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# From the Bankruptcy Courts

Benjamin Weintraub\* and Alan N. Resnick\*\*

## DEFINITION OF "INSOLVENT" FOR RECLAMATION PURPOSES: BANKRUPTCY CODE vs. UCC

Many cases reflecting the interrelationship between bankruptcy and nonbankruptcy law are found in the current bankruptcy reporters. Labor law, environmental protection statutes, product liability principles, real estate law, and contract doctrines are only a few of the areas that have become important in the processing of a bankruptcy case. Of course, this interrelationship of bankruptcy and nonbankruptcy law has been appreciated for many years as reflected more than thirty years ago in the comments of a learned commentator: "The interdependence of non-bankruptcy and bankruptcy rights and remedies is such that an evaluation of one set of remedies presupposes familiarity with others."<sup>1</sup>

No body of law interrelates with the Bankruptcy Code more than the Uniform Commercial Code. Determining the rights of a secured creditor, for example, requires an understanding of Article 9 of the UCC. Clearly, the extent of the trustee's reach under the "strong-arm clause"<sup>2</sup> cannot be ascertained without evaluating the rights of a judicial lien creditor as against a competing secured creditor under the UCC.<sup>3</sup> Similarly, compliance with the bulk sale provisions of Article 6 of the UCC is relevant when determining whether the trustee, standing in the shoes of an unsecured creditor,<sup>4</sup> could avoid prebankruptcy bulk transfers.

### *In re AIC Photos, Inc.*

There is no doubt that the interrelationship of bankruptcy law and the UCC was intended by Congress when enacting the Bankruptcy Code. One of the clearest illustrations of this deliberate interdependence relates to the rights of the reclaiming seller who delivered goods to the debtor shortly before bankruptcy.<sup>5</sup> How-

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<sup>1</sup> J. Moore, *Debtors' and Creditors' Rights*, Preface (1955 ed.).

<sup>2</sup> 11 U.S.C. § 544(a).

<sup>3</sup> See U.C.C. § 9-301.

<sup>4</sup> 11 U.S.C. § 544(b).

<sup>5</sup> See 11 U.S.C. § 546(c); U.C.C. § 2-702(2). For a discussion of other as-

ever, this area also illustrates how the extent to which the UCC controls bankruptcy issues is sometimes ambiguous. Such ambiguity is reflected in the recent reclamation proceeding in *In re AIC Photos, Inc.*<sup>6</sup>

In *AIC Photo*, a creditor instituted an adversary proceeding to reclaim certain goods delivered to the debtor on credit only two days prior to the commencement of the debtor's chapter 11 case. Most of the essential facts regarding the seller's right to reclaim were undisputed. The seller had made a written demand for the return of the delivered equipment in accordance with Section 546(c) of the Bankruptcy Code and Section 2-702(2) of the Uniform Commercial Code, as enacted in New York. The debtor had not complied with the seller's demand. By stipulating to the use of evidence previously taken in the bankruptcy case regarding the debtor's financial condition, there was no dispute that "the sum of its [the debtor's] debts was not greater than the fair value of all of its assets."<sup>7</sup> The parties also agreed that reclamation rights are based exclusively on Section 546(c) of the Bankruptcy Code and Section 2-702(2) of the UCC, and that under both sections the right to reclaim exists only if the debtor

received the goods while insolvent.

### Definition of "Insolvency"

Although the parties agreed that the term "insolvent" is controlled by Section 1-201(23) of the UCC, the bankruptcy court nonetheless focused on the legal question whether the term "insolvency" is to be defined by the UCC or by the Bankruptcy Code for reclamation purposes.

Before arriving at its conclusions of law, the court considered the intention of Congress "to recognize, in part, the validity of Section 2-702 of the Uniform Commercial Code, which has generated much litigation, confusion and divergent decisions in different circuits."<sup>8</sup> This was done by making the rights and powers of the trustee under the various provisions of the Bankruptcy Code subordinate to those of a reclaiming creditor. "To exercise a right of reclamation, the seller must demand reclamation of such goods 'before ten days after the receipt of such goods by the debtor.' In lieu of actual reclamation, the Court may grant the seller a priority claim or lien."<sup>9</sup>

The court observed that "[t]here would be no doubt in this case that [the seller] came within the protection of § 546(c) were it

pects of the seller's right to reclaim goods, see B. Weintraub & A. Resnick, *Bankruptcy Law Manual* ¶ 5.12 (rev. ed. 1986).

<sup>6</sup> 57 Bankr. 56 (E.D.N.Y. 1985).

<sup>7</sup> *Id.* at 57.

<sup>8</sup> *Id.* at 58 (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 371-372 (1977)).

<sup>9</sup> *Id.* at 58.

not for the ambiguity created by the requirement that the debtor have received the goods being reclaimed 'while insolvent' <sup>10</sup> since insolvency is defined differently in the Uniform Commercial Code than it is in the Bankruptcy Code. Under Section 1-201(23) of the UCC, a "person is 'insolvent' who either has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due or is insolvent within the meaning of the Federal Bankruptcy Law."<sup>11</sup> It is to be noted that the UCC contains both the so-called equity definition and the bankruptcy definition, making the insolvency definition as broad and all-inclusive as possible.

What the UCC designates as "federal bankruptcy law," a non-descriptive term, is the Bankruptcy Code, whose definition is limited to the extent that "'insolvent' means—with reference to an entity other than a partnership, financial condition such that the sum of such entity's debts is greater than all such entity's property, at a fair valuation. . . ."<sup>12</sup> In other words, the bankruptcy insolvency test is limited in scope to the so-called balance sheet definition.

By stating that the controlling definition of insolvency is the one contained in the UCC, instead of

the bankruptcy balance sheet test, the bankruptcy court disagreed with a prestigious commentator: "No less an authority than Colliers has suggested that this difference in definition is fatal to a seller unable to establish an excess of liabilities over assets. . . ."<sup>13</sup> The court then observed that Colliers, however, "supplies no reasons for a result which would seem to create as much confusion as § 546(c) was enacted to dissipate."<sup>14</sup>

The reasons for the court's conclusion include the difficulty and complexity of ascertaining the debtor's assets and liabilities, both "factually and legally"; many debtors seek long extensions of time to file schedules "because of the difficulty they have in determining their own assets and liabilities."<sup>15</sup> Requiring "a supplier, a stranger to the debtor's affairs, to carry the burden of proving excess of liabilities over assets. . . . would be to make the right of reclamation largely illusory" and would defeat Congress's "express intention in enacting the Code [which] was to recognize the right of reclamation created by § 2-702 of the Uniform Commercial Code."<sup>16</sup>

The court conceded that Congress intended to recognize UCC

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* (quoting U.C.C. § 101(23)).

<sup>12</sup> See 11 U.S.C. § 101(29).

<sup>13</sup> 57 Bankr. at 59 (citing 4 *Colliers on Bankruptcy* ¶ 546.04 (15th ed. 1985)).

<sup>14</sup> 57 Bankr. at 59.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

Section 2-702(2) "in part," but the part that was being eliminated in bankruptcy is the part of section 2-702(2) which excuses the ten day demand limitation when the right to reclaim is based on the debtor's written misrepresentation of insolvency made within three months before delivery. "But there is nothing in the legislative history to suggest that Congress intended to cut back the right of reclamation still further and to allow it only in a fraction of the cases falling within the ten day rule."<sup>17</sup> To recognize a right of reclamation only where the buyer satisfies one of the three tests of insolvency set forth in the UCC "would be to radically reduce the right of reclamation without explanation or justification even as Congress says it is recognizing it."<sup>18</sup>

The court concluded its discussion of insolvency with the statement that whether or not there is a right to reclaim depends upon state law subject to the added limitation that the demand must be made within ten days after receipt. The court considered the phrase "if the debtor has received such goods while insolvent" as part of the larger descriptive wording of the right that is being elevated above the trustee's powers, namely, the common law or statutory right to reclaim the goods.

### Observation

In the *AIC Photo* case, the court went outside the Bankruptcy Code in search of a definition which was clearly set forth in the Bankruptcy Code. While the court's logic is sound and experience indicates that the road toward reclamation is often a tortuous one if the hills of the balance sheet test are to be traversed, nonetheless, there is little support for the conclusion that a reclamation under § 546(c) is satisfied with an equity definition when the Bankruptcy Code provides the balance sheet test under § 101(29).<sup>19</sup>

One can easily argue that if Congress desired to ease the reclaiming seller's burden of proving insolvency, it could have expressly included in Section 546(c) a separate equity test definition applicable to that section only. Indeed, several Code sections contain their own definitions applicable to that section only. For example, Section 547(a)(2) defines "new value" for preference purposes only, while Section 548(d)(2)(A) defines "value" for fraudulent transfer purposes only. There is no doubt that Congress recognized the inability to pay debts

<sup>19</sup> See *In re Flagstaff Foodservice Corp.*, 56 Bankr. 899, 905 (S.D.N.Y. 1986): "The definitional sections . . . are applicable to all provisions of the Bankruptcy Code. . . . Accordingly, the question of insolvency is to be determined by the test enunciated in Section 101(26)."

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

as a test in other contexts, such as the ground for involuntary bankruptcy under Section 303(h). Finally, Congress could have eased the seller's task on the insolvency issue by including in Section 546(b) a subsection placing the burden of proof on the debtor. Paraphrasing from a similar provision contained in Section 547(f) relating to preferences, Section 546(b) could have provided as follows: "For the purposes of this section, the debtor is presumed to have been insolvent at the time of the receipt of the goods." The burden would be on the debtor to prove solvency, which is where it should be, when goods are received so close to the commencement of a bankruptcy case.

The question whether the court should use a UCC definition when interpreting a term used in the Bankruptcy Code requires a different response when the Bankruptcy Code does not contain its own definition. The *Marin Motor Oil*<sup>20</sup> case is a good example of the appropriate use of a UCC definition to interpret the seller's right of reclamation under Section 546(c) of the Bankruptcy Code. In *Marin Motor Oil*, the seller of oil dispatched a reclamation demand by telex. The issue to be resolved was whether the "demand" was made upon dispatching by telex or upon its receipt. The court of appeals held that the time of dis-

patch was the time of the demand for Section 546(c) purposes. In its opinion, the court considered the meaning of the term "receipt" which Congress did not define. "There is no definition of 'receipt' in the Bankruptcy Code, but U.C.C. § 2-103(1)(c) defines receipt of goods as 'taking physical possession of them.'"<sup>21</sup>

In a footnote, the court stated that its reliance on the UCC "for determining the time of receipt does not mean that the definition of receipt under § 546(c) is a matter of state law and might change were an individual state to alter its version of the Uniform Commercial Code. . . . Rather, the Uniform Commercial Code assumes relevance in this regard because, in adopting Section 546(c), Congress essentially borrowed from the U.C.C. Thus, we assume Congress also borrowed the standard definition of receipt contained in the U.C.C."<sup>22</sup>

### Conclusion

Although the court's opinion in *AIC Photo* represents a sound and practical solution to a burdensome problem facing reclaiming sellers, one which we would like to see Congress adopt as an amendment to the Bankruptcy Code, it is difficult to justify the use of the UCC insolvency defini-

<sup>20</sup> *In re Marin Motor Oil, Inc.*, 740 F.2d 220 (3d Cir. 1984).

<sup>21</sup> *Id.* at 224-225.

<sup>22</sup> *Id.* at 225 n.9.

tion to construe "insolvent" in Section 546(c) of the Bankruptcy Code when a different insolvency definition is contained in the Bankruptcy Code itself. If *AIC Photo* is widely followed, "insolvency" as used in the Bankruptcy Code will have different meanings despite the fact that the statute contains only one definition; the balance sheet test will be used for preference and fraudulent transfer purposes but the equity test will be used for reclamation purposes. On the other hand, reference to UCC definitions is appropriate in the absence of a definition contained in the Bankruptcy Code.

However, we cannot overlook the three alternatives<sup>23</sup> contained in the UCC that define 'insolvency'. Therefore, since a prepetition reclaiming creditor can rely on the equity definition to sustain its case, it should follow that if bankruptcy ensues before the goods have been returned, such creditor's rights should be preserved by proof of the equity definition while the case is pending in bankruptcy.

<sup>23</sup> See Official Uniform Comment to U.C.C. § 1-201, No. 23, " 'Insolvent.' . . . The three tests of insolvency . . . are expressly set up as alternative tests and must be approached from a commercial standpoint."