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From the Bankruptcy Courts

Benjamin Weintraub* and Alan N. Resnick**

A SELLER'S RIGHT TO RECLAIM GOODS UNDER THE BANKRUPTCY CODE—A LOOK AT CURRENT CASES

The first thought that comes to an unpaid seller of goods upon obtaining information that a customer has become a debtor under chapter 11 of the Bankruptcy Code is to obtain a quick printout of the customer's record from the computer. The second thought is to ascertain how recently the company's goods were delivered to the debtor. A further thought comes to mind: Is there time to request a return of the goods? All of this is done with an eye to reclamation. Although it should be easy to ascertain these facts, the computer printout may not be current and invoices and delivery receipts may have to be checked.

Assuming that all data are immediately available, how easy is recovery for the seller? Although Congress anticipated that the enactment of the Bankruptcy Code would provide an easy answer to the problem of recovery for the seller, recent decisions indicate that a tortuous road still lies ahead for the credit

grantor. In particular, two recent cases which may be helpful in indicating some of the hazards which face the unpaid seller in an effort to recover the goods are *In re Flagstaff Foodservice Corporation*,¹ and *In re Contract Interiors, Inc.*²

Section 546(c) of the Bankruptcy Code (BC) contains an important limitation on the avoiding powers of the trustee or debtor in possession which is designed to benefit sellers who deliver goods to the debtor on credit shortly before the commencement of the bankruptcy case. That section subjects the trustee's rights and powers of avoidance "to any statutory right or common law right of a seller, in the ordinary course of such seller's business, of goods to the debtor to reclaim such goods if the debtor has received such goods while insolvent."³

There follows a significant "but"; namely, this right to reclaim is dependent upon the seller demanding "in writing reclamation of such goods before ten days after receipt of such goods by the debtor."⁴ Assuming

¹ BCD 120 (S.D.N.Y. 1981) (Babbitt, J.).

² 8 BCD 174 (E.D. Mich. 1981) (Brody, J.).

³ 11 U.S.C. § 546(c). The avoiding powers to which the section refers includes the trustee's status as a lien creditor (§ 544(a)), the power to avoid certain statutory liens (§ 545), the power to avoid preferences (§ 547), and the power to avoid postpetition transfers (§ 549).

⁴ 11 U.S.C. § 546(c)(1).

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such notice has been sent, the bankruptcy court has three alternatives:

- (1) It may grant the reclamation request and compel the return of the goods to the seller;
- (2) It may deny such reclamation and grant the claim of the seller a priority as an administrative expense; or
- (3) It may secure the seller's claim by a lien on the goods or on other property.⁵

Although all of these alternatives are disjunctive, it is conceivable that the bankruptcy court may grant a partial return of goods, a lien and/or an administrative expense as to such application. However, consistent with congressional intent to encourage rehabilitation of the debtor and since the goods usually are needed for continuation of the debtor's operation, the court will generally allow the debtor to keep the goods and grant the creditor an administrative expense priority.

In re Flagstaff Foodservice Corporation

The two cases mentioned above throw a good deal of light, as well as cast certain shadows, on the seller's ability to reclaim the goods. In the *Flagstaff* case, the debtor resold a portion of the goods and, therefore, no longer had possession of a portion of the goods on the day that it received the demand for reclamation. The reclaiming creditor commenced an adversary proceeding under Rule 701(1) of the Bankruptcy Rules of Procedure seeking reclamation and making the requisite demand as prescribed by Section 546(c) of the BC. The debtor's defense was that the creditor could reclaim only those

goods in the debtor's possession at the time the demand for reclamation was received and that, in any event, the creditor could not receive payment for the value of such goods but would have to accept a priority status as an administrative expense creditor based on the price of the goods on hand. The reclaiming creditor, however, insisted that it was entitled to an administrative expense claim for the sales price with respect to *all* of the goods delivered, or a lien to that extent, without regard to whether any or all of the shipped goods could be retrieved by reclamation.

The debtor insisted that the discretion to be exercised in the application of the alternatives to reclamation set forth in Section 546(c), including the granting of an administrative expense claim, could be exercised only to the extent that goods were in the debtor's possession at the time that it received the written demand for reclamation.

The court first examined the common law and found that reclamation rights were then governed by the law of contracts which permitted rescission by a seller who was induced to enter into a contract by a fraudulent or innocent misrepresentation. However, the appropriate remedy flowing from rescission was not always easy to determine. The seller's ability to retrieve the property sold turned on several factors, including the identification of goods, their fungibility, commingling, and the like. Indeed, where the goods had already been resold by the buyer, the seller was allowed to trace the funds which specifically were allocable to the seller's goods.⁶

⁶ The court cited Weintraub & Edelman, "Seller's Right to Reclaim Prop-

⁵ 11 U.S.C. § 546(c)(2).

Section 2-702(2)

The court then addressed Section 2-702(2) of the Uniform Commercial Code which replaced common-law principles, indicating that this section was "designed to afford certainty and completeness in preference to those sources of general law to which we were accustomed to resort."⁷ Section 2-702(2) provides:

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.

Following the analysis of this Uniform Commercial Code section, which was predicated upon "the existence of the goods in the seller's possession and therefore able to be claimed,"⁸ the court dealt with the cases under the former Bankruptcy Act with respect to the seller's right to reclaim. The court indicated that some jurisdictions had denied the right to reclaim pursuant to Section 2-702(2) of the Uniform Commer-

cial Code because it merely "disguised priorities"⁹ that actually resembled state statutory liens which became effective only upon the insolvency of the debtor. Such statutory liens could be avoided under the former Bankruptcy Act as they now can under Section 545 of the BC. On the other hand, other jurisdictions have held that the right to reclaim under the Uniform Commercial Code is invulnerable and was nothing more than a right to rescind a contract. This conflict among jurisdictions formed a basis for Congress' enactment of Section 546(c) of the BC. In essence, whatever weapons a bankruptcy trustee might have in his arsenal to gather the estate are subject to the UCC statutory right or common-law right of a seller to retrieve his goods.

Because Section 2-702(2) of the UCC permits the reclamation of goods in the buyer's possession, and does not give the seller the right to receive the proceeds of goods already resold by the buyer, the court in *Flagstaff* was faced with the issue of "whether, if reclamation is denied, and the court exercises its judgment to grant the seller a priority administrative claim or a lien, both authorized by section 546(c)(2), the extent of either will exceed the value of the property which could be retrieved so that the full value of the goods sold will fix the reach of the priority or the lien."¹⁰

In concluding that the administrative expense claim could not exceed the price of the goods remaining in the debtor's possession, the court focused on two "truths." First, "it must be recognized that Congress' scheme of priority creditors, while designed

erty Under Section 2-702(2) of the Code Under the Bankruptcy Act: Fact or Fancy," 32 Bus. Law. 1165, 1167 (1977).

⁷ *In re Flagstaff Foodservice Corp.*, note 1 *supra*, at 122.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.* at 123.

to achieve important policy aims thought relevant, nevertheless distorts one of the dominant schemes of bankruptcy—equality of distribution.”¹¹ The court noted that “if Congress meant to give the 10-day seller so much more than he ever had under nonbankruptcy law to the exclusion and detriment of the 11-day seller, it would have expressed itself far more clearly.”¹² The second truth is that “reorganization under chapter 11 is one of the desired aims of Congress for the financially pressed but honest debtor.”¹³ The court reads Section 546(c)(2) as striking a balance so that the debtor has the use of the goods it needs for its ongoing business while the seller has an administrative expense priority for the value of the goods that the seller would otherwise be able to reclaim in a nonbankruptcy setting. “To give the seller more, absent a clear indication that this should be so, cuts against the grain of compelling bankruptcy themes.”¹⁴

In re Contract Interiors, Inc.

We next turn our attention to the *Contract Interiors* case. The facts indicate that on December 24, 1980, the plaintiff shipped certain decorative goods to the debtor. Shortly thereafter, and on February 5, 1981, the debtor filed a petition for relief under chapter 11. The plaintiff made demand in writing for the return of the goods on February 20, 1981. Upon debtor's failure to deliver the goods, it instituted this adversary proceeding contending that it was in-

duced to ship the goods upon a false financial statement submitted by the debtor, and, therefore, it was entitled to reclaim the goods either by virtue of Section 2-702 of the Uniform Commercial Code or based upon a common-law right.

Focusing upon Section 546(c), the debtor argued that a seller may reclaim the goods it was induced to sell by fraudulent representation only upon the seller's complying with the requirements of Section 546(c) and since the demand was not made within ten days of the receipt of the goods, the seller is precluded from reclaiming the goods. Counsel for the plaintiff, however, maintained that Section 546 dealt with the limitations of the trustee's avoiding power and that its construction merely prevents the trustee from relying upon its rights and powers to defeat any statutory or common-law right of a seller to reclaim the goods sold in the ordinary course of business if the seller complies with the conditions set forth in Section 546(c), but that a seller may still rely upon any statutory or common-law right that it may have to reclaim goods sold to the debtor even though there is no compliance with the conditions set forth in Section 546(c), and if the seller does so, the trustee may employ all the avoiding powers to resist the seller's claim. After examining the authority which supported such a position, the court reviewed the history and background of the section in much the same light as the *Flagstaff* court.

The court indicated that the legislative history of Section 546 made it clear that the drafters intended to retain only that part of Section 2-702 which permitted reclamation if demand was made for the return of goods within ten days after receipt

¹¹ *Id.* at 124.

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

and to make this right to reclaim exclusive in order to put an end to the disruptive litigation engendered by Section 2-702(c).

In the footnote, the court quoted the following:

This is actually the solution that was suggested by Weintraub & Edelman: "Seller's Right to Reclaim Property Under Section 2.702(2) of the Code Under the Bankruptcy Act: Fact or Fantasy," 32 Bus. Law 1165 (1977). This recommendation was based, in part, on the view that so limiting the right of seller to reclaim goods would eliminate costly, time-consuming litigation, enhance the likelihood of successful reorganization, and give relief in those cases in which there is an "overwhelming aura of fraud" cases in which sellers were induced to deliver goods to a debtor on the eve of bankruptcy.¹⁵

The court concluded that this purpose set forth in the legislative history can be given effect only if it is held that Section 546(c) provides the exclusive remedy for a reclaiming creditor.

Furthermore, the court also indicated that this did not affect a seller's right to recovery of goods in transit which were covered by Section 2-705 of the Uniform Commercial Code. The court therefore dismissed the complaint.

Lessons to Be Learned

These recent cases, barring reversal, seem to be sound and logical

and have nailed down three of the many controversial problems still extant, namely: (1) reclamation can only cover goods in the debtor's possession at the time the written notice is received by the debtor; (2) the service of the written notice within ten days of the receipt of the goods is essential to recovery; and (3) reclamation of goods under Section 546(c) is the exclusive remedy for such recovery.

Where does this leave the defrauded seller? The *Flagstaff* court cited existing problems of identification of goods, fungibility, commingling, and the like. The *Contract Interiors* court recognized the erosion of the ten-day period caused by lack of information of the debtor's bankruptcy. A host of other problems may be added—delay in delivery of mail and disposition of goods after receipt of notice if the debtor in possession is not enjoined. Extremely significant is the time of receipt of goods.

Balancing the equities between the necessity of debtors to continue to purchase goods until the commencement of a chapter 11 case, as against the seller's entrapment in a concealment of the debtor's insolvency, presents a difficult problem. The *Contract Interiors* court suggested the possibility of additional legislation. Several cases have indicated a practical solution: compromise between creditors and debtors who resolve the many complex issues by setting up a separate class for preferential treatment of the so-called ten-day deliveries in the plan of reorganization. In the interim, vigilance is the order of the day in two areas: written demand for reclamation should be delivered by hand and the debtor's inventory at the time of delivery of such demand should be ascertained.

¹⁵ The court cites Henson, "Reclamation Rights of a Seller Under Section 2-702," 22 N.Y.L.F. 41, 49 (1975).