



## RECLAMATION RIGHTS AFTER BAPCPA: 11 U.S.C. §§ 546(a) AND 503(b)(9)

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Prior to the effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Bankruptcy Code §546(c) restricted the bankruptcy trustee's ability to assert his or her strong-arm and avoidance powers against a seller of goods with "any statutory or common-law right" to reclaim such goods. For example, where a seller discovers that the buyer has received goods on credit while insolvent, §2-702 of the Uniform Commercial Code (UCC) allows the seller to "reclaim" goods by demanding their return within 10 days after the buyer received them.<sup>1</sup> The right of reclamation under UCC §2-702 is explicitly subject to the rights of a buyer in the ordinary course of business or a good-faith purchaser. *See In re Pester Ref. Co.*, 964 F.2d 842, 845 (8<sup>th</sup> Cir. 1992) ("Since most secured creditors are good faith

<sup>1</sup> U.C.C. § 2-702 provides:

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### **Seller's Remedies on Discovery of Buyer's Insolvency**

(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 Article (Section 2-705).

(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 in writing 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.

(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 (Section 2-403). Successful reclamation of goods excludes all other remedies with respect to them.

purchasers under the UCC, [§ 2-702] has the effect, in priority terms, of placing the reclaiming seller behind the insolvent buyer's secured creditors who have security interests in the goods, but ahead of the buyer's general unsecured creditors.... This prioritizing is consistent with the historic roots of the reclamation remedy.”). Traditionally, reclamation is a “rescissional remedy, based upon the theory that the seller has been defrauded. Indeed, at common law and under the Uniform Sales Act, the seller could only reclaim goods by proving that the buyer fraudulently induced delivery by misrepresenting its solvency.” *Id.* at 844.

Bankruptcy Code Section 546(c) allows U.C.C. § 2-702 to have the same effect in bankruptcy cases.<sup>2</sup> Under Section 546(c), prior to BAPCPA, the seller had to demand reclamation, in writing, before ten days after receipt of the goods by the debtor, or within 20 days after receipt if the 10-day period expired after the bankruptcy case had been commenced. The bankruptcy court could only deny a seller's right of reclamation if the seller was granted a priority claim under 11 U.S.C. § 503(b) or if the claim was secured by a lien.

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<sup>2</sup> Prior to the effective date of BAPCPA, Section 546(c) provided:

(c) Except as provided in subsection (d) of this section [pertaining to producers of grain and fishermen], the rights and powers of a trustee under sections 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 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 section 503(b) of this title; or

(B) secures such claim by a lien.

With the amendments from BAPCPA discussed below, more goods are now subject to the right of reclamation, and the addition of Section 503(b)(9) is likely to increase the number of administrative creditors and the total amount of administrative claims in certain bankruptcy cases. While the amendments provide greater, albeit more complicated, reclamation rights to sellers of goods, they may create additional hurdles in Chapter 11 reorganizations and hasten administrative insolvency in some cases.

### **Changes made by BAPCPA to Section 546(c)**

BAPCPA amended Section 546(c) by expanding the reach-back period during which goods are subject to reclamation from 10 days to 45 days, and the “grace period” during which their return may be demanded after the bankruptcy case has been filed has been changed from 10 days to 20 days.<sup>3</sup> The Section now states that this right is specifically “subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof.” The reference 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” was replaced by “*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” (emphasis added). Although the legislative history is silent on the

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<sup>3</sup> As amended by BAPCPA, Section 546(c) provides:

(c)(1) Except as provided in subsection (d) of this section and in section 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 sections 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—

(A) not later than 45 days after the date of receipt of such goods by the debtor; or

(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 section 503(b)(9).

subject, some courts have debated whether this change in language created a new, federal right to reclamation. *See, e.g., In re Incredible Auto Sales*, 2007 WL 927615 at \*6-7 (Bankr. D. Mont. March 26, 2007); *In re Tucker*, 329 B.R. 291, 298, n. 8 (Bankr. D. Ariz. 2005). This argument was considered and rejected by *In re Dana Corp.*, 2007 WL 1199221 (Bankr. S.D.N.Y. April 19, 2007).

***In re Dana Corp.***

In *In re Dana Corp.*, various parties who shipped goods to the debtor shortly before the bankruptcy filing asserted reclamation claims in the bankruptcy case. The aggregate amount of the goods exceeded \$297 million. Judge Burton R. Lifland valued the reclamation claims at zero because the existence of prior liens on the reclaimed goods rendered the “otherwise valid reclamation claims valueless and entitled to only general unsecured claim status.” 2007 WL 1199221 at \*2.

In *Dana* Judge Lifland followed *In re Dairy Mart Convenience Stores*, 302 B.R. 128 (Bankr. S.D.N.Y. 2003), in which Judge Arthur J. Gonzalez held that certain reclamation claims had no value in view of a secured lender’s previously existing floating lien over the debtor’s inventory. Thus, where the claim of a prepetition secured lender is to be paid from a floating lien on the debtor’s inventory, the sale of goods in satisfaction of that lien renders all reclamation claims for those goods valueless. 302 B.R. at 134. Judge Lifland observed in *Dana*: “Reclamation is an in rem remedy, and reclaiming sellers have no right to compel a lienholder to satisfy its claim from other collateral.... Accordingly, if the value of any given reclaiming supplier’s goods does not exceed the amount of debt secured by the prior lien, that reclamation claim is valueless.” 2007 WL 1199221 at \*8 (citations omitted). Judge Lifland distinguished *In re Phar-Mor, Inc.*, 301 B.R. 482 (Bankr. N.D. Ohio 2003) because the credit facility in that case

resulted in a release of the liens over the goods subject to the reclamation claim. The cases differed based upon the manner in which the pre-petition liens were satisfied. 2007 WL 1199221 at \*9. Like those in *Dairy Mart*, the goods subject to reclamation in *Dana*, “effectively were disposed of as part of the March 2006 repayment of the Prepetition Credit Facility” and the “lien chain continued unbroken.” 2007 WL 1199221 at \*9. *See also Advanced Mktg. Servs.*, 360 B.R. 421 (Bankr. D. Del. 2007) (denying reclamation claimant’s request under BAPCPA for temporary restraining order for reclamation because the goods were already subject to the lien of the senior pre- and post-petition lender).

As noted above, prior to the BAPCPA amendments, Section 546(c) stated that the avoidance powers were “subject to any statutory or common-law right of a seller of goods,” and BAPCPA amended the phrase to “subject to the right of a seller of goods.” The reclamation parties in *Dana* argued that this change to Section 546 created a federal right to reclamation, an argument rejected by Judge Lifland. Notwithstanding the changes added by BAPCPA, Section 546(c) remains a limitation on avoidance powers and not an independent federal right of reclamation. Judge Lifland observed:

[T]he limitation that the reclamation claimant’s right is “subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof” does not deal with the rights of other “purchasers” or “buyers” of goods whereas the U.C.C. specifically makes a seller’s reclamation right “subject to the rights of a buyer in ordinary course or other good faith purchaser.”

*Id.* at \*6 (footnote omitted). Thus, a reclaiming seller in a bankruptcy case would have rights superior to those of buyers in the ordinary course of business, lien creditors and good faith purchasers (parties to whom the seller’s reclamation right would be inferior under U.C.C. 2-702) except for the holder of a prior security interest (the only party mentioned in Section 546(c) as

having superior rights). *Id.* at \*6. “Clearly Congress could not have intended to permit reclamation of goods that have been sold to consumers or other good faith purchasers.” *Id.*

### **Section 503(b)(9)**

BAPCPA also amended Section 546(c)(2) to provide that: “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 section 503(b)(9).” Thus, “546(c) is no longer an exclusive remedy for a prepetition seller” *In re Dana Corp.*, 2007 WL 1199221 at \*2. Bankruptcy Code Section 503(b)(9) states that, after notice and a hearing, the court shall allow as an administrative expense, “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 by the debtor in the ordinary course of such debtor’s business.” Under Section 503(b)(9), even if a seller of goods fails to provide notice required under 546(c), the seller may still assert an administrative claim in the bankruptcy case equal to “the value of any goods received by the debtor within 20 days before the commencement of a case.”

Though *Dana* did not reach the issues presented by Section 503(b)(9), Judge Lifland noted:

With the introduction of Section 503(b)(9) priority, reclamation claims under amended section 546(c) have decreased importance because goods delivered to a debtor in the 20 days prior to bankruptcy will have automatic priority. Thus, reclamation rights are now mainly beneficial for goods delivered in 21 to 45 days prior to the bankruptcy filing under amended section 546(c). **However, with the expansion of the reclamation period, the likelihood of early administrative insolvency will increase, and debtor companies will need greater financial resources to reorganize.**

2007 WL 1199221 at \*10, n.5 (emphasis added). Section 503(b)(9) raises many issues, including the following:

1. **The method of valuation.** Section 503(b)(9) provides no guidance as to the proper standard for determining the value of the subject goods and does not prescribe the date on which the goods should be valued. For example, the amount of an administrative reclamation claim may increase or decrease significantly depending on whether the goods are valued on a retail, wholesale or liquidation basis, and on whether that value is measured as of the petition date or the hearing date.<sup>4</sup>

2. **How and when the claim may be asserted.** Section 503(b)(9) does not set a deadline for requesting an administrative claim. Issues will certainly arise as to whether, and under what circumstances, the right to assert an administrative claim under Section 503(b)(9) may be subject to a general claims bar date order.

3. **When the claim must be paid.** In *In re Global Home Prods.*, 2006 WL 3791955 (Bankr. D. Del. Dec. 21, 2006), the bankruptcy court denied a motion by an aluminum supplier for immediate payment of its Section 503(b)(9) administrative expense claim, exceeding \$200,000. The creditor argued that the aluminum had already been used by the debtor in manufacturing and generated significant post-petition revenues, which should be used to pay its administrative claim. *Id.* at \*2. The bankruptcy court noted that Section 503(b)(9) provides a rule of priority, but leaves the timing of the payment to the discretion of the Court. *Id.* at \*3. The creditor's demand for payment was denied because it would have adversely impacted the debtor's ability to borrow under the debtor-in-possession financing agreement. *Id.* at \*4. *See also Advanced Mktg. Servs.*, 360 B.R. at 424 (publisher brought adversary proceeding to reclaim goods and sought "immediate repayment" of administrative expense claims).

4. **Whether the claims must be paid at the same time as other priority and administrative expenses.** The bankruptcy court in *In re Bookbinders' Rest.*, 2006 WL 3858020 at \*1 (Bankr. E.D. Pa. Dec. 28, 2006) held that creditors are not entitled to immediate payment of the Section 503(b)(9) claim as a matter of law when the debtor had been paying other administrative expenses, such as postpetition trade debt. The court scheduled an evidentiary hearing to determine whether to compel payment of allowed administrative claim should be paid immediately, or at a later stage in the case. *Id.*; *see also Fashion Shop of Ky.*, 2007 WL 777852 (Bankr. W.D. Ky. March 14, 2007) (creditor objected to payment of interim compensation to debtor-in-possession's financial adviser prior to payment of its Section 503(b)(9) claim; court awarded compensation but withheld 20% of compensation to be paid upon final application).

5. **Disputes between reclamation creditors and secured lenders.** As noted in the cases discussed above, the limitation on the right to reclamation in Section 546(c) combined with the "consolation prize" of administrative claim status under Section 503(b)(9) has already created tension between secured lenders,

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<sup>4</sup> With regard to timing, one court has suggested that a literal reading of the phrase "before the date of commencement of a case" in Section 503(b)(9) would lead to absurd results because "goods received prepetition on the day of the filing of the petition would not give rise to an administrative claim but they would if received the preceding day." *In re Barbaran*, 2007 WL 973945 at \*4, n. 6 (Bankr. D. Colo. March 29, 2007) (interpreting consumer credit counseling requirement in 11 U.S.C. § 109(h)).

reclamation claimants, “critical vendors” and other administrative claimants – placing the debtor-in-possession and the courts at the center of the conflict.

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