20-JUN Am. Bankr. Inst. J. 14

American Bankruptcy Institute Journal
June, 2001

Column
Last in Line

*14 THE TRADE CREDITOR'S FIRST REMEDIES

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It happens all the time. A client calls, complaining that his company recently shipped a large volume of products to a customer, and now he has learned that the buyer is insolvent and might file for bankruptcy protection. Your client is nervous, and asks for your help.

If the Goods Have Not Yet Been Delivered, Your Client May Be Able to Stop Them in Mid-transit

Uniform Commercial Code §2-705 (1) states:

> The seller may stop delivery of goods in the possession of a carrier or other bailee when he discovers the buyer to be insolvent ...

In order to stop delivery in transit, your client must notify the carrier in sufficient time to prevent the carrier, exercising reasonable diligence, from delivering the goods to the buyer. *See* UCC §2-705(3)(a). Although UCC §2-705(3)(a) does not require the seller's notification to be in writing, it is good practice for the seller to send (by telegram or facsimile, if possible) written confirmation of any oral request for stoppage in transit. Your client should also advise the customer that it is stopping the goods in transit. [1]

Once the carrier receives notification from the seller to stop the goods in transit, that carrier *must* hold the goods and deliver them according to the seller's instructions, but the seller is liable to the carrier for any ensuing charges or damages. UCC §2-705(3)(b).

The seller may stop goods in transit irrespective of whether the goods are in the hands of a carrier, or a warehouseman for shipment or for storage: The right of stoppage in transit exists *as long as* the buyer has not "received" or taken physical possession of the goods. [2] That said, if the buyer sends its *own* company truck to pick up the goods from the seller, then the buyer has taken possession of the goods, thereby terminating the seller's right of stoppage in transit. In other words, even though the goods may technically be "in transit," if they are on a truck *owned* by the buyer, then the buyer has possession of the goods and the seller has no right to stop in transit.

In *In re Bill's Dollar Stores*, 164 B.R. 471 (Bankr. D. Del. 1994), the court was forced to determine exactly when goods were no longer "in transit," and when they were deemed "received." The court found that once the carrier disengaged the trailer in the buyer's yard and left the buyer's yard with a signed bill of lading, the goods had been "received" by the buyer and the seller could no longer stop them in transit. (The court rejected the argument that the goods were received only when they were unloaded from the trailer.)

UCC §2-705(2) sets forth the four circumstances under which the seller loses the right to stop goods in transit as follows: (a) the buyer receives the goods (this "receipt" may be by a third party on behalf of the buyer);[3] (b) a bailee *other than a carrier* acknowledges that it is holding the goods for the buyer's account;[4] (c) a carrier acknowledges to the buyer that it holds the goods for the buyer, either by reshipping the goods according to the buyer's instructions or by the carrier's acknowledgment to the buyer that it is holding the buyer's goods as a warehouseman for the buyer;[5] or (d) a negotiable document of title, such as a bill of lading or a warehouse receipt, is negotiated to the buyer.[6]

One frequently asked question is whether the seller loses the right to stop goods in transit if title to those goods has passed to the buyer. Because the right to stop in transit depends on who has *possession* of the goods, the seller does not lose the right of stoppage in transit simply because title to the goods may have passed to the buyer.[7]

Fortunately, case law has evolved to clarify that a seller's stoppage in transit does not violate the automatic stay embodied in 11 U.S.C. §362(a), nor does it result in an avoidable statutory lien.[8] Therefore, if a seller learns that the buyer filed bankruptcy before the buyer received the seller's product, the seller may still exercise the right of stoppage in transit.

If the Buyer has Already Received the Goods, Your Client May Be Able to Reclaim Them

The Uniform Commercial Code (§2-702) and the Bankruptcy Code (§546(c)) enable a seller to reclaim goods when the seller learns of the buyer's insolvency. Obviously, UCC §2-702 governs before the buyer files a bankruptcy petition, and §546(c) governs post-petition. Under UCC §2-702, the seller has the right to reclaim goods upon learning of the buyer's insolvency; the seller does *not* have to wait and see if the buyer files a bankruptcy petition.

UCC §2-702 provides, in pertinent part:
(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, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery, the 10-day limitation does not apply ...

(3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good-faith purchaser or lien creditor under this article (§2403). Successful reclamation of goods excludes all other remedies with respect to them.
11 U.S.C. §546(c) states in pertinent part:

Except as provided in subsection (d) of this section, the rights and powers of a trustee under §§544(a), 545, 547 and 549 of this title are subject to any statutory or common-law 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, but
(1) such a seller may not reclaim any such goods unless such seller demands in writing reclamation of such goods—
(A) before 10 days after receipt of ***15** such goods by the debtor, or

(B) if such 10-day period expires after the commencement of the case, before 20 days after receipt of such goods by the debtor, and

(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 a seller priority as a claim of a kind specified in §503 (b) of this title, or

(B) secures such claim by a lien.

Although UCC §2-702 and Bankruptcy Code §546(c) are similar, there are important differences between them. For example, UCC §2-702 is silent on whether the seller's reclamation demand needs to be in writing, but 11 U.S.C. §546(c) *requires* a written reclamation demand. Like UCC §2-702, 11 U.S.C. §546(c) requires the reclamation demand within 10 days after delivery of the goods *but*, unlike UCC §2-702, if that 10-day period expires after the buyer is in bankruptcy, then (*and only then*) the seller has a total of 20 days from the buyer's receipt of the goods in which to make the reclamation demand. Unlike UCC §2-702, 11 U.S.C. §546(c) gives no special rights to reclaiming sellers if the buyer gave that seller a written misrepresentation of solvency. Moreover, the test of insolvency (which is a "balance sheet test") as set forth in the Bankruptcy Code[9] may be much more difficult and expensive to prove than the test of insolvency under the Uniform Commercial Code (which is inability to pay debts as they become due).

Although UCC §2-702 and 11 U.S.C. §546(c) seem straightforward, questions often arise in their practical application, as follows:

• *How should a written demand be delivered*? Although UCC §2-702 is silent on whether the reclamation demand needs to be in writing (and although two courts have held that an oral demand was sufficient[10]) the *safest* reclamation demand is a written one because (1) it avoids future proof problems; (2) insolvent buyers often file for bankruptcy protection and then argue that 11 U.S.C. §546(c) is the sole reclamation remedy; and (3) §546(c) requires a *written* reclamation demand.

The most effective method of delivery is by facsimile or hand delivery, with the seller retaining the fax confirmation sheet or a proof of delivery. Telegrams or mailgrams might also work, but *only* if the seller insists on receiving written confirmation of the time and date that the reclamation demand was *delivered* to the buyer.

Sending the reclamation demand by regular, certified or even registered mail can be disastrous due to the typical delays in mail service: Sellers who send reclamation demands using regular mail often find that many of the goods delivered fall outside the 10-day reclamation period simply because the reclamation demand was delivered so late.

• *How should the reclamation demand be worded*? The wording of the reclamation demand should be broad enough to include deliveries made by all divisions of the seller's corporation to all divisions of the buyer's corporation. The demand should also be as specific as possible (*i.e.*, list as many invoices as possible), and should also include a "catch-all" in case the seller misses an invoice or two. For example, the seller can "demand all goods delivered within the applicable period under UCC §2-702 and/or 11 U.S.C. §546(c) including, but not limited to ..." After the reclamation demand is delivered, the seller should follow it up with a letter that details *all* of the specific invoices.

If the goods are fungible, then the reclamation demand *must* identify the goods as to which reclamation is sought.[11]

• *To whom should the reclamation demand be sent*? It is also important that the reclamation demand properly identify both the seller and the buyer of the goods in question. This issue often arises in the context of corporate parents and subsidiaries. Although a reclamation demand issued by a corporation would include all deliveries made by divisions of that corporation, it probably does not include deliveries made by subsidiary corporations. Similarly, a reclamation demand served upon a corporation is sufficient to reclaim all goods delivered to divisions of that corporation, but probably won't include deliveries made to subsidiaries and/or affiliate corporations. If a seller is uncertain as to the buyer's identity, the seller should serve the reclamation demand upon all possible entities.

*17 • *What is the procedure after the reclamation demand? What can be reclaimed*? Section 2-702(3) of the Uniform Commercial Code states that the seller's reclamation rights are subject to the rights of a buyer in the ordinary course, other

good faith purchaser *or lien creditors*. Thus, as a practical matter, under the Uniform Commercial Code a secured creditor with a perfected lien in after-acquired inventory will defeat the claim of any reclaiming seller. If there are no lien creditors, buyers in the ordinary course or good-faith purchasers, then generally a reclamation demand is effective to reclaim only the goods that (a) were received by the buyer from the reclaiming seller within 10 days before the reclamation demand, *and* (b) the buyer still has in its possession when the reclamation demand is made. Courts have held that goods are "received by the buyer" when the buyer obtains physical possession of them. [12] A reclamation demand does not cover the proceeds of goods already sold. [13] If the buyer has processed the seller's goods before the buyer received the reclamation demand, then they are non-identifiable and consequently not subject to reclamation. [14] Fungible goods can be reclaimed only if they can be traced to an identifiable mass. [15]

Thus, once the reclamation demand is delivered to the buyer, the seller should quickly send its representative to the buyer's place of business (preferably with an objective third party) to inventory the seller's goods that the buyer still has on hand when the reclamation demand was delivered. Alternatively, the seller can obtain a stipulation from the buyer itemizing the seller's goods that the buyer still has on hand.

The seller should also speak to the buyer to determine its intentions regarding return of the goods. Usually buyers refuse to return the goods; in this scenario, the seller should immediately file a state court action (or an adversary proceeding in bankruptcy court if the buyer is now in bankruptcy) seeking a temporary restraining order and preliminary injunction prohibiting the buyer from selling or processing the goods, and ultimately seek a court order directing the buyer to return the reclaimed goods to the seller. It is important for the reclaiming seller to *promptly* commence a lawsuit or an adversary proceeding in order to preserve reclamation rights: At least one bankruptcy court has held that a seller who did not file the reclamation adversary proceeding until eight months after the reclamation demand lost its reclamation rights. [16] The reclaiming seller has the burden of establishing each element of the reclamation claim. [17]

• *What if the buyer gave the seller a written misrepresentation of solvency within three months before the goods were delivered?* Although the buyer's written misrepresentation of solvency is irrelevant under 11 U.S.C. §546(c), UCC §2-702(2) expands the seller's reclamation rights if there has been written misrepresentation of the buyer's solvency made to the *particular* seller, within three months before delivery of the goods. In this scenario, the 10-day limit does not apply, and (subject to UCC §2-702(3)) the seller can reclaim any goods that (a) the buyer received from the seller on credit *and* (b) the buyer still has on hand. Although UCC §2-702(2) requires the misrepresentation of solvency to be in writing, the UCC is conspicuously silent on the type of writing, and there is no requirement that the document be signed by the buyer. Generally, any form of writing given to *that particular seller* will suffice. Courts have held, however, that a check returned for insufficient funds is not a sufficient writing under UCC §2-702(2). [18]

UCC §2-702(2) requires that the buyer's misrepresentation of solvency be made to a *particular* seller—this means that a general representation made to a credit association or reporting service will not suffice. ***36** Although the written misrepresentation has to have been made to the seller within three months before the goods were delivered to the buyer, the three-month period has been held to commence from the date the writing is presented to the seller, rather than on the date of the writing itself. [19]

Although UCC §2-702 (2) relaxes the time limit on the seller's reclamation demand for sellers who received a written misrepresentation of solvency from the buyer, it remains good practice for the seller to act *as quickly as possible* because the longer the seller waits, the fewer goods the buyer will have on hand for the seller to reclaim.

• *Is 11 U.S.C. §546(c) the exclusive remedy once the buyer files a bankruptcy petition?* The vast majority of courts have determined that Bankruptcy Code §546(c) is the exclusive remedy once the buyer is in bankruptcy; [20] however, at least one court seems to have held that 11 U.S.C. §546(c) is *not* the exclusive remedy. [21] Consequently, it is still advisable for a seller's

written reclamation demand to include a reference to both Uniform Commercial Code §2-702 and Bankruptcy Code §546(c), just in case the seller is litigating in a jurisdiction that holds that §546(c) is not the exclusive remedy.

• *Does service of the reclamation demand violate bankruptcy's automatic stay*? Service of a reclamation demand after the buyer is in bankruptcy has been held *not* ***37** to violate the automatic stay embodied in 11 U.S.C. §362(a).[22] If the buyer sells the goods after receiving a reclamation demand, the majority of cases have awarded liens to reclaiming sellers (rather than determining their reclamation rights unenforceable).[23]

• *How often does the reclaiming seller actually get goods back from a bankrupt buyer*? In bankruptcy cases, few reclaiming sellers actually get their goods back, in part because so many bankruptcy cases involve secured creditors with liens on after-acquired inventory. A majority of cases have held that a secured creditor with a perfected security interest in after-acquired inventory is a good-faith purchaser with rights superior to those of the reclaiming seller, and that the right of reclamation continues to exist but it is subject or subordinate to the perfected security interest. In this scenario, many courts have granted the reclaiming seller a second lien or an administrative expense claim.[24] Other courts have held, however, that a security interest in after-acquired inventory extinguishes the reclamation claim.[25]

Even if there is no perfected security interest in the goods sought to be reclaimed, and *even if* the reclaiming seller has fully complied with §546(c) of the Bankruptcy Code and has proven every element of its reclamation claim in the adversary proceeding, the seller still might not get the goods back: 11 U.S.C. §546(c)(2) empowers the bankruptcy court to deny the seller's right to physically reclaim the goods, but *only if* the court grants the seller an administrative expense claim *or* secures the seller's claim by a lien on property. This statutory provision recognizes that any debtor attempting to reorganize in bankruptcy needs all of its inventory, and as much cash as possible. Consequently, most bankruptcy courts are loathe to allow a reclaiming seller to physically repossess its goods (which could result in reclaiming sellers literally pulling their goods off the debtor's shelves), because that would disrupt the debtor's business and would likely injure the debtor's chances of a successful reorganization.

Often, bankruptcy courts grant administrative expense claim status to the reclaiming seller's claim, which means that the seller's reclamation claim is placed relatively high on the priority ladder and is much more likely to be paid than unsecured claims. However, this is still an unsatisfactory remedy for the seller because if the buyer's bankruptcy case is converted from a chapter 11 reorganization to a chapter 7 liquidation, and if there are insufficient assets to fully pay all administrative priority claimants, then the reclaiming seller would only receive partial payment even on its administrative expense claim. Consequently, it is preferable for reclaiming sellers to attempt to negotiate for a junior lien on all property of the estate, or to seek cash payment (perhaps on a deferred basis) during the administration of the bankruptcy case so that the unpaid portion of the seller's reclamation claim is quickly reduced.

Conclusion

Though trade creditors often feel anxious and powerless when learning of their customer's insolvency or bankruptcy, the trade creditor's right to stop goods in transit and reclaim them after delivery can be helpful tools, yet they must be used quickly and properly for the creditor to reap the maximum benefit and avoid being "last in line."

Footnotes

1 *Indussa Corp. v. Reliable Stainless Steel Supply Co.*, 369 F. Supp. 976 (E.D. Pa. 1974).

2 *In re Bill's Dollar Stores Inc.*, 164 B.R. 471 (Bankr. D. Del. 1994).

3 *Donegal Steel Foundry Co. v. Accurate Products Co.*, 516 F. 2d 583 (3rd Cir. 1975); *In re Julien Co.*, 128 B.R. 987 (Bankr. W.D. Tenn. 1991), *aff'd*, 44 F. 3d 426 (6th Cir. 1995).

4 *Jimani Corp. v. S.L.T. Warehouse Co.*, 409 S. 2d 496 (Fla. App. 1982), *petition den.*, *Metrobank of Dallas v. S.L.T. Warehouse Co.*, 417 S. 2d 330 (Fla. 1982); *C.F. Sales Inc. v. Amfert Inc.* 344 NW 2d 543 (Iowa 1983).

5 *Butts v. Glendale Plywood Co.*, 710 F.2d 504 (9th Cir. 1983).

6 *In re New York Wholesale Distributors Corp.*, 58 B.R. 497 (Bankr. S.D.N.Y. 1986); and *In re Julien*, 128 B.R. 987 (Bankr. W.D. Tenn. 1991), *aff'd*, 44 F. 3d 426 (6th Cir. 1995).

7 *In re National Sugar Refining Co.*, 27 B.R. 565 (S.D.N.Y. 1983); *In re Julien*, 128 B.R. 987 (Bankr. W.D. Tenn. 1991), *aff'd.*, 44 F. 3d 426 (6th Cir. 1995).

8 *In re National Sugar Refining Co.*, 27 B.R. 565 (S.D.N.Y. 1983); *In re Julien*, 128 B.R. 987 (Bankr. W.D. Tenn. 1991), *aff'd.*, 44 F. 3d 426 (6th Cir. 1995).

9 11 U.S.C. § 101(32).

10 *In re A.G.S. Food Systems Inc.*, 14 B.R. 27 (Bankr. D. S.C. 1980); *In re Bearhouse Inc.*, 84 B.R. 552 (Bankr. W.D. Ark. 1988).

11 *See In re Braniff Inc.*, 113 B.R. 745, 752 (Bankr. M.D. Fla. 1990).

12 *In re Martin Motor Oil Inc.*, 740 F. 2d 220 (3rd Cir. 1984); *In re First Software Corp*, 72 B.R. 403 (Bankr. D. Mass. 1987). *See, also*, UCC §2-103 (1)(c), which defines "receipt."

13 *In re Rawson Food Service Inc.*, 846 F. 2d 1343 (11th Cir. 1988); *In re Coast Trading Co.*, 744 F. 2d 686, 691 (9th Cir. 1984).

14 *In re Wheeling-Pittsburgh Steel Corp.*, 74 B.R. 656 (Bankr. W.D. Pa. 1987).

15 *In re Charter Co.*, 54 B.R. 91 (Bankr. M.D. Fla. 1985); *In re Braniff Inc.*, 113 B.R. 745 (Bankr. M.D. Fla. 1990).

16 *Matter of Crofton & Sons Inc.*, 139 B.R. 567 (Bankr. M.D. Fla. 1992).

17 *In re Rawson Food Service Inc.*, 846 F. 2d 1343 (11th Cir. 1988).

18 *In re Bar-Wood Inc.*, 15 UCC Rep. Serv. 828 (Bankr. S.D. Fla. 1974). *But, see Theo Hamm Brewing Co. v. First Trust and Savings Bank*, 5 UCC Rep. Serv. 1230 (Ill. App. 1968).

19 *In re Bel Air Carpets Inc.*, 452 F. 2d 1210 (9th Cir. 1971).

20 *In re Contract Interiors Inc.*, 14 B.R. 670 (Bankr. E.D. Mich. 1981).

21 *In re A.G.S. Food Systems Inc.*, 14 B.R. 27 (Bankr. D.S.C. 1980).

22 *In re Production Steel Inc.*, 21 B.R. 951 (Bankr. M.D. Tenn. 1982).

23 *In re Davidson Lumber Co.*, 22 B.R. 775 (Bankr. S.D. Fla. 1982); *In re Braniff Inc.*, 113 B.R. 745, 756 (Bankr. M.D. Fla. 1990).

24 *In re Pester Refining Co.*, 964 F. 2d 842 (8th Cir. 1992); *In re Blinn Wholesale Drug Co. Inc.*, 164 B.R. 440 (Bankr. E.D.N.Y. 1994); *In re Reliable Drug Stores*, 70 F.3d 948 (7th Cir. 1995).

25 *In re Lawrence Paperboard Corp.*, 52 B.R. 907 (Bankr. D. Mass. 1985); *In re Shattuc Cable Corp.*, 138 B.R. 557 (Bankr. N.D. Ill. 1992).

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