

Reclamation Rights And Federal Bankruptcy Law



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Reclamation rights are now enhanced under Federal Bankruptcy Law, but there is some uncertainty about their allowance under section 503 of the Bankruptcy Code.

FOR BUSINESSES that sell goods, reclamation rights play an important role in protecting a client's right to receive payment on goods delivered in the ordinary course of business. Using its reclamation rights, when the seller discovers the buyer to be insolvent, it may take back its product or refuse delivery of goods notwithstanding the contract between the parties. These rights are especially important in a bankruptcy case, where a seller's inventory may be folded into the general bankruptcy estate, leaving the seller with nothing more than a general unsecured claim. At that point, a seller will likely wait months (maybe years) for a substantially reduced payment, if anything at all. However, if a seller of goods retains its right to reclaim its goods, those rights will be recognized and (somewhat) preserved in a bankruptcy proceeding.

For the purposes of this article, we will take as a starting point the Uniform Commercial Code's definition of reclamation, as adopted by numerous states. *See, e.g.*, the California Commercial Code §2702.1. Under the Uniform Commercial Code, a seller's reclamation rights are set forth in §2-702.1, which states:

- “(1) Where the seller discovers the buyer to be insolvent he may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery under this division
- (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. Except as provided in this subdivision 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.
- (3) The seller’s right to reclaim under subdivision (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser under this division [section 2403]. Successful reclamation of goods excludes all other remedies with respect to them.”

Generally speaking, under the Uniform Commercial Code, once a seller of goods discovers a buyer to be insolvent, he may refuse to deliver goods except for a cash payment or, if the buyer received goods on credit, the seller may take back his goods upon a timely written demand.

THE INTERPLAY BETWEEN RECLAMATION AND FEDERAL BANKRUPTCY LAW

• Federal bankruptcy law recognizes a seller’s right to reclamation, and these rights were enhanced in the 2005 amendments to the Bankruptcy Code under the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). Under its current incarnation, there are two code provisions dealing with reclamation rights: 11 U.S.C. sections 546(c) and 503(b)(9) (unless otherwise noted, all statutory references refer to Title 11 of the United States Code).

Section 546

Section 546 generally limits the rights of a bankruptcy trustee to avoid certain kinds of transfers. These types of transfers are commonly referred to as preferences or fraudulent transfers. With respect to a seller of goods, section 546(c) limits a bankruptcy trustee’s right to take back goods when a seller properly exercises its right to reclamation. In order to qualify for this exception, the seller must have sold the goods to the debtor in the ordinary course of business, the debtor received the goods when the debtor was insolvent, and within the 45 days before the debtor filed for bankruptcy protection. In addition, the seller must make a timely written demand for reclamation within 45 days after the debtor receives the goods, or 20 days after the debtor files for bankruptcy if the 45-day period expired before the bankruptcy filing. Under these conditions, a seller does not need to give back goods it recovered or money it received when it properly exercised its reclamation rights under state law.

Section 503

BAPCPA added extra protections to sellers of goods. Even if the seller failed to provide timely written notice, a seller of goods may be entitled to an elevated priority position for payment from the bankruptcy estate under section 503(b)(9). In order to understand the significance of this provision, one must first understand how claims and expenses are paid in a bankruptcy proceeding. In a bankruptcy case, creditors are paid by the priorities set forth in the Bankruptcy Code. The priority scheme works as a “waterfall,” in which a higher priority must be paid in full before money can flow to the next lower priority. In addition, bankruptcy law requires administrative expenses to be paid in full on the effective date of a plan of reorganization unless the administrative creditor agrees otherwise, as opposed to other lower priority creditors who most likely will wait to receive money from the estate and

over a longer period of time. 11 U.S.C. §1129(a)(9). Generally speaking, the priorities go in this order:

- Administrative expenses, which normally accrue after the filing of a bankruptcy case;
- Priority creditors;
- Unsecured creditors;
- Equity holders.

(Secured creditors are entitled to look to their collateral. Additionally, there are specifically delineated priorities within each general category not discussed here.)

Administrative Expenses

Section 503(b)(9) provides for the allowance of administrative expenses (the highest category) for reclamation claims for the value of goods sold in the ordinary course to a debtor during the period 20 days prior to the petition date. (While this claim is in the highest priority category, it is not the highest claim in this class.) BAPCPA added section 503(b)(9), which represents Congress' deliberate and focused expansion of the bankruptcy estate's administrative expenses. *See Southern Polymer, Inc. v. TI Acquisition, (In re TI Acquisition, LLC)*, 410 B.R. 742, 746 (Bankr. N.D. Ga. 2009). As the court observed in *In re TI Acquisition*:

“The treatment of expenses in §503(b)(9) appears to be an outgrowth of the policy that first appeared in 11 U.S.C. §546(c), which preserved the right of reclamation to certain sellers of goods on credit; BAPCPA included both the addition of §503(b)(9) and the amendment of §546(c). The combination of these changes suggests that Congress intended to recognize a reclamation right for sellers that was no longer exclusively dependent upon state law. Alternatively, and at a minimum, these two changes to the Bankruptcy Code expanded certain aspects of state law reclamation. *See In re*

Dana Corp., 367 B.R. 409 (Bankr. S.D.N.Y. 2007) (rejecting the creation of an independent federal right); Collier on Bankruptcy ¶ 546.04[2] (15th rev. ed.) (explaining that the amendment's deletion of the language “any statutory or common law” could serve no purpose if not to uncouple bankruptcy right of reclamation from state law). Prior to BAPCPA, §546(c) provided for an administrative priority claim for reclaiming sellers who were denied a right of reclamation by the court. BAPCPA deleted that portion of §546(c)(2) and added §503(b)(9), thus according protection to sellers of goods on credit in the period immediately preceding the filing of a bankruptcy petition, regardless of whether the technical requirements for reclamation were met. *While no legislative history exists, one can only surmise that these amendments reflect Congress' intent to better insure that ordinary course of business sellers of goods received by the debtor in the twenty days before the petition date gain priority in payment over most other creditors.”*

In re TI Acquisition, supra, 410 B.R. at 745-46 (emphasis added).

As such, these administrative expenses, which arise within 20 days before the petition date, are not of the same nature as pre-petition general unsecured claims. Congress has elected to treat section 503(b)(9) claims exactly like other administrative claims of the estate arising out of section 503(b). Although a recently enacted code section, several courts have already been forced to analyze the applicability of section 503(b), including whether or not this kind of elevated claim can be temporarily disallowed.

Can The Priority Claims Be Disallowed?

As noted above, section 546(c) deals with limits on a trustee's right to avoid certain transfers. In addition to formal litigation rights to affirmatively recover an avoided transfer, a bankruptcy trustee may also seek to *stop* payment from the estate to the creditor of an otherwise allowable claim *if* the claimant owes the estate money on account of receiving an avoidable transfer (e.g. a preference or fraudulent transfer). 11 U.S.C. §502(d). This type of objection is significant. Not only can it prevent a creditor from receiving a distribution that it is admittedly owed from the bankruptcy estate, it can prevent the creditor from voting on a plan of reorganization or otherwise paralyze a creditor from asserting its rights in a bankruptcy case. The question as it applies to reclamation claims is whether a bankruptcy trustee can assert this type of objection to the newly elevated administrative expense claim for reclamation under 11 section 503(b)(9). If successful, although a holder of an administrative reclamation expense claim should be paid on the effective date of a plan of reorganization, if that creditor received a preference or fraudulent transfer, it will be at least temporarily deprived of the payment on its claim. It may also deprive the administrative expense holder the right to vote on a plan of reorganization which in turn, will allow other creditors to decide the fate of a chapter 11 plan of reorganization, perhaps to your client's detriment.

The case law on this matter is inconclusive, as courts dealing with this issue have acknowledged the inconsistencies in answering the question. Some of prevailing recent cases on the issue are summarized below:

- *In re Ames Department Stores, Inc.*, 582 F.3d 422 (2nd Cir. 2009). The Second Circuit held, in an issue of first impression in that Circuit, that section 502(d) does not bar the allowance of administrative expenses within the scope of section 503(b) (e.g. administrative expenses).
- In addressing the issue, the court dissected the specific language of section 502 and 503, noting that the “language of §502(d) suggests that it applies only in the context of section 502, and not to claims addressed by §503. ... The express invocation of § 502(d) suggests that the section did not already apply to such claims before they were brought within §502's reach, and that it does not apply to post-petition claims remaining outside 502, such as the requests for administrative expenses addressed by 503(b).” The court went on further to note that “the mandatory terms in which §503(b) is drafted, requiring courts to allow requests for administrative expenses, suggest a conflict with §502(d)'s equally mandatory disallowance of claims.” The *Ames* opinion is the only Circuit level decision to date to address the issue, and since it was published, many courts and practitioners have engaged in a debate about the applicability of this case for a number of reasons. This includes a distinction between administrative expenses and claims and that most administrative expenses arise after the commencement of a bankruptcy case. However, part of the debate relates to the fact that reclamation claims under 11 U.S.C. section 503(b)(9), by their very nature, occur within 20 days before the bankruptcy filing;
- *MicroAge, Inc. v. Viewsonic Corp. (In re MicroAge, Inc.)*, 291 B.R. 503 (9th Cir. BAP 2002). The Ninth Circuit Bankruptcy Appellate Panel in *MicroAge* ruled that section 502(d) can be used by a bankruptcy trustee to disallow administrative expenses under section 503(b) finding that legislative history indicates that section 502(d) applies to all claims, including those arising under section 503(b) and that an administrative expense is also a “claim.” Addressing the issue as a matter of first impression for the Ninth Circuit, the court noted that “[n]othing in the plain language of section 502(d) limits its application to prepetition claims. Section 502(d)

by its terms applies to ‘any claim’ of an entity that received an avoidable transfer, and the definition of a ‘claim’ in §101(5) is sufficiently broad to include requests for payment of expenses of administration. [] Further, there is no introductory language in §502 that limits the application of the subsections that follow to claims for which proofs of claim must be filed or prepetition claims.” *Id.* at 508. Although this case is strong precedent in the Ninth Circuit, other courts have distinguished the ruling in this case, holding that this represents a minority view not adopted by other courts. *See e.g., In re Circuit City Stores, Inc.*, 426 B.R. 560, 569 (Bankr. E.D. Va. 2010) (noting a “minority of courts have adopted the contrary position and read the definition of “claim” in §101(5) as broad enough to cover administrative expenses”); *In re Plastech Engineered Prods.*, 394 B.R. 147, 157 (Bankr. E.D. Mich. 2008) (noting in “contrast to *MicroAge* there are a number of bankruptcy court decisions that have held that the disallowance provision of §502(d) does not apply to §503(b) administrative expenses”);

- *In re Plastech Engineered Products, Inc.*, 394 B.R. 147 (Bankr. E.D. Mich. 2008). *Plastech* was the first published opinion following BAPCPA to discuss the applicability of section 502(d) to an administrative claim for reclamation under section 503(b)(9). This court rejected the rationale of *MicroAge* and reasoned that there was a distinction between an “administrative expense” and a “claim.” It held that a section 502(d) objection cannot be used to disallow an administrative expense under section 503(b)(9). The court acknowledged the new set of issues that debtors would face in determining the applicability of section 503(b)(9) and how the case law had yet to scratch the surface in clarifying these issues. Specifically, the court noted, for example, that “[t]he cash needs for a debtor trying to exit chapter 11 by confirming a plan of re-

organization are now significantly greater than pre-BAPCPA. This is because of the plan confirmation requirement in section 1129(a)(9)(A) that all administrative expenses be paid in full on the effective date of a plan. A debtor may no longer confirm a plan that provides for payment over time or partial payment for the value of goods received in the debtor’s ordinary course of business and received within 20 days before the petition date over the dissent of the holders of such debts. Instead, a debtor must pay those debts in full on the effective date of the plan. In addition to creating a large and potentially insurmountable cash hurdle for a debtor to confirm a plan, section 503(b)(9) also results in significant differences in the treatment of prepetition debts of creditors who otherwise appear to be similarly situated. *Id.* at 151. After an in-depth analysis of the conflicting case law regarding the interplay between section 502 and section 503, the court, in adopting its decision, focused on six factors. First, the court agreed with the cases holding that the allowance of claims under section 502 is entirely separate from the allowance of administrative expenses under section 503. Second, the court noted the procedural differences if requests for payment of administrative expenses expressly filed under section 503(a) and “claims” filed under section 501. The court noted that it “[did] not conclude that a §503(b)(9) administrative expense cannot be a ‘claim.’ Instead, the Court [found] that a §503(b)(9) administrative expense is simply not a type of claim that is filed under §501, and allowed or disallowed under §502.” Third, the Court reconciled the meanings of section 502(d) and section 503(b) as to avoid collision between the provisions, noting “[t]here [was] no conflict between the mandatory allowance of claims under §502(a) and (b), and the mandatory disallowance of claims under §502(d)... [because the] mandatory disallowance provi-

sion of §502(d) applies only to those claims governed by the claims allowance process under §502. The mandatory allowance provision of §503(b) applies only to administrative expenses and nothing else.” *Id.* Fourth, the court found that section 503(b)(9) should be interpreted as just another example of Congress defining a specific type of pre-petition obligation that it determined should be afforded administrative expense priority treatment, despite it being a potentially larger claim than other provisions set forth in section 503(b). Fifth, the court found that there is no special distinction between section 503(b)(9) administrative expenses from other section 503(b) administrative expenses. Sixth, the Court found Congress did intend to make section 503(b)(9) a “special class” and if intended to do so could have done so by statute, by not doing so, Congress placed section 503(b)(9) administrative expenses beyond the reach of section 502(d);

- *In re TI Acquisition, LLC*, 410 B.R. 742 (Bankr. N.D. Ga. 2009). As set forth above, like *Plas-tech* and following its lead, the court ruled that a section 502(d) objection is not available to object to an administrative expense under section 503(b)(9);
- *In re Circuit City*, 2010 WL 56076 (Bankr. E.D. Va. 2010). The Virginia bankruptcy court recently reviewed the various cases cited above (and others). It followed the *MicroAge* Court’s reasoning and found that a section 502(d) objection was available to a bankruptcy trustee to temporarily disallow an administrative expense under section 503(b)(9). In its decision it noted that “Courts are split on the issue of whether or not §502(d) can be read to apply to claims for administrative expense. The majority of courts have held that §502(d) is generally not applica-

ble to §503(b) claims. A minority of courts have adopted the contrary position and read the definition of “claim” in §101(5) as broad enough to cover administrative expenses. *Id.* at 569 (internal citations omitted). The Court held, relying on the Fourth Circuit precedent in *Durham*, that section 502(d) may be used to temporarily disallow section 503(b)(9) claims and to bar claims filed under section 501. Specifically, the Court noted in its holding that Rules 3002 and 3003 of the Federal Rules of Bankruptcy Procedure mandate that all creditors must file proofs of claim pursuant to section 501(a). By definition, section 503(b)(9) “claims” arise within the 20 days before the petition date. This means that claimants, as holders of section 503(b)(9) claims, are creditors as defined in section 101(10)(A). As creditors, claimants must file a proof of claim under section 501(a). Therefore, section 502(d) may be used to temporarily disallow the claims filed under section 501(a) up to the amount of the alleged preferential transfers;

- *In re Commissary Operation, Inc.*, (unpublished opinion) USBC Case No. 3:09-ap-00280, docket number 13. On the same day that the Virginia Court issued its Memorandum Opinion in the *Circuit City* case, the Tennessee bankruptcy court issued its Memorandum Opinion and ruled on slightly different grounds that section 502(d) could not be used to disallow a claim under section 503(b)(9).

CONCLUSION • Given the conflicting opinions on this issue, it is possible that this question will be reviewed by the United States Supreme Court within the next few years. Until that time, practitioners must be aware that this issue is evolving quickly and decided differently in each court.