RECLAMATION AND PREFERENCE DEFENSES PRIMER

By: Eric S. Prezant

This article provides a brief review of the law relating to reclamation and further discusses common defenses to preference actions under the U.S. Bankruptcy Code (the "Code" or "Bankruptcy Code"). Although these two Bankruptcy Code sections are unrelated, they both may impact upon the rights of sellers who supply goods to a debtor before or after the debtor files a petition for relief under Chapter 11 of the U.S. Bankruptcy Code.

RECLAMATION

In a reclamation, a seller may "reclaim" goods that were sold and shipped to a customer on credit before learning that the customer was insolvent. For a seller to reclaim its goods, it must make a demand on the customer for their return. The Uniform Commercial Code ("UCC") § 2-702(2) states:

> *(2) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller within three months before delivery the ten day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.*

However, the application of section 2-702(2) is greatly limited by UCC § 2-702(3), which states:

> *(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 under this Article [2] (section 2-403). Successful reclamation of goods excludes all other remedies with respect to them.*

I. THE ROAD TO BANKRUPTCY

When a company is struggling financially, the receipt of a UCC reclamation demand from a key vendor may be the catalyst for the company to file a voluntary petition for relief under Chapter 7 or 11 of the United States Bankruptcy Code. Once a bankruptcy case is initiated, Section 546(c) provides the exclusive remedy for a seller who is seeking to reclaim its goods. *In re Julien Co.*, 44 F.3d 426 (6th Cir. 1995); *In re Koro Corp.*, 20 B.R. 241 (B.A.P. 1st Dist. 1982); *In re MGS Marketing*, 111 B.R. 264 (9th Cir. 1990). Therefore, once a debtor initiates a Bankruptcy case, a seller must establish its right to reclaim the goods pursuant to Section 546(c) of the Code.

A seller's reclamation rights arise under Section 546(c) of the Code only if the seller has a right to reclaim under the non-bankruptcy law (generally the UCC) of the state where the goods were sold. In addition to the non-bankruptcy law requirements, a seller's failure to comply with the additional strictures of Section 546(c) will terminate his reclamation rights, regardless of whether or not it complied with more liberal reclamation requirements of the state's non-bankruptcy laws. Id.

II. SECTION 546(C)

11 U.S.C. § 546(c) states:

> *(c) Except as provided in subsection (d) of this section, the rights and powers of a trustee . . . 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 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 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 section 503(b) of this title; or
(B) secures such claim by a lien.

The language contained in Section 546(c) is straight-forward and similar to (although narrower than) Section 2-702(2) of the UCC. Also, the case law relating to Section 546(c) is well-defined. Case law has distilled Section 546(c) into five basic elements which give rise to a seller's reclamation rights. These elements are as follows:

1. The seller sold goods to the debtor on credit;

2. The sale of goods was in the ordinary course of business of both the debtor and the seller;

3. The seller delivered the goods at a time when the debtor was insolvent, as defined by the Code;

4. The seller made a written demand for return of the goods within ten days (or twenty days if the ten day period expired after the petition date) after the goods were delivered to the debtor;

5. The debtor had possession of the goods at the time of the written demand; the goods were not in the debtor's possession in the ordinary course of business; or the goods had been sold to a good-faith purchaser at the time of demand.

III. BALANCING OF THE EQUITIES

Even though Section 546(c) entitles a seller to reclamation rights, a seller will not automatically receive the goods back from the debtor. The Bankruptcy Court has discretion to

"balance the equities" between the debtor's need for the goods to continue its business operations and the seller's interest in the value of the goods. *In the Matter of Continental Airlines*, 125 B.R. 415 (Bankr. D. Del. 1991). If the Bankruptcy Court determines that the debtor's need for the goods for its reorganization outweighs the sellers need to resell the goods for cash, the Bankruptcy Court must grant the seller an administrative expense priority or a secured claim by lien on the assets of the estate. *In the Matter of Griffin Retreading Co.*, 795 F.2d 676 (8th Cir. 1986); *In re Pester Refining Co.*, 964 F.2d 842 (8th Cir. 1992).

If the Bankruptcy Court grants a seller a lien or an administrative priority in lieu of returning the goods, the reclaiming seller is entitled to the full invoice price for the goods. *Pester*, 964 F.2d at 848. Nevertheless, return of the goods in most cases is the preferred remedy for sellers because a lien or an administrative expense priority claim may only be paid from the residual value of the goods after all secured claims collateralized by the goods have been paid. *Id.* If the secured creditors' claims amount to the entire value of the goods, the seller's lien or administrative expense claim is worthless. *Id.*; *see In the Matter of Reliable Drug Stores, Inc.*, 70 F.3d 948 (7th Cir. 1995).

IV. RECLAMATION RIGHTS VS. SECURED CREDITORS AND/OR GOOD FAITH PURCHASERS

A seller seeking reclamation must contend with two common barriers to recovering his goods from the debtor. The first barrier is a prior secured creditor with a floating lien on the assets of the debtor (discussed above). The second barrier is a good faith purchaser situation, where a debtor no longer has the goods because they were sold to a good faith purchaser prior to the reclamation demand. Additionally, Section 2-702(3) of the UCC provides that a seller's reclamation rights are "subject to the rights of a buyer in the ordinary course or other good faith purchaser. . ." Since secured creditors are considered good-faith purchasers pursuant to sections 1-201(32) and (33) of the

UCC, a seller is unable to reclaim the physical possession of the goods against either a secured creditor or a good faith purchaser. UCC 1-202(32) and (33); see Collier on Bankruptcy ¶ 546[2][a][ii].

The presence of one or both of these barriers generally does not extinguish a seller's reclamation rights. The seller's reclamation rights are merely subordinated to the rights of the secured creditor or the good faith creditor and the seller will be granted an administrative priority or subordinated secured lien on the assets of the debtor. *See, e.g., In re Reliable Drug Stores, Inc.*, 181 B.R. 374 (Bankr. S.D. Ind. 1995); (holding that a seller's reclamation right is subject to the lien of a prior secured creditor); *see also In re Rea Keech Buick, Inc.* 139 B.R. 625 (Bankr. D. Md. 1992); *In re Wathen's Elevators, Inc.*, 32 B.R. 912 (Bankr. W.D. Ky. 1983) (holding that a seller's reclamation right is subject to the rights of a good faith purchaser); *In re Blinn Wholesale Drug Co., Inc.*, 164 B.R. 440 (Bankr. E.D.N.Y. 1994).

V. BANKRUPTCY CODE VS. THE UCC

The UCC and Section 546(c) reclamation provisions are similar, but not identical. Several common "pitfalls" for the unwary seller arise from the differences between the UCC and Section 546(c). Since Section 546(c) requires a seller to comply with non-bankruptcy law as well as its own provisions, it is important to note the differences between the two provisions. Section 546(c) and the UCC differ in their definitions of insolvent and the ten-day notice requirement.

A. Definition of Insolvent

A debtor is "insolvent" under the UCC if it has ceased to pay its debts in the ordinary course of business or cannot pay its debts as they become due. However, under the Bankruptcy Code, a

debtor is "insolvent" if it meets the Code's "balance sheet" test, requiring that "the sum of the entity's debt is greater than all of the entity's property, at fair valuation . . ."

In *In re Julien Co.*, 44 F.3d 426 (6th Cir. 1995), the seller sought reclamation pursuant to Section 546(c) for a prepetition delivery of cotton to the debtor. Regardless of the seller's compliance with the UCC's reclamation requirements, the Court denied the seller's request for reclamation because the seller offered no evidence that the debtor's liabilities exceeded its assets at the time the seller demanded the return of the cotton, as required under Section 546(c) of the Code.

However, in *In re Flagstaff Foodservice Corp.*, 56 B.R. 899 (Bankr. S.D.N.Y. 1986), the Court held that the debtor's poor financial condition, evidenced by its schedules and the fact that the debtor filed its petition in the bankruptcy court within one week after it received the goods, provided the seller with strong probative evidence that the debtor's liabilities exceeded its assets at the time the seller demanded the return of his goods.

B. *Written Notice within Ten-Days after the Debtor's Receipt of the Goods*

Unlike some states' non-bankruptcy laws which allow for oral demand by the seller for return of goods, Section 546(c) requires the demand to be in writing. *In re Video King of Illinois, Inc.*, 100 B.R. 1008 (Bankr. N.D. Ill. 1989). Moreover, unlike some states' non-bankruptcy laws which provide that a seller's reclamation rights ripen upon discovery of the debtor's insolvency, Section 546(c) provides that a seller's reclamation rights are extinguished 10-days after receipt of the goods. *In re K Chemical Corp.*, 188 B.R. 89 (Bankr. D. Conn. 1995). Section 546(c) has, however, been modified to extend a seller's reclamation rights to 20-days after receipt of the goods if the regular 10-day expiration period ends after the petition date. *Jameson Home Products, Inc. v. Handy Andy Home Improvement Centers, Inc.*, 213 B.R. 1000 (Bankr. N.D. Ill. 1997) (holding that the

seller's reclamation rights were not extended to 20-days because the 10-day expiration period ended prior to the petition date).

C. *Sample Reclamation Letter*

Attached hereto as Exhibit A is a sample reclamation letter which incorporates the requirements of Section 546(c) and the UCC. Although this letter constitutes a proper reclamation demand in most states, counsel should examine the non-bankruptcy law of the state in which the transaction occurred to ensure full compliance with an individual state's reclamation laws.

VI. THE DEFINITION OF RECEIPT

The date of "receipt" is crucial in determining when the 10-day (or 20-day) reclamation demand period expires. Section 2-103 of the UCC defines "receipt" of goods as "taking physical possession of them." UCC § 2-103(1)(c). Case law has set forth a general test to determine if goods were received pursuant to the Bankruptcy Code. Generally, goods are "received" when the seller can no longer stop delivery of goods and is left with only the remedy of reclamation. *In re Bill's Dollar Stores, Inc.*, 164 B.R. 471 (Bankr. D. Del. 1994) (holding that the goods were received when they were unhitched and left in the buyer's yard by the carriers, not when they were unloaded into the debtor's warehouse); *In re First Software Corp.*, 72 B.R. 403 (Bankr. D. Mass) (holding that receipt occurred at delivery, not when title to the goods passed from the seller to the buyer).

VII. STOPPAGE IN TRANSIT

In some cases, a seller may discover that the buyer is insolvent when the goods are "in transit," i.e. after the buyer places an order but before the buyer receives actual physical possession of the goods. Although no specific language in the Bankruptcy Code permits a seller to stop shipment of the goods in transit, the reclamation section of the Code includes, by implication, the

seller's prior right to stop goods in transit. *In re Fabric Buys*, 34 B.R. 471 (Bankr. S.D.N.Y. 1983). "Congressional silence as to stoppage in transit should be considered . . . more in the nature of an approval of the harmonious precedent in favor of the seller's right of stoppage rather than a disallowal by omission." *Id.* at 474.

CONCLUSION

It is essential that creditors who have a right to reclaim act expeditiously and in conformity with the Uniform Commercial Code and the Bankruptcy Code. Without doing so, the rights of a seller to reclaim his goods will be extinguished and the seller will be forced to "step to the back of the line" with the rest of the unsecured creditors. Consequently, counsel should stay abreast of current case law relating to reclamation.

PREFERENCES - CREDITOR DEFENSES TO A PREFERENCE ACTION

I. OVERVIEW OF PREFERENCES

Section 547 of the Bankruptcy Code provides for the recovery of "preferences"—payments made by the debtor to certain creditors on the "eve of bankruptcy" that allow the recipients to receive more than they would have received if the payment had not been made and the debtor's assets were divided equally among all creditors. *See generally In re Cybermech, Inc.*, 13 F.3d 818 (4th Cir. 1994); *Kenan v. Fort Worth Pipe Co.* (*In re* George Rodman, Inc.), 792 F.2d 125, 127 (10th Cir. 1986). According to the legislative history of Section 547, the purpose of the preference section is two-fold: (1) to discourage creditors from racing to the courthouse to dismember the debtor during the debtor's slide into bankruptcy; and (2) to facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-78 (1977).

11 U.S.C. § 547(b) states:

> *(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—*
>
> *(1) to or for the benefit of a creditor;*
>
> *(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;*
>
> *(3) made while the debtor was insolvent;*
>
> *(4) made—*
>
> *(A) on or within 90 days before the date of the filing of the petition; or*
>
> *(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and*
>
> *(5) that enables such creditor to receive more than such creditor would receive if—*
>
> *(A) the case were under chapter 7 of the title;*
>
> *(B) the transfer had not been made; and*

> *(C) such creditor received payment of such debt to the extent provided by the provisions of this title.*

The intent of the debtor or creditor is immaterial for the purposes of preferences. *In re Marathon Oil Co. v. Flatau* (*In re* Craig Oil Co.) 785 F.2d 1563, 1566 (11th Cir. 1986). Instead, the effect of the transfer is the controlling factor. *Id.* Therefore, any transfer of an interest in any property (including money) of the debtor on or within 90 days (or one year if the creditor is an insider) prior to the filing of the petition is susceptible to being categorized as preference.

II. DEFENSES TO PREFERENCE ACTIONS

Preferences are frequently misunderstood by creditors who believe that being named as a defendant in a preference action connotes some sort of "wrongdoing" on their part. Not surprisingly, many of these creditors, especially those unfamiliar with this type of proceeding, become upset or outright hostile at the thought of being sued by the trustee of a company that owed (and may still owe) them money. However unfair it seems to a creditor to be named as a defendant in a preference action, the creditor can rest assured that it is not a personal attack for any wrongdoing. Preferences are also usually defensible, at least in part, and the creditor should examine all of the preference defenses that are found under Section 547(c) as well as any other potential defenses that may be asserted which are not contained in Section 547(c). *See In re Grabill Corp.*, 135 B.R. 101 (Bankr. N.D. Ill. 1991). This article addresses only the most common preference defenses and should not be read to the exclusion of those not discussed further.

A. The New Value Exception

Section 547(c)(1) sets forth the "new value" exception to a preference action. Pursuant to this section, the trustee may not avoid as a preference a transfer:

(1) to the extent that such transfer was—

(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

(B) in fact a substantially contemporaneous exchange.

Section 547(a)(2) defines "new value" as:

Money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation.

Three main issues arise when a creditor seeks to invoke the new value exception:

(1) What constitutes new value?

(2) Was the exchange <u>intended</u> to be contemporaneous?

(3) Was the exchange <u>in fact</u> contemporaneous?

Below are annotations which address the issues relating to new value exception. However, each preference case is fact specific:

1. What Constitutes New Value

- ♦ The extension of new credit may constitute new value. *In the Matter of Anderson-Smith & Associates, Inc.*, 188 B.R. 679 (Bankr. N.D. Ala. 1995).
- ♦ The maturation of a contingent right caused by the debtor's prepetition payment on a loan does not constitute new value. *In re Chase & Sanborn Corp.*, 124 B.R. 371 (Bankr. S.D. Fla. 1991).

2. Contemporaneousness

- ♦ A two or three week delay in payment did not defeat the contemporaneous nature of the exchange. *Pine Top Ins. Co. v. Bank of America National Trust and Savings Assoc.*, 969 F.2d 321 (7th Cir. 1992).

- A check is considered transferred for the purpose of the new value exception on the date that the creditor receives the debtor's check, as long as the debtor's bank subsequently honors the check. *In re Transport Associates, Inc.*, 171 B.R. 232 (Bankr. W.D. Ky. 1994).

- A check must be deposited within a reasonable amount of time after receipt to be considered a contemporaneous exchange for new value. *In re Plaza Hotel Corp.*, 111 F.3d 220 (1st Cir. 1997).

- A replacement check to make good on a bad check is not a contemporaneous exchange for new value. *In re Old Electralloy Corp.*, 32 B.R. 705 (Bankr. W.D. Pa. 1991).

- The receipt of a post-dated check was not a contemporaneous exchange. *In re New York City Shoes, Inc.*, 880 F.2d 679 (3rd Cir. 1989).

- Forbearance on going forward with a lawsuit did not qualify as contemporaneous new value under Section 547(c)(1). *In re Aero-Fastener, Inc.*, 177 B.R. 120 (Bankr. D. Mass. 1994).

B. *The Ordinary Course of Business Exception*

Section 547(c)(2) provides for the ordinary course of business exception. Pursuant to this section, the trustee may not avoid as a preference a transfer:

(2) to the extent that such transfer was—
(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
(C) made according to ordinary business terms.

This exception incorporates three elements:

(1) The debt must be in the ordinary course of both the debtor's and creditor's businesses;

(2) The payment must be in the ordinary course of both the debtor's and creditor's businesses; and

(3) The payment must be made in accordance with ordinary business terms.

There is no precise legal test to determine if a transaction falls within the ordinary course of business exception. *In re Fulghum Construction Corp.,* 875 F.2d 739 (6th Cir. 1989). Rather, the analysis is fact intensive. *Id*. Generally, the court will look at several factors, including timing and the amount and manner of transaction payment, and the circumstances under which the transfer was made, including industry practices. *In re Yurika Foods Corp.*, 888 F.2d 42 (6th Cir. 1989). Below are case law annotations which address the issues relating to the ordinary course of business exception.

- The court will consider the debtor's history of making late payments to determine if the transaction was in the ordinary course of business. *In re Ajayem Lumber Corp.*, 145 B.R. 813 (Bankr. S.D.N.Y. 1992).
- Late payments must constitute the norm rather than the exception to be considered in the ordinary course of business. *In re Cook United, Inc.*, 117 B.R. 884 (Bankr. N.D. Ohio 1990).
- The ordinary course of business analysis requires an examination of the practices of the particular parties, not the generally prevailing industry standards. *In re Graphic Productions Corp.*, 176 B.R. 65 (Bankr. S.D. Fla. 1994).
- A debtor may incur long-term debt in its ordinary course of business. *In re Marlene M. Finn*, 909 F.2d 903 (6th Cir. 1990).
- Customary credit transactions are generally considered within the ordinary course of business. *In re Fulghum Construction Corp*, 875 F.2d 739 (6th Cir. 1989).
- Overdraft protection was a transaction that occurred within the ordinary course of business. *Id.*

C. *Enabling Loan Exception*

The enabling loan exception is found in Section 547(c)(3). This exception can be broken down into the following four elements:

(1) The creditor gives "new value" to the debtor to acquire certain real or personal property;

(2) The debtor gives the creditor a security interest in the property, by signing a security agreement;

(3) The debtor <u>in fact</u> acquires the property using the "new value"; and

(4) The creditor perfects the security interest within twenty days after the debtor receives possession of the property.

The enabling loan exception was enacted to protect creditors who lend money to "enable" financially distressed debtors to acquire rights in real or personal property. Since the debtor cannot acquire rights in the property until <u>after</u> it receives the enabling loan (i.e. an antecedent debt), this type of transaction is, by definition, a preference. Therefore, the enabling loan exception contained in Section 547(c)(3) prevents the trustee from attacking this type of transaction as a preference.

D. *<u>Subsequent Transfer of New Value Exception</u>*

The subsequent transfer of new value exception is found in Section 547(c)(4). This exception is implicated only after a creditor already has received a preference which is not unavoidable under any other exception. This exemption serves to offset the creditor's prior preferences with any subsequent unsecured credit supplied to the debtor by that creditor. The subsequent transfer of new value exception is applicable if the following three requirements are met:

(1) The creditor received a preference which is unavoidable under any other exception;

(2) After receiving the preference, the creditor advances additional unsecured credit to the debtor; and

(3) The additional credit must be unpaid, in whole or in part, on the date the petition was filed.

If all these requirements are met, the preference is offset to the extent of the new value the creditor extended to the debtor.

CONCLUSION

While it is never desirable to be named as a defendant in a preference lawsuit, several defenses may protect creditors from liability. The foregoing exceptions are the most utilized defenses to preference actions by creditors. As is evident by the various tests and the supporting case law, these defenses are often fact specific and depend upon the particular factual circumstances of the case. An experienced bankruptcy attorney can assist you in identifying and evaluating your potential preference defenses.

EXHIBIT "A" – SAMPLE RECLAMATION LETTER

March 8, 2002

VIA FACSIMILE AND FEDERAL EXPRESS

Joseph Cogswell, President and CEO
Cogswell Cogs Company
201 N. LaSalle Street
Chicago, Illinois 60601

Re: Reclamation of Goods of Spacely SS, Inc. ("Spacely")

Dear Mr. Cogswell:

Please be advised that pursuant to Section 2-702 of the Uniform Commercial Code, Section 546 of the United States Bankruptcy Code, 11 U.S.C. §§ 101 *et seq*., and other applicable law, you are hereby notified that Spacely reclaims all of the goods described in the Schedule attached hereto (collectively, the "Goods"). Please call the undersigned to arrange for the immediate return of the Goods. In the interim, please segregate the Goods and provide us with written confirmation that the Goods are on your premises.

Spacely hereby expressly reserves every right, power, remedy, claim and defense now or hereinafter existing at law, in equity or by statute, and the exercise or non-exercise of any such right, power, remedy, claim or defense shall not be construed as a waiver of the right to exercise, at the same time or thereafter, such right, power, remedy, claim or defense.

Very truly yours,

Eric S. Prezant

ESP/jr
Enclosures