22-MAR Am. Bankr. Inst. J. 20

American Bankruptcy Institute Journal
March, 2003

Column
Last in Line

*20 SELLER BEWARE! IS YOUR RECLAMATION CLAIM AS STRONG AS YOU THINK IT IS?

Lisa S. Gretchko
Pepper Hamilton LLP; Detroit, gretchkol@pepperlaw.com

Some things, like wine, improve with age. Vendors' reclamation rights, however, are not among them. Even though vendor support is crucial to every reorganization, and even though prompt payment of the vendor's reclamation claim is important in garnering vendor support, case law has evolved to expose several pitfalls that can eviscerate reclamation claims.

The Statute

The vendor's reclamation remedy is a creature of state law—embodied in UCC § 2-702 as follows:
(2) Where the seller discovers that the buyer has received goods on credit while insolvent, he may reclaim the goods upon demand made within 10 days after the receipt ...

(3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in the ordinary course or other good-faith purchaser under this Article. Successful reclamation of goods excludes all other remedies with respect to them.

Because insolvent buyers often wind up in bankruptcy, Bankruptcy Code § 546(c) is designed to protect the vendor's reclamation right against a buyer who becomes a debtor, so long as the prerequisites of § 546(c)(1) regarding the timely written reclamation demand are fully satisfied. Vendors like to think that their reclamation rights are sacrosanct in bankruptcy because § 546(c)(2) *seems* to bar a court from denying a reclamation demand unless the vendor gets a lien or an administrative expense claim, as follows:
(2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court—
(A) grants the claim of such seller priority as a claim of a kind specified in § 503(b) of this title; or

(B) secures such claim by a lien. [1]

By its very language, however, § 546(c)(2) applies *only if* the vendor *has* a right of reclamation. Obviously, if the vendor has failed to satisfy any of the statutory prerequisites, the vendor will not *have* a right of reclamation. For example, if the vendor fails to deliver a timely or properly written reclamation demand to the debtor, then it has no right of reclamation. [2] Because UCC § 2-702(2) makes reclamation available only to vendors who *discover* that the buyer received goods on credit while insolvent, a vendor who *knows* the buyer is insolvent but continues to sell goods to that buyer on credit loses the right to reclamation.

Ordinary Course Purchaser

But even if the vendor has satisfied all of the statutory prerequisites for reclamation, its right of reclamation is not absolute. For example, it is *subject* to the rights of a buyer in the ordinary course of business or other good-faith purchaser. The secured creditor with a perfected security interest in after-acquired inventory qualifies as a "good faith purchaser"[3] unless the reclaiming vendor proves some misconduct by the secured creditor. *See, e.g.,* In re Arlco, 239 B.R. 261, 271 (Bankr. S.D.N.Y.). However, courts are split on whether the vendor's right of reclamation is extinguished by, or just subordinated to, a perfected security interest in the buyer's/ debtor's inventory. Some courts have held that the mere existence of a secured creditor with a perfected security interest in after-acquired inventory extinguishes the reclamation claim altogether. *See, e.g.,* In re Lawrence Paperboard Corp., 52 B.R. 907, 911 (Bankr. D. Mass. 1985); *In re Shattuc Cable Corp.*, 138 B.R. 557, 563 (Bankr. N.D. Ill. 1992). Fortunately for vendors, a majority of the decisions on this issue have held that the existence of a creditor with a perfected security interest in after-acquired inventory does not extinguish the vendor's reclamation remedy, but merely subordinates it to the secured creditor's claim. *See, e.g.,* In re Pester, 964 F.2d 842, 846 (8th Cir. 1992); *In re Arlco*, 239 B.R. 261, 267 (Bankr. S.D.N.Y. 1999).

Split of Authority

Although § 546(c)(2) is not ambiguous on its face, there is a split among the courts regarding the scope of the relief to be given to the vendor that asserts a reclamation claim when a secured creditor has a perfected security interest in after-acquired inventory. One line of cases holds that once a vendor establishes a valid right to reclaim,[4] then, pursuant to § 546(c)(2), the vendor is entitled to a lien or an administrative priority claim for the amount of the goods sought to be reclaimed (or the traceable proceeds therefrom), regardless of whether the vendor's reclamation remedy would be worthless under state law due to a secured creditor's perfected security interest in after-acquired inventory. *See, e.g.,* In re Marko Electronics Inc., 145 B.R. 25, 29 (Bankr. N.D. Ohio 1992); *In re Sunstate Dairy and Food Products*, 145 B.R. 341, 346 (Bankr. N.D. Fla. 1992); *Diversified Food Service*, 130 B.R. 427, 430 (Bankr. S.D.N.Y. 1991); *In re Roberts*, 103 B.R. 396, 399 (Bankr. N.D.N.Y. 1988); *In re Bosler Supply Group*, 74 B.R. 250, 254-255 (N.D. Ill. 1987); *In re Wathens Elevators Inc.*, 32 B.R. 912, 923 (Bankr. W.D. Ky. 1983). This approach seems consistent with the wording of § 546(c)(2), which neither limits the property of the debtor's estate on which the lien or administrative claim is granted, nor extinguishes the reclamation claim when there exists a perfected security interest in inventory.

There is a second line of cases, however, that observes that § 546 is designed *only to protect* a vendor's reclamation rights, not enhance them. These courts reject the notion that § 546(c)(2) empowers them to grant a lien or administrative claim on *any* property of the debtor's estate. Instead, they conclude that the reclaiming vendor's lien or administrative claim can be imposed *only* on the goods that the vendor seeks to reclaim, or the traceable proceeds of those goods, as follows:

> When there are goods or traceable proceeds available to reclaim, the ***21** alternative remedies in § 546(c)(2) provide needed flexibility. But when the secured creditors have satisfied their claims *out of the goods to be reclaimed*, granting § 546(c)(2) relief would afford the reclamation seller something it does not have under the UCC—a priority interest in the buyer's assets other than the goods to be reclaimed.

In re Pester, 964 F.2d 842, 847 (8th Cir. 1992).

Consequently, these bankruptcy courts are determined *not* to give value (via a lien or an administrative expense claim) to a vendor whose reclamation claim would be worthless in the non-bankruptcy context due to a secured creditor with a perfected security interest in after-acquired inventory. *See, e.g., In re Arlco*, 239 B.R. 261 (Bankr. S.D.N.Y. 1999); *In re Steinberg's, Inc.*, 226 B.R. 8,12 (Bankr. S.D. Ohio 1998); *In re Video King of Illinois*, 100 B.R. 1008 (Bankr. N.D. Ill. 1989); *FCX*, 62 B.R. 315, 322-323 (Bankr. E.D.N.C. 1986); *In re Leeds Building Products Inc.*, 141 B.R. 265 (Bankr. N.D. Ga. 1982). Under this line of cases, it is only when (a) the secured creditor releases its lien on the goods sought to be reclaimed (*See, e.g., In re Pester*, 964

F. 2d 842, 848 (8th Cir., 1992)), or (b) the reclaiming vendor's goods (or traceable proceeds therefrom) *exceed* the amount of senior secured claims *in the goods sought to be reclaimed*, that the reclamation claim has value so as to entitle the vendor to an administrative claim or lien. If the security interest in goods is released, then the vendor is entitled to either reclaim the goods, or receive a lien or administrative claim valued at the full invoice price of the goods sought to be reclaimed. *See Pester, supra* at 848. If the secured creditor doesn't release its security interest, but the value of the goods sought to be reclaimed exceeds the secured claim thereon, then the vendor whose reclamation demand is denied is entitled to a lien or an administrative claim in an amount equal to the surplus that remains after payment of the secured creditor's claim in those reclamation goods. *See In re Houlihan's Restaurant Inc.*, 286 B.R. 137, 140 (Bankr. W.D. Mo. 2002); *In re Arlco Inc.*, 239 B.R. 261, 272 (Bankr. S.D.N.Y. 1999); *In re Steinberg's Inc.*, 226 B.R. 8, 12 (Bankr. S.D. Ohio 1998).

One case is particularly troubling for vendors. In *In re Arlco*, 239 B.R. 261 (Bankr. S.D.N.Y. 1999), the lender held a perfected security interest in all of the debtor's assets, but apparently the liquidation of the debtor resulted in the inventory being sold first. Consequently, the inventory proceeds were paid to the lender first, before the balance of the collateral was liquidated. The debtor's liquidation continued, and the proceeds of the other collateral were paid to the lender, satisfying the lender's claim. *Arlco*, 239 B.R. at 273. Thus, the reclaiming vendor asked the bankruptcy court to invoke the marshalling doctrine to create a basis for granting the vendor's reclamation claim. In denying the vendor's request, the court noted that marshalling would have been more expensive and time-consuming for the lender, and was inapplicable anyway because marshalling requires *two* secured creditors. (In *Arlco*, the court found that there was only one secured creditor—the lender—because the right of reclamation does not create a security interest in the goods at issue. *Arlco*, 239 B.R. at 274). The court then held:

> In summary, in the context of a secured creditor that qualifies as a good-faith purchaser, the value of the reclaiming seller's reclamation claim will depend on whether the goods or the proceeds from the goods have been used to satisfy the secured creditor's claim. *Once the goods or the proceeds from the sale of those goods have been "paid" to the secured creditor, the reclaiming seller's claim in those goods is* ***50** *valued at zero, regardless of whether the secured creditor is ultimately paid in full and its lien released as to the other collateral* (emphasis added).

Arlco, 239 B.R. at 276.

The holding in *Arlco* is insensitive to the reality that inventory is often liquidated first and the proceeds paid to the secured creditor, and ignores the protection that UCC § 2-702 and Code § 546(c)(2) intended to give to reclaiming vendors. Basically, *Arlco* extinguishes a reclamation claim *whenever* the inventory proceeds are paid to a secured creditor—even if the secured creditor is ultimately *oversecured* when *all* of its collateral is liquidated. Fortunately for vendors, at least one court seems troubled by *Arlco*. In *In re Suwanee Swifty Stores Inc.*, 2000 Bankr. LEXIS 2005, p.1, p. 10 (Bankr. M.D. Ga. 2000), the court (in dicta) expressed its disagreement with *Arlco* and its inclination to allow marshalling so as to give vendors a reclamation remedy, *citing In re Maddox*, 84 B.R. 251, 258 (Bankr. N.D. Ga. 1987).

Realistic Expectations and Strategies

By now, you must be wondering what vendors can do to protect themselves. At a minimum, vendors need to adjust their expectations. They must understand that case law has evolved to render the reclamation remedy of today more fragile than before; consequently, vendors must fight harder than ever before to protect their reclamation claims. First, vendors *must know* the customer's financial condition and watch for *any* sign that indicates a buyer's insolvency. Second, a vendor *must* exercise its reclamation rights as vigorously as possible, as soon as it *discovers* the buyer's insolvency. If the vendor discovers the buyer's insolvency while the goods are in transit, it should use UCC § 2-705 to stop them in transit and require cash in advance or COD payment for those goods. Obviously, once the vendor stops goods in transit, it should also stop selling to this buyer on credit.

If the vendor discovers the buyer's insolvency *after* the goods have already been delivered, the vendor should immediately (a) *deliver* the reclamation demand by hand, fax or some other expedited method that provides proof of delivery, (b) start a state court action (or an adversary proceeding, if the buyer is in bankruptcy) seeking a temporary restraining order and preliminary and permanent injunction to prevent the insolvent buyer from altering, processing or disposing of the goods, plus an order that grants the vendor both the right to inspect the goods (and the buyer's records regarding the goods) and a turnover of the goods sought to be reclaimed, and (c) contact other vendors to coordinate their reclamation efforts. Reclamation lawsuits filed by several vendors (or by a coordinated group of vendors) might give the vendors valuable leverage. Debtors (and their lenders) often respond to a flock of these actions with a global reclamation program to maintain vendor goodwill and to avoid the possibility that the debtor's shelves could become bare. Reclaiming vendors should try to participate actively in the negotiation of any global reclamation program and should not be afraid to remind the debtor and its lenders that prompt payment of reclamation claims is a prerequisite to vendor support, and that without vendor support, there may be no inventory and hence no business to reorganize.

Anything is possible in negotiation. If there is no secured creditor, vendors whose reclamation demand is denied may want to seek a lien because payment of a lien is not dependent on the solvency of the bankruptcy estate. If the debtor already has one or more secured creditors, then the reclaiming vendors will probably have to settle for an administrative claim rather than a junior lien. In this situation, vendors should try to negotiate for the quickest, fullest payment of their reclamation claims. If the partial payment is significant enough, then vendors need to weigh whether quick partial payment of reclamation claims is more advantageous than delayed fuller payments, because a debtor can become administratively insolvent and unable to pay even the negotiated reclamation claims. The caselaw teaches vendors that they should ask the secured creditor for a "carve out" or release of its security interest in the goods that are subject to valid, timely reclamation demands, or should push to have the secured creditor with an all-asset security interest agree that it will look first to non-inventory assets for collection. Although the evolution of case law has not been kind to reclamation claims, these strategies might help vendors get the protection that UCC § 2-702 and Code § 546(c)(2) intended, and might keep reclamation claims from falling to "last in line."

Footnotes

1 The right to a lien or administrative priority claim is in lieu of, not in addition to, any right to reclaim. *In re Leeds Building Products Inc.*, 141 B.R. 265, 268. (Bankr. N.D. Ga. 1992.).

2 Under UCC § 2-702, the seller must make the reclamation demand within 10 days after the buyer receives the goods. Pursuant to Code § 546(c)(1)(B), if the 10-day period has not expired when the buyer files bankruptcy, the seller has an additional 10 days within which to make the demand.

3 *See, e.g.*, *Los Angeles Paper Bag Co. v. James Talcott*, 604 F.2d 38 (9th Cir. 1979); *In re Samuels & Co. Inc.*, 526 F.2d 1238 (5th Cir. 1976), *cert. denied*, 429 U.S. 834 (1976); *In re Griffin Retreading Co.*, 795 F.2d 676 (8th Cir. 1976); *In re Haywood Woolen Co.*, 3 UCC Rep. 1103 (Bankr. D. Mass. 1967). Indeed, the only case to hold otherwise is *In re American Food Purveyors Inc.*, 17 UCC Rep. Serv. 436 (Bankr. N.D. Ga. 1974), but that decision is rather old and has not generally been followed. *See, e.g., In re Melvin Liquid Fertilizer Inc.*, 37 B.R. at 589.

4 Bankruptcy Code § 546(c) requires the vendor to establish that (1) it has a statutory or common law right to reclaim the goods; (2) the goods were sold to the buyer on credit; (3) the goods were sold in the ordinary course of the seller's business; (4) the debtor was insolvent when the goods were received; (5) the vendor made a written demand for reclamation within the statutory time limit after the debtor received the goods; (6) the buyer was still in possession or control of the goods when the reclamation demand was made; and (7) the goods are identifiable as those sold to the debtor.

22-MAR AMBKRIJ 20

End of Document