The Bankruptcy Reform Act One Year Later: A Disappointment for Trade Creditors

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The Bankruptcy Reform Act of 2005 (BAPCPA) gave trade creditors new hope for additional rights in the bankruptcy process because it revised §546(c) to expand the reclamation period to 45 days and added new §503(b)(9), which allows creditors to assert an administrative claim for goods delivered to the debtor within 20 days before the bankruptcy. However, the year since BAPCPA became effective has been disappointing for trade creditors as courts (and attorneys) have begun to interpret and apply the new law.

The New Reclamation Statute: 11 U.S.C. §546(c)


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Under the *old* §546(c), trade creditors who delivered goods to a customer while that customer was insolvent could reclaim those goods *under applicable nonbankruptcy law* (*e.g.*, UCC §2-702) if the supplier delivered a reclamation demand within the applicable time period. Under the old law, the bankruptcy court could deny the trade creditor's reclamation claim *only if* it gave the seller an administrative claim or lien to secure the amount of the reclamation claim.

The reclamation remedy was once powerful and sacrosanct—but that was long ago. Over the past 20 years, the reclamation remedy has been eroded by a line of cases holding that the seller's reclamation right under UCC §2-702 is *subject to* the rights of a prior secured creditor with a lien on whatever the seller seeks to reclaim, and consequently, the seller's reclamation claim was held to be either invalid or "valueless" when there was no equity in the item beyond the secured creditor's claim. However, if equity existed over and above the security interest, or if the debtor's trade creditors could negotiate with the lender, reclaiming sellers often received a lien or an administrative expense claim in exchange for letting the debtor retain the goods.

About the Author

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The Reform Act amended 11 U.S.C. §546(c) to read as follows:

> (c)(1) Except as provided in subsection (d) of this section and in §507(c), and subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under §§544(a), 545, 547 and 549 are subject to the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days before the date of the commencement of a case under this title, but such seller may not reclaim such goods unless such seller demands in writing reclamation of such goods—
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> (A) not later than 45 days after the date of receipt of such goods by the debtor; or
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> (B) not later than 20 days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.
>
> (2) If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in §503(b)(9).

Initially, trade creditors applauded BAPCPA's dramatic extension of the reclamation period from 10 days to *45 days*. However, new 11 U.S.C. §546(c) constitutes statutory codification that reclamation claims are subject to the prior rights of a secured creditor with a lien on the goods that the seller seeks to reclaim, or the proceeds thereof. Unfortunately, the new §546(c) fails to address the key issues—namely what happens when equity exists in the items the seller seeks to reclaim, when and how that calculation of equity is to be made, and who has the burden of proof on which issues. BAPCPA was a golden opportunity for Congress to provide guidance on those important reclamation issues—but the opportunity was missed.

Perhaps the most significant revision to §546(c) is the language that was *eliminated* from the old law. These deletions are likely to spawn confusion and litigation. For example, the old version of §546(c) permitted the bankruptcy court to deny reclamation to a seller that was entitled to it *only if* the court gave the reclaiming seller an administrative claim or a lien for the value of the reclamation claim. BAPCPA deleted that language; does that mean that actual reclamation of the goods is the seller's *only* remedy? Are bankruptcy courts prohibited from granting a reclaiming seller an administrative claim or a lien in lieu of actual reclamation? The Reform Act's changes to §546(c) also eliminate any reference to statutory or common law rights (such as the UCC); does this create a new "federal" reclamation remedy? Does it mean that the principles of the UCC and the cases interpreting UCC §2-702 *don't* apply in construing the new §546(c)? Are the UCC defenses to reclamation still available as defenses? In the year since BAPCPA became effective, issues like these have caused trade creditors to conclude that despite the enhancement of the reclamation period, BAPCPA's new §546(c) does not provide the beneficial treatment that they had hoped for.

New 11 U.S.C. §503(b)(9)

Perhaps because new §546(c) provides little benefit, trade creditors were especially

[1] With thanks to Deborah Kovsky-Apap of Pepper Hamilton LLP for her assistance and updates regarding *Southern Products Co.*, discussed in this article. See also a related article on p. 28.

delighted to see BAPCPA add 11 U.S.C. §503(b)(9), which states:

> (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—
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> > (9) the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.

Section 503(b)(9) is important because it applies to *all* sellers, irrespective of whether the seller delivers a reclamation demand. A §503(b)(9) claim is independent of a reclamation claim and does not trigger the debtor's (and lender's) frequent defenses to a reclamation claim. Trade creditors were thrilled to see that the §503(b)(9) claim is high on bankruptcy's priority ladder; indeed, it enjoys the same payment priority as the debtor's professionals. 11 U.S.C. §507(a)(2).

However, in the year since BAPCPA became effective, the application of §503(b)(9) has dampened trade creditors' enthusiasm. The first hurdle is that administrative claims are not procedurally automatic. Trade creditors generally need to file an application for allowance and payment of an administrative claim. This is a rude awakening to creditors who don't want to have to retain counsel (often in a distant jurisdiction) to file a motion or application in order to get the administrative priority claim that BAPCPA promised them.

Worse yet, the last year has taught trade creditors that even if they are awarded a §503(b)(9) administrative claim, that claim is vulnerable and may not get paid—for several reasons. First, the chapter 11 estate might be (or become) administratively insolvent, in which case the §503(b)(9) claim won't get paid in full (or perhaps at all). Indeed, §503(b)(9) claims themselves increase the risk of the debtor's administrative insolvency. Second, debtor-in-possession (DIP) financing orders tend to give lenders a first-priority lien on all assets. Although trade creditors argue that this favorable treatment should be limited to "new cash" from the lender, some courts overrule that objection. Aggressive administrative claimants might seek a carve-out from the secured creditor's collateral or an assignment of other assets in order to ensure payment of the §503(b)(9) claim. But the single trade creditor is often unwilling to finance that fight, or doesn't have enough at stake to warrant the legal expense.

Finally, while §503(b)(9) affords trade creditors an administrative claim, chapter 11 debtors can stall the payment of those administrative claims until the end of the case because, pursuant to 11 U.S.C. §1129(a)(9), administrative claims are not required to be paid until the effective date of a plan in a chapter 11. Also, as *Southern Products* (discussed below) illustrates, a debtor can use 11 U.S.C. §502(d) to argue that the trade creditor's §503(b)(9) claim must be disallowed until and unless the trade creditor repays preferential and other avoidable transfers to the bankruptcy estate. Indeed, the intersection of §§502(d) and 503(b)(9) threatens to hamstring the §503(b)(9) claim. Fortunately for trade creditors, BAPCPA also amended the frequently used "ordinary course of business" preference defense embodied in 11 U.S.C. §547(c)(2) to make it easier for trade creditors to defend preferences and thereby overcome the debtor's attempt to use 11 U.S.C. §502(d) to disallow the §503(b)(9) claims.

Trade creditors might seek adequate assurance that their administrative claims

continued on page 45

Last in Line: Bankruptcy Reform Act a Disappointment for Trade Creditors

from page 19

will be paid, and if the debtor is unable to provide that assurance, then they might be able to push for conversion of the case. However, some trade creditors are loath to seek conversion of the bankruptcy case because that would result in a liquidation of the debtor and the trade creditor would lose a customer, let alone the risk that the liquidation proceeds are not sufficient to reach administrative claims. Also, these protections are theoretical, at best, to the single trade creditor that doesn't want to pay the legal fees inherent in obtaining them. Because §503(b)(9) administrative claims are adverse to general unsecured claims (due to their payment priority), trade creditors with administrative claims cannot rely on the unsecured creditors committee to protect their administrative claims—so they must either "go it alone" or form ad hoc committees (with cost-sharing arrangements) to protect their administrative claims.

In the year since BAPCPA took effect, new §503(b)(9) has spawned several questions. For example, must the bankruptcy court authorize payment of the §503(b)(9) claims? How will the ordinary course of the *debtor's* business be determined, and will it be the same criteria as the "ordinary course of business" for preference purposes? Will trade creditors with part §503(b)(9) claims, and part general unsecured claims, be eligible to serve on creditors' committees in bankruptcy cases? If not, will the new §503(b)(9) shift the balance on unsecured creditors' committees away from trade creditors serving on the committee—to the detriment of all trade creditors? These issues, plus the obstacles to actual *payment* of the §503(b)(9) claims, leave trade creditors (and their counsel) skeptical as to whether §503(b)(9) will provide them with the significant benefits they had hoped for.

Case law in the last year has produced some interesting examples of how the new §§546(c) and 503(b)(9) are being applied and interpreted in various bankruptcy cases. For example:

• ***Dana Corporation*, Case No. 06-10354 (Bankr. S.D.N.Y.):** The debtors filed a motion and obtained an order clarifying that they were authorized, *but not required,* to pay the §503(b)(9) administrative claims (or any portion thereof) on such terms as the *debtors* deemed appropriate. This gave the debtors power to negotiate the amount and timing of the payment on §503(b)(9) claims (*e.g.*, rapid payment of the § 503(b)(9) claim in exchange for the claimant agreeing to reduce the amount of the §503(b)(9) claim, etc.).

The debtors also filed a Motion to Establish Procedures Motion for Resolving Reclamation Claims, and sought authority to negotiate (in their sole discretion) an agreement to resolve any seller's reclamation claim. The debtors filed this motion in order to, *inter alia,* prohibit sellers from filing adversary proceedings seeking to reclaim their goods under new §546(c). The motion was granted.

The debtors' Motion to Establish a Claims Bar Date demonstrates a global approach to §503(b)(9) claims. In this innocuously titled motion, the debtors sought to deem the filing a proof of claim for a §503(b)(9) claim satisfaction of the *procedural* requirements for administrative claims under §503(b). The debtors even sought approval of a *modified proof of claim form* so that creditors could literally "check the box" in order to identify their §503(b)(9) claim. This motion was granted.

• ***JL French Automotive Castings Inc.*, Case No. 06-10119 (Bankr. D. Del.):** The debtors filed a first-day motion for an order permitting them to "provisionally" pay the §503(b)(9) claims *early in the case,* while their payment could still induce the trade creditors to adhere to favorable trade terms on a going-forward basis. The debtors argued that the relief requested would actually preserve the debtors' liquidity by enticing trade creditors to give favorable trade terms, and that the relief would also preserve the court's resources by avoiding numerous §503(b)(9) motions. The creditors' committee filed a limited objection that was resolved; the motion was granted with some modifications.

• ***Southern Products Co.*, Case No. 05-61822 (Bankr. E.D. Mo.):** An ad hoc committee of reclamation and §503(b)(9) claimants filed a Request for Payment of §503(b)(9) Claims and a Motion for Return of Goods under §546(c). With respect to the reclamation issues, the ad hoc committee argued that the debtors had already admitted that the bank was oversecured and, consequently, the reclamation claims were not junior to the bank's security interest. The debtors objected to reclamation and to payment of §503(b)(9) claims, arguing that the claimants may have received preferential transfers, and consequently, payment of their claims would be precluded under 11 U.S.C. §502(d). (The debtors later withdrew this argument because the claimants provided information demonstrating that they had valid preference defenses and no preference exposure.) The debtors also complained that immediate payment would cause liquidity problems. The bankruptcy case was converted to chapter 7, and the substantive issues of §503(b)(9) claims were initially deferred until the chapter 7 trustee knew whether funds existed to pay administrative claims. According to Deborah Kovsky-Apap of Pepper Hamilton LLP (the firm representing the ad hoc committee), the chapter 7 trustee eventually allowed the claimants' reclamation claims and their §503(b)(9) claims, all as chapter 11 administrative claims—*but as of Jan. 3, 2007, there has been no money in the estate to pay them*!

Conclusion

Although interpretations of the new §§546(c) and 503(b)(9) are disappointing, they present new and interesting issues for trade creditors and their counsel. Trade creditors are well-advised to band together in order to assert their reclamation rights, protect their §503(b)(9) claims, and remind the debtor (and its lender) of the importance of vendor support in the reorganization process. Trade creditors' and their counsel need to watch for modified proof of claim forms and, perhaps, revised local bankruptcy rules or other procedural mechanisms (which might be buried in seemingly innocuous motions or rules—such as those governing the claims bar date) for dealing with §503(b)(9) claims. Because there are economic incentives for debtors to craft procedures that limit §503(b)(9) administrative priority claims (or exchange them for something that the debtor needs—such as favorable trade terms), trade creditors and their counsel need to be especially alert to the evolving dynamics of §503(b)(9)—all in the ongoing quest to avoid being "last in line." ■