

Reclamation in insolvency proceedings

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Sellers of tangible personal property to distressed debtors on the eve of insolvency have special rights under US law. They have the right to recover the sold goods or at least to have a preferred claim over other unsecured creditors in an insolvency proceeding. This chapter reviews the rights of sellers of tangible personal property in such circumstances.

Outside bankruptcy law

Outside bankruptcy, the reclamation of goods is governed by Section 2-702 of the Uniform Commercial Code. Section 2-702 provides that if a seller discovers that the buyer has received goods on credit while insolvent (and is thus unable to pay its bills when they become due), the seller may reclaim the goods upon written demand made within 10 days of the buyer's receipt of the goods, or within 30 days if there has been a written misstatement of solvency. A newer version of Article 2 of the Uniform Commercial Code has been presented to the states for consideration; this new version would liberalise the notice period by removing the term '10 days' and replacing it with the term 'reasonable time'. At the time of writing, no US jurisdiction has repealed the 10-day period and replaced it with the proposed 'reasonable time'. Nevertheless, because a proposed amendment to the Uniform Commercial Code is pending, the reclaiming creditor must know which version of the Uniform Commercial Code governs its transaction in the relevant jurisdiction. Section 2-702 further provides that the rights of a reclaiming seller are subordinate to the rights of a buyer in the ordinary course of business (including the rights of a lender which took a lien, charge or security interest in the buyer's inventory) or a *bona fide* purchaser for value. Once the seller serves the reclamation notice, it must then file a *replevin* (ie, an action to recover the possession of personal property taken or withheld from the owner unlawfully) or claim and delivery action in an appropriate court. The reclaiming creditor will gain little from a mere notice of reclamation if it does not act on its rights.

Under bankruptcy law

However, once the buyer files for bankruptcy the rules change. The reclaiming seller can choose between two distinctive remedies:

- the new pre-petition administrative claim procedure under Section 503(b)(9) of Chapter 11 of the US Code; and
- the traditional reclamation procedures under Section 546(c) of Chapter 11 of the US Code.

Section 503(b)(9)

Section 503(b)(9) of Chapter 11 is relatively new and applies to cases that were filed after October 17 2005. This section provides that sellers which provided

goods in the ordinary course of business to a distressed debtor in the 20 days before the date of commencement of a bankruptcy case are entitled to an administrative priority equal to the value of the goods sold. An administrative priority is the highest preference afforded to an unsecured claim in a Chapter 11 reorganisation. Creditors with administrative claims receive 100 per cent of their claims upon confirmation of a Chapter 11 plan of reorganisation and may even be paid earlier than confirmation, while other general unsecured creditors must wait and may receive little or nothing. Section 503(b)(9) may also provide a more convenient substitute for the so-called ‘critical vendor’ motions where the debtor seeks to pay pre-petition trade creditors. This section does not require that the creditor serve a reclamation notice on the distressed buyer.

However, several important issues remain unresolved with Section 503(b)(9):

- What constitutes ‘the ordinary course of business’? It is likely that the court will look to the ordinary course tests used by bankruptcy courts in interpreting the ordinary course of business transactions under Section 363 of Chapter 11.
- What is the value to be considered? Is it the original sale price, the liquidation value or another value developed by the case law? Will the seller be able to make a claim for the sales taxes? At the time of writing, these questions have not been resolved by the courts.
- Section 503(b)(9) applies only to the sale of goods, not to services. So what are ‘goods’? Although the Bankruptcy Code does not define the term ‘goods’, Section 2-101(k) of the Uniform Commercial Code may supply the answer. Under that code, the term ‘goods’ means all things that are movable at the time of identification to a contract of sale. It includes future goods, for example:
 - manufactured goods;
 - the unborn young of animals;
 - growing crops; and
 - other identified things attached to realty.

The term ‘goods’ does not include information or investment securities. However, there are still unresolved problems. For example, should a part or tooling that has been significantly altered by a creditor be categorised as ‘goods’ or ‘services’?

- How does a creditor prosecute its claim? Should it file an administrative proof of claim or a motion for payment of an administrative

expense? The answer to this question varies according to jurisdiction.

- When must such a claim or motion be filed? At least one court – the US Bankruptcy Court for the District of Massachusetts – has established a bar date according to local rules. Other bankruptcy courts may bury the Section 503(b)(9) bar date in a first or second-day order. The Section 503(b)(9) creditor must consult with local counsel to determine which direction the court in question will take.
- Must a Section 503(b)(9) creditor return an alleged preference before it can receive its administrative claim? The answer is probably yes, but again there have been no definitive decisions.
- Can a creditor claim a credit for unpaid goods that are subject to a Section 503(b)(9) priority as a subsequent advance of credit for purposes of a preference defence under Section 547(c)(4) of Chapter 11? The answer should be no, but yet again no definitive answer has been given.
- When will the administrative claim be paid? Early court decisions suggest that unless the Section 503(b)(9) creditor can show undue hardship on itself and no hardship on the debtor, the administrative creditor must wait until confirmation, or the end of the case if it is converted to a Chapter 7 liquidation case. If the Chapter 7 expenses in a converted case or the secured creditor receive all the liquidation proceeds, the Section 503(b)(9) claim would be worthless.

Section 546(b)(9): traditional reclamation

Section 546(c) of Chapter 11 provides that a reclaiming seller may recover the goods that it has sold within 45 days of the date of the debtor’s bankruptcy petition. Although there has been some controversy as to whether Section 546(c) creates a new federal reclamation right or simply embraces state law rights of reclamation under the Uniform Commercial Code, to date the decisions that have been handed down point to the latter theory that there must first be a state law right of reclamation before Section 546(c) applies.

There are several key issues to consider regarding traditional reclamation as it exists in most states:

- Unlike the Section 503(b)(9) creditor, the Section 546(c) creditor must serve written notice within 45 days of the shipment, or within 20 days after the case is filed if the 45 days had

not expired as of the petition date. If there is no notice, there can be no reclamation.

- Under the pre-October 17 2005 law, the bankruptcy court could grant the successful reclaiming creditor an administrative priority claim or a secured claim. However, that language was repealed by the new law and a remedy for the Section 546(c) reclaiming creditor is now missing from the section. Arguably, all the Section 546(c) creditor can do is to file an adversary proceeding demanding the return of its goods or prosecute an administrative claim for common law conversion if the reclaimed goods are subsequently sold after receipt of the reclamation notice. In addition, if local law so provides, the reclaiming creditor can sue the debtor's officers and directors for aiding and abetting a tort of conversion. In reality, bankruptcy courts will craft orders to deal with

these types of reclamation which provide some degree of priority treatment. Nevertheless, a Section 546(c) creditor must understand that if it does nothing but serve the reclamation notice, a bankruptcy court may rule that it has waived its reclamation rights.

- The rights of reclamation creditors are dependent on the reclaimed goods still being in the buyer's possession in roughly their original form. In an era of 'just in time' inventory, if the buyer sells or fabricates the seller's goods prior to receipt of the reclamation notice, the seller's reclamation rights lost.
- The inventory lender is a "buyer in the ordinary course" under the Uniform Commercial Code. As a result, if the buyer has granted a lender a security interest in its inventory and the value of the collateral is less than the amount of the loan, the reclaiming seller's rights are also fatally compromised.