the requirements of due process in extraordinary situations requiring special protection for the interests of the state or creditors seeking a seizure of wages, but found no such situation present.[6] Noting the impact that a prejudgment wage garnishment could have on a wage earner and his dependents and the leverage which it gave to the creditor, the Court concluded that there was an obvious taking of property requiring, under fundamental principles of due process, notice to the debtor and a prior hearing. Since the Wisconsin statute did not provide these safeguards, it was unconstitutional.

Mr. Justice Harlan concurred in a separate opinion, making explicit his view that the property taken was the petitioner's use of the wages during the period that they were frozen, which was not a de minimis interest. He also stated that due process could be afforded only by the kind of notice and hearing which established at least the probable validity of the underlying debt before the debtor's use of his property is restricted.

In his dissenting opinion, Mr. Justice Black argued that the majority had held the Wisconsin procedure unconstitutional because they viewed it to be based on an unwise state policy, and that such a holding amounted to an unauthorized

[5] In fact, the garnishee and the debtor were served on the same day in *Sniadach*. *Id.* at 338.

[6] The Wisconsin statute was not limited to such situations. *Id.* at 339.

judicial usurpation of state legislative power. Justice Black also observed that a postgarnishment hearing was available in Wisconsin through a motion to dismiss the garnishment proceeding.

The broad application of the due process principles enunciated in *Sniadach* was uncertain for at least two reasons. First, *Sniadach* represented a departure by the Supreme Court from its earlier decisions which had suggested that federal due process requirements could be met by statutory procedures providing for a hearing before a taking becomes final.[7] Second, Justice Douglas' emphasis on the peculiar nature of wages offered a basis for distinguishing the procedure in *Sniadach* from those which authorized the prejudgment seizure of other kinds of property. Not surprisingly, the lower courts divided on the broad precedential value of *Sniadach*.[8] The confusion did not last long, however, because in 1972 the Supreme Court seemed to clearly signal, in *Fuentes v. Shevin*,[9] that other summary creditor's remedies which were applicable to other kinds of property would also have to afford notice and a preseizure hearing in order to be constitutional.[10]

In *Fuentes* the appellants alleged that the prejudgment replevin statutes of Florida and Pennsylvania were violative of the fourteenth amendment's due process guarantees. The statutes had been invoked by creditors to obtain the seizure of consumer chattels in which the creditors had retained nonpossessory interests to secure payment.[11] Under the Florida

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[7] *See, e.g.*, McInnes v. McKay, 279 U.S. 820 (1929) (prejudgment attachment for a private purpose); Coffin Bros. & Co. v. Bennett, 277 U.S. 29 (1928) (seizure for a public purpose). *See generally* Note, *Garnishment of Wages Prior to Judgment Is a Denial of Due Process: The Sniadach Case and Its Implications for Related Areas of the Law*, 68 MICH. L. REV. 986, 989-90 (1970). The *Sniadach* majority distinguished these precedents in that they involved extraordinary situations and because the instant case involved the seizure of a debtor's wages. 395 U.S. at 339-40.

[8] *See* Fuentes v. Shevin, 407 U.S. 67, 72 n.5. *See generally* Williams, *Creditor's Prejudgment Remedies: Expanding Strictures on Traditional Rights*, 25 U. FLA. L. REV. 60, 83-87, 96-98 (1972).

[9] 407 U.S. 67 (1972).

[10] One case decided by the Supreme Court after *Sniadach* and before *Fuentes* extended *Sniadach* notions of due process to the taking away of a driver's license by the state. *See* Bell v. Burson, 402 U.S. 535 (1971). *See also* Goldberg v. Kelly, 397 U.S. 254 (1970) (termination of welfare benefits without a prior hearing).

[11] There was one exception to this pattern. The deputy sheriff, who was the husband of one of the appellants, used the statute to seize the belongings of his son over whom he was attempting to gain custody. 407 U.S. at 72.

statute, any person whose goods or chattels were wrongfully detained by any other person could obtain a writ of replevin. The statute did not require the creditor, prior to the seizure, to make a convincing showing of wrongful detention. Rather, a bare conclusory assertion of lawful entitlement by the creditor in a complaint initiating an action for repossession, and the posting of a bond in at least double the amount of the property to be replevied, allowed the court clerk to issue a writ commanding the sheriff to replevy the goods and summon the debtor to answer. The debtor could reclaim possession of the goods seized within 72 hours after the seizure by posting a bond in an amount double the value of the property. If such a bond was not posted, the property would be transferred to the creditor. There was no opportunity for a hearing on the merits of the creditor's claim until the trial of the repossession action. The Pennsylvania statute was substantially the same except that it did not require the initiation of a repossession action by the creditor. The debtor would have to initiate an action himself if he was to ever obtain a hearing. In addition, the Pennsylvania statute required only an affidavit as to the value of the property to be replevied, rather than an allegation of lawful entitlement.

The majority opinion, written by Mr. Justice Stewart, considered the primary question in the case as one of whether the statutes were constitutionally defective in failing to provide for a hearing at a meaningful time and concluded that only a preseizure hearing could prevent arbitrary or mistaken taking of property.[12] The deterrent effect of the statutes' requirement that the creditor post a bond was not sufficient to save the statutes because this merely tested the creditor's belief in his own rights. That the debtor could post a bond and regain possession of his goods and that he lacked full title to the goods did not render the taking so insignificant as to obviate the necessity for a prior hearing. The Court did recognize, as it had in *Sniadach*, that there were extraordinary situations in which postseizure notice and hearing could be justified.[13] However,

[12] *Id.* at 80. The court indicated that the hearing could be waived by the debtor. *Id.* at 82. However, none of the debtors in *Fuentes* made an effective waiver of his due process rights. *Id.* at 94-95.

[13] The statutes were not limited to extraordinary situations.

the Court indicated that such an extraordinary situation would not normally exist when the state intervenes in a private dispute.[14]

In a dissenting opinion, Mr. Justice White (who was joined by Chief Justice Burger and Justice Blackmun) argued that the majority had not struck an appropriate balance between the competing interests of creditors and debtors. By his analysis, practical and economic considerations such as a creditor-businessman's natural preference for a nonlitigious resolution of disputes with customer-debtors and the cost of instituting a replevin action and posting a bond insured that most replevin actions would be well founded and made a preseizure hearing unnecessary. Furthermore, creditors, whose equity in the property might exceed that of their debtors, had a legitimate interest in preventing the additional use and deterioration of the property after a default had occurred.

The decision in *Fuentes* greatly increased the amount of litigation involving challenges to the constitutionality of creditor's prejudgment remedies.[15] The attacks were not limited to statutes involving significant state action in the form of court procedures and the use of state power to take debtor's property. "Self-help" remedies, such as a secured creditor's post-default right under the Uniform Commercial Code to take possession of and sell collateral without judicial process, were also challenged.[16] However, certain aspects of *Fuentes* suggested that its value as a precedent might be short-lived. Although it cast a shadow over the provisional and "self-help" remedies in many jurisdictions,[17] *Fuentes* was a 4-3 decision in which Justices Powell and Rehnquist had not participated. And although the

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[14] *Id.* at 92. The Court suggested that such extraordinary circumstances demanding prompt action might exist in a case in which a creditor could show an immediate danger that this collateral might be concealed or destroyed, if the statute was narrowly drawn to deal with such situations. Even then, a state official would have to participate in the decision to issue the writ. *Id.* at 93.

[15] *See generally* West, *Fuentes Revisited*, 80 COM. L.J. 10 (1975).

[16] *See* UNIFORM COMMERCIAL CODE §§ 9-503, 9-504. Other creditor's remedies not requiring judicial process that were challenged included garagemen's liens, landlord's liens, and innkeeper's liens. *See generally* Comment, *Fuentes v. Shevin: The Application of Constitutional Due Process to the Garagemen's Lien in Kentucky*, 62 KY. L.J. 1133, 1134 (1974); Clark and Landers, *Sniadach, Fuentes, and Beyond: The Creditor Meets the Constitution*, 59 VA. L. REV. 335 (1973).

[17] *See* note 3 *supra* for Kentucky cases.

Fuentes requirements of notice and a prior hearing would be easy to apply in determining whether a particular creditor's prejudgment remedy was constitutional, it was not clear that the decision gave adequate protection to the interests of creditors and appropriate consideration to the impact that these safeguards might have on the availability and cost of credit.[18] The majority in *Fuentes* had considered the interests of creditors, but had concluded that "[t]he requirement of notice and an opportunity to be heard raises no impenetrable barrier to the taking of a person's possessions"[19] and that reducing costs did not justify overriding due process rights.[20] Thus, it was not a total surprise when, in June of 1974, the *Fuentes* dissenters became part of the majority in *Mitchell v. W. T. Grant Co.*,[21] which upheld the constitutionality of a prejudgment creditor's statutory remedy that did not afford notice and a prior hearing to the debtor.

In *Mitchell*, a Louisiana judge had ordered, with neither notice nor prior hearing, the sequestration of a debtor's consumer goods on the application of a creditor who claimed that the goods were subject to a vendor's lien. Naturally, the debtor challenged the seizure on the grounds that he was denied the fairness guaranteed to him by the due process clause of the fourteenth amendment to the Constitution.[22] After stating the essential facts, the majority opinion, written by Justice White,

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[18] Justice White was concerned with *Fuentes'* impact on the availability and cost of credit. 407 U.S. at 103. *See generally* Williams, *Creditor's Prejudgement Remedies: Expanding Structures or Traditional Rights*, 25 U. FLA. L. REV. 60, 101 (1972); Johnson, *Denial of Self-Help Repossession: An Economic Analysis*, 47 S. CAL. L. REV. 82 (1973); Dauer & Gelhoal, *The Economics of Constitutionalized Repossession: A Critique for Professor Johnson and a Partial Reply*, 47 S. CAL. L. REV. 116 (1973).

[19] 407 U.S. at 81.

[20] *Id.* at 92 n.29.

[21] 416 U.S. 600 (1974). *See also* Arnett v. Kennedy, 416 U.S. 134 (1974) (due process in termination of public employment).

[22] The debtor also challenged the seizure under the due process clause of Louisiana's state constitution. One of the author's students in a consumer credit seminar given last fall, Charles R. Keeton, searched out cases in which the issue of the constitutionality of a prejudgment creditor's remedy under state constitutional provisions was considered. He was able to locate only one case, Messenger v. Sandy Motors, Inc., 295 A.2d 402, 411 (N.J. Super. 1972), which dismissed the argument without discussion and a single law review student comment, Comment, *Self-Help Repossession: Fuentes and Judicial Process*, 46 TEMPLE L.Q. 540, n.66 (1974), which briefly discussed the question.

wasted no time in indicating that notice and a hearing would no longer always be required before a creditor could constitutionally take property from a debtor under nonextraordinary circumstances through the use of state power. Instead, resolution of the due process issue would henceforth emphasize the interest of the seller in preserving his collateral after a default[23] and the interests of the state furthered by the provisional remedy. Such state interests could include those of providing remedies for protection of creditors and avoiding the breaches of the peace which could result if creditors were required to resort to "self-help" remedies.[24]

The majority considered several aspects of the Louisiana procedure significant in determining that it struck an appropriate balance between these competing interests:

> 1. The writ of sequestration would not issue on the mere conclusory allegations of ownership or possessory right. Instead, the writ would issue only after the nature of the claim, the amount thereof, and the grounds relied upon for the issuance of the writ clearly appeared from specific facts shown by a verified petition or affidavit.
> 2. The showing of these facts was required to be made to a judge in an ex parte hearing and the writ would issue only on his authorization.[25]
> 3. The creditor seeking the writ was required to file a bond sufficient to protect the debtor against all damages if the sequestration was shown to be improvident.
> 4. The statute entitled the debtor to immediately seek dissolution of the writ, which would be ordered unless the creditor was able to substantiate the grounds which resulted in issuance of the writ. If the creditor could not meet this burden the property would be returned to the debtor who would be entitled to damages, including attorney's fees.
> 5. The debtor could, with or without moving to dissolve the sequestration, regain possession of his property by filing a bond.

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[23] 416 U.S. 600, 604 (1974).

[24] *Id.* at 604-605. Concerning "self-help" remedies, *see* note 16 and accompanying text *supra.*

[25] This was not required in all parishes. However, it was required and complied with by the debtor in Orleans Parish where the writ was issued. *See id.* at 606 n.5. Concerning the merits of requiring judicial participation *see* note 32 and accompanying text *infra.*

The impact on a debtor of the deprivation without notice or prior hearing did not, in the Court's view, outweigh a debtor's possible inability to compensate the creditor should the value of the goods as collateral be lost or diminished.

The *Mitchell* Court drew support for its holding from an analysis of the position of a seller holding a lien on goods as security for their payment. He is entitled to be paid, or to foreclose on the goods if the buyer defaults. So long as the buyer remains in possession he has the power to destroy, abscond with, conceal, or transfer the goods. Even if the buyer does none of these things, his mere postdefault use of the goods for their intended purpose must result in a decline in their value, and thus, a decline in the value of the seller's security. Moreover, in Louisiana, where a transfer of possession of the goods by the buyer to a third person could cut off the seller's lien, notice and a prior hearing might seriously jeopardize a seller's secured status.[26]

The Court also found support for its holding from the fact that even in the preseizure hearing required by *Fuentes* a seller would need only to establish the probable validity of his entitlement to a prejudgment seizure of goods in which he had retained an interest. The issues in such a determination would be the existence of a debt, the lien, and an act of default, all of which lend themselves to documentary proof through sworn ex parte statements of the type required by the Louisiana procedure. These statements, along with the opportunity for an immediate postseizure hearing and the creditor's normal interest in having the transaction go forward without interruption, minimized the risk of the wrongful issuance of a writ.

The *Mitchell* majority attempted to reconcile its holding with those in *Sniadach* and *Fuentes*. They viewed *Sniadach* as raising special considerations relating to the seizure of a person's basic source of income, his wages,[27] and noted that the procedure in that case did not contain the sort of safeguards found in the Louisiana statute. Furthermore, the creditor in

[26] In Uniform Commercial Code jurisdictions, such as Kentucky, the seller of consumer goods who has retained a perfected security interest is not so exposed. *See* UNIFORM COMMERCIAL CODE §§ 9-201, 9-301(1), 9-307(2). Even the unperfected-secured seller receives some protection. *Id.* § 9-307(2).

[27] The *Fuentes* majority was not willing to make a distinction between wages and other kinds of property. *See* 407 U.S. 67, 88 (1972).

Sniadach had no prior rights in the wages attached.[28] *Fuentes* involved replevin statutes which did not require judicial participation in the decision to authorize the writ. Under those statutes goods could be seized without verified statements containing the narrowly confined facts required under the Louisiana statute, and an immediate postseizure hearing was not available. The majority also pointed out that its holding was consistent with the pre-*Sniadach* decisions which had upheld statutes validating prejudgment seizures without a prior hearing.[29]

In a concurring opinion Justice Powell stated that the majority had justifiably overruled *Fuentes* to the extent that it required an adversary proceeding before there could be a temporary deprivation of property. In his view, the Louisiana statute provided a reasonable and fair procedure which facilitated credit transactions and protected the interests of both creditor and debtor.

Justice Stewart (joined by Justices Douglas and Marshall and, in part, by Justice Brennan) dissented, arguing that the majority's attempt to distinguish *Fuentes* could not be justified. In his view, the deprivation of property in both cases was identical and the differences between the statutes in the two cases made no constitutional difference, since the Louisiana statute, just as those in *Fuentes*, permitted an ex parte seizure without proper notice or hearing.

Regardless of whether *Mitchell* successfully distinguished or actually overruled *Fuentes*, it makes clear that, for the time being at least, notice and a prior hearing will not generally be required to save a statutory prejudgment creditor's remedy from a fourteenth amendment due process challenge. Instead, notice and a hearing must be afforded sometime before the seizure of a debtor's property can become final. A balancing test, which takes into account the nature of the creditor's and debtor's interests in the property seized, the state's interest in providing the challenged remedy, and the nature of the property, will be applied on a case by case basis to determine the constitutionality of the remedy when the requisite state action

[28] Concerning this distinction, *see* Recent Development, *Due Process, Replevin, and Summary Remedies: What Sniadach Hath Wrought*, 22 CATH. L. REV. 667, 675 (1972).

[29] *See* note 7 and accompanying text *supra*.

is present.[30] If the procedural safeguards afforded by the statute sufficiently protect the debtor's interest in not being wrongfully deprived of his property, in light of the state's interests in providing the remedy and the creditor's interest in summarily taking possession, the remedy will be constitutional. A case decided by the Supreme Court in January of 1975, *North Georgia Finishing, Inc. v. Di-Chem, Inc.*,[31] employs this balancing test. The decision is of additional interest because it is the first opinion by the Court to consider a prejudgment taking of the assets of a commercial debtor.

Under the Georgia statute considered by the Supreme Court in *Di-Chem*, plaintiffs in pending law suits were entitled to the process of garnishment. The statute required that the plaintiff make an affidavit before a court clerk stating the amount claimed to be due in the pending action and that the plaintiff has reason to apprehend the loss of all or part of the amount unless the garnishment is issued. The plaintiff was also required to file a bond for an amount double that sworn to be due. The defendant could dissolve the garnishment by filing a bond covering any judgment which might be rendered against him in the action on the debt.

The respondent in *Di-Chem* used this procedure to seize the petitioner's corporate bank account. Petitioner, after obtaining a dissolution of the garnishment by filing a bond, filed a motion to have the garnishment dismissed on the grounds that the garnishment procedure was not constitutional. The Supreme Court agreed with the petitioner's contention.

The Court reasoned, on the authority of *Fuentes*, that the statute involved the state in a constitutionally significant taking of property without notice or an opportunity for an early hearing, and without the participation of a judicial officer. *Mitchell* could not save the Georgia statute because the affidavit required under the statute did not have to clearly set out the facts entitling the creditor to the garnishment. Furthermore, the writ of garnishment could be issued without the participation of a judge, and although the debtor would be deprived of the use of funds after the writ was served on the

[30] *See* note 1 and accompanying text *supra*.

[31] 95 S. Ct. 719 (1975).

garnishee, there was no provision for an early hearing at which the creditor could be required to show probable cause.

In his concurring opinion, Mr. Justice Stewart rejoiced that his conclusion in *Mitchell*—that *Fuentes* had been overruled—was apparently erroneous, or at least, premature. Justice Powell also concurred, but objected to the majority opinion's reliance on *Fuentes*, which might suggest that preseizure notice and hearing requirements are still constitutionally mandated for prejudgment creditor's remedies involving the requisite state action. Justice Powell also did not agree with the majority's suggestion that a judicial officer would be constitutionally required to issue the writ of garnishment. In his view, the debtor's real protection lay in the requirement of a prompt postseizure hearing before a judge.[32] The lack of such a hearing, he concluded, was the most serious deficiency in the Georgia procedure.

Justices Blackmun, Rehnquist, and Burger dissented on several grounds, among which was the contention that the Georgia statute afforded commercial entities sufficient due process protection.

Di-Chem should not be read as resurrecting *Fuentes*. It did not hold that notice and a preseizure hearing would be necessary to save the Georgia prejudgment garnishment statute, but only that the statute did not afford sufficient due process.

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[32] *Id.* at 725 n.3. The three dissenters in *Mitchell* also questioned whether requiring a judge to issue the writ, instead of a clerk, could make any constitutional difference. Mitchell v. W.T. Grant Co., 416 U.S. 600, 632 (1974) (dissent).