

*Reclamation Rights in Bankruptcy  
What Every Credit Manager  
Needs to Know  
By: Schuyler G. Carroll, Esq. &  
George Angelich, Esq.*

***Abstract***

Vendors of goods regularly extend business credit to customers. However, when a customer becomes a chapter 11 debtor, it is up to the credit manager to assess options, reduce risk and improve the chances of getting paid. One of the tools available to credit managers is the right to “reclaim” goods shipped to a customer in financial distress.

Chapter 11 debtors present credit managers with a unique problem: how do you receive payment for pre-petition claims without violating the Bankruptcy Code? Reclamation is an important tool to assist vendors in getting their pre-petition claims paid. The commonly understood definition of reclamation is that it is a way for vendors to retrieve their goods or otherwise stop delivery. Its benefit is limited, however, as we will discuss in this article.

For bankruptcy cases filed after October 17, 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “2005 Amendments”) changed the law of reclamation and strengthened creditors’ rights. Vendors now have greater tools available than ever before with fewer hoops to jump through.

State law provides vendors a right of reclamation, but once a customer files for bankruptcy, vendors must look to their rights under the United States Bankruptcy Code. The Bankruptcy Code grants vendors the right to reclaim products that are delivered to a chapter 11 debtor within a specified timeframe. Trade creditors may be entitled to reclaim the actual goods or the value of those goods.

This article provides an overview of an evolving area of bankruptcy law in order to equip credit managers with the tools for maximizing the opportunity to get paid from a chapter 11 debtor.

## **The 2005 Amendments Provides Credit Managers Two Options**

The 2005 Amendments reinforces the rights of vendors with reclamation claims through two (2) key provisions.

First, the 2005 Amendments permits vendors to make a written reclamation demand for goods transferred to a debtor in the 45-days immediately preceding the chapter 11 debtor's bankruptcy filing. If the 45 day period expires after the bankruptcy filing, the vendor is given an additional 20 days to make a demand (thereby potentially giving the vendor up to 65 days to recovery goods). Vendors who sell goods that have a slower turnover rate will benefit from this extended timeframe. This section of the amendments, Section 546(c), is viewed as creating a new right under federal law to reclaim goods.

Second, the 2005 Amendments created new rights to payment for reclamation creditors even if they do not make a written reclamation demand within the 45 day period. The 2005 Amendments grants vendors the right to receive an administrative expense claim for the value of goods delivered within 20 days prior to the debtor's petition date, so long as the goods were sold in the ordinary course of business.

These new provisions enhance creditors' rights by expanding the scope of existing rights and effectively providing creditors the choice of obtaining return of their goods or receiving an administrative expense claim for the value of the goods the debtor received during the 20 days prior to the debtor's bankruptcy petition date.

Creditors have the option of demanding that the debtor-in-possession return the goods or receive an administrative expense claim which must be paid on par with other post-bankruptcy expenses, such as legal fees. Since most vendors will prefer cash instead of return of the goods, let us explore how quickly vendors really can get their cash and whether there are any obstacles, differences or rights that might warrant seeking return instead of payment. Do vendors have to wait for plan confirmation – which can take months or even years – in order to receive payment for goods delivered in the 20 day period? Credit managers need to carefully evaluate their options and whether they seek to reclaim their goods or elect to receive an administrative expense will depend on a number of factors including the size of their claim. But the 2005 Amendments are new and it is yet unclear how these provisions will be interpreted.

## **Overview of Bankruptcy Payment Priority Structure**

The 2005 Amendments grant vendors an administrative expense claim for certain shipments. To understand the importance of what this special status means, it is important to review the hierarchy of bankruptcy claims and who gets paid and why.

Pursuant to the 2005 Amendments, a debtor must pay reclamation claims in full because they are "administrative" in nature. The timing of when these claims must be paid is not set forth in the 2005 Amendments (and as explained below courts are still using pre-2005 Amendment case law to decide when administrative claims should be paid and therefore leaving the timing issue up to judicial discretion).

The Bankruptcy Code categorizes claims in three main groups: (i) secured claims, (ii) priority and (iii) general unsecured claims. All claims are subject to the priority structure set forth in Section 507 of the Bankruptcy Code.

First, “secured claims” are obligations secured by a lien on property. Secured creditors get paid from the proceeds of this property. Typical examples are home mortgages or a bank that lends to a company in exchange for a lien on all the company’s assets.

Second, “unsecured claims” are either priority or general unsecured. Claimants holding priority unsecured claims are generally taxing authorities. On the other hand, general unsecured claims (which typically includes most trades and vendor claims) receive the most junior treatment under the bankruptcy priority scheme. Consequently, pre-petition vendors of goods likely will only get paid after secured and priority creditors are paid in full, unless vendors obtain administrative expense priority status.

The Bankruptcy Code (both before and after the 2005 Amendments) grants the highest level of priority to those claims known as “administrative expenses”. The 2005 Amendments expanded this priority to include the value of shipments delivered to a debtor during the 20 day period before a bankruptcy filing.

### **Pre-2005 Amendments Recovery Strategy**

Prior to the 2005 Amendments, vendors would only have a general unsecured claim unless they sought to enforce their state law reclamation rights in bankruptcy court. The vendor would have to seek return of goods by sending a written demand for reclamation within 10 days of the debtor’s receipt of the goods, or, if the 10 day period had not elapsed as of the bankruptcy filing, the vendor was allowed 20 days from the date of receipt of the goods.

This substantive right of reclamation was not found within the Bankruptcy Code; rather, state law applied – specifically, Section 2-702 of the Uniform Commercial Code. There were several limitations, however. For example, Section 2-702 reclamation rights are subject to the rights of “good faith purchasers” which – typically included a secured lender who had a lien on inventory – thus, wiping out any chance to assert reclamation claims in the majority of cases.

Debtors attempted to prevent reclamation litigation and maintain vendor relationships. Consequently, debtors often sought bankruptcy court approval to pay the pre-petition claims of so-called “critical vendors” in order to maintain the supply chain.

This practice was the subject of widespread criticism and fell into disfavor when a Federal Appeals Court rejected it in *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004). This decision brought to the forefront a growing debate within the financial restructuring community over whether there was a genuine legal justification to permit the practice of “critical vendor” motions.

## The 2005 Amendments In Focus

There are two key provisions credit managers must be familiar with: Section 546(c) “Federal Reclamation”; and Section 503(b)(9) “Reclamation Administrative Expense”.

**“Federal Reclamation” Section 546(c):** This Section arguably creates a right to reclamation that is separate and apart from the state law of reclamation. Prior to the 2005 Amendments, vendors could only assert rights under state law, namely, those found in Section 2-702 of the Uniform Commercial Code. The 2005 Amendments modified Section 546(c) so that now a vendor of goods may reclaim goods sold during the 45 days before the petition date so long as the goods were sold in the ordinary course of business. What is not clear is whether the definition of “ordinary course of business” could affect any potential avoidance litigation.

Vendors must still make a written demand for reclamation. However, vendors now have 45 days after the debtor received the goods to make the demand, or, 20 days post-petition if the 45 day period expires after the debtor files its bankruptcy petition.

Unfortunately, however, Section 546(c) was also amended to explicitly state that reclamation rights are “subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof”. This specifically continues the limitations of the “good faith purchaser,” so that vendors’ rights are still behind any lien of a lender.

At the same time, Congress also deleted an important protection which expressly required bankruptcy courts to grant vendors an administrative or secured claim if it denied a vendor’s request to reclaim goods.

Amended Section 546(c) has already generated a bankruptcy court opinion from Delaware. In *In re Advanced Marketing Services, Inc.* the bankruptcy court denied a vendor’s request to issue a temporary restraining order to enjoin a debtor from selling the vendor’s goods. The vendor argued that the amendment to Section 546(c)(2) (which as explained in the preceding paragraph deleted a vendors right to an administrative expense if reclamation was denied by the court) provided a statutory right to the goods which needed to be enforced by court order or else the right would be denied. The Court held that the vendor did not have a strong probability of success on the merits and denied the temporary restraining order because the debtor’s pre and post-petition lenders liens were superior to the vendor’s reclamation claim.

This decision is important because it signals that prior case law on the effect of pre-petition liens on inventory remains in effect, notwithstanding the deletion of the alternatives provided in pre-2005 Amendment Section 546(c)(2).

**Section 503(b)(9) “Reclamation Administrative Expense”:** This section grants vendors an administrative expense claim in certain circumstances. As explained above, administrative expenses occupy a senior position in the order of payments of claims. Under pre-2005 bankruptcy law, vendors with reclamation claims were treated as general unsecured creditors unless their request for reclamation was expressly denied by the bankruptcy court and specifically granted administrative expense status.

In order to receive an administrative expense under Section 503(b)(9), vendors can seek the “value of any goods [sold to a debtor in the ordinary course of business] received by the debtor within 20 days before commencement of the case”.

The right to administrative expense treatment is – despite appearances – not automatic. Rather, vendors’ administrative expenses will be allowed after “notice and hearing”. Thus, although a written reclamation demand is not necessary, the right to an administrative expense requires some act and apparent judicial intervention before being allowed.

It is important to note that Congress did not give vendors the same 45 day period that is available under Section 546(c). Debtors and vendors may disagree on several components to this standard. For example, there will likely be disagreement over the “value” of “goods” and whether the goods were sold “in the ordinary course of business”.

Section 503(b)(9) does say anything about when these administrative expenses must be paid. Two recent decisions denied vendor’s attempts to compel debtor to pay reclamation administrative claims. These decisions show that the 2005 Amendments have not caused courts to accelerate the timing of payment of reclamation claims. All administrative claims are required to be paid in full as a condition to confirming a chapter 11 plan. Consequently, debtors will require more cash in order to pay reclamation claims during a case or upon confirmation, but it is unlikely vendors can force a debtor to pay the claims anytime sooner. At the end of the case, vendors and lenders will be placed in competing positions because the funds used to pay reclamation claims will reduce dollar for dollar the funds available to pay lender claims if a plan is proposed.

## **Telltale Signs Your Customer Is In Trouble**

As explained above, debtors will need more time to plan their bankruptcy filings in light of the 2005 Amendments. Typically, bankruptcy preparation is done in plain sight of creditors, for example, your customer’s check bounces; there is a change in your customer’s payment habits; financial losses; your company’s sales force report problems; lawsuits commenced for failure to pay taxes or other vendors; and several other more subtle indicators that we frequently see from company’s that are losing market share or control over their financial condition.

## **Protecting Your Rights**

A proactive approach to dealing with customer problems can mitigate exposure and potential losses arising from a bankruptcy filing. But even the most vigilant vendors will have some exposure when a customer files for bankruptcy. To navigate the post-petition world, vendors should immediately identify and segregate the invoices for goods shipped during the 45 day reclamation period. Because of the complexities of these issues, it often will make sense to retain counsel.

If you decide to reclaim the goods, a written demand is needed. If you conclude that recovering an administrative expense would be more appropriate you should consider filing an administrative expense claim for your reclamation claim. Even though this is not specifically required by the 2005 Amendments, if you do not file, you can be sure that no one is going to call

and ask if you want to assert a claim. In addition, you may need to follow up the proof of claim with a motion demanding payment.

Reclamation creditors need to also be aware that the debtor's post-petition financing may place limitations and restrictions on the payments of these claims. It may therefore be necessary to make an early appearance in the case to oppose restrictive financing provisions. Otherwise, your ability to be paid on a reclamation claim could be seriously limited by court order. For vendors with large claims, it may make sense to oppose these types of limitations. Vendors with smaller claims could potentially band together to form a committee to represent the interests of reclamation claimants and argue that reclamation claims be specifically carved out and paid at the outset of the case.

Finally, in those instances where debtors seek to pay administrative expenses following a demand, it may be strategically beneficial to work out a deal whereby the debtor waives any preference claims.

## **Conclusion**

The requirement to pay administrative expenses prior to confirmation places substantial pressure on chapter 11 debtors to fund reclamation claims. Debtors may need to engage in pre-bankruptcy planning to hedge against the possibility that on the day they file they are rendered administratively insolvent – or have no products to sell – due to vendors' reclamation rights. Consequently, with additional pre-confirmation funding requirements, some debtors will face new hurdles to a successful reorganization.

The additional funding pressures placed on debtors to pay vendor claims could lead to the failure of many chapter 11 cases that have a lot of potential reclamation claims. If chapter 11 failures rise because of reclamation rights, vendors could find themselves receiving insignificant distributions – even on their administrative reclamation claims.

Courts, vendors, lenders and debtors will need to strike a balance between satisfying pre-petition vendor claims in accordance with the 2005 Amendments and the financial condition of a chapter 11 debtor. Debtors came up with complex justifications in support of "critical vendor" motions. In most circumstances, it is no longer necessary for debtors to make these types of motions because the 2005 Amendments allows debtors to make payments. It is now incumbent upon vendors to seek payment and become actively involved in the early phases of a bankruptcy case.

***Schuyler G. Carroll is a partner and George Angelich is an associate, practicing in the Financial Restructuring and Bankruptcy Group in the New York office of Arent Fox LLP. Arent Fox is a full-service law firm with a national practice. For information about our lawyers, visit our website at [www.ArentFox.com](http://www.ArentFox.com).***