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Alan N. Resnick

*Maurice A. Deane School of Law at Hofstra University*

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# From the Bankruptcy Courts

*Alan N. Resnick\**

## **A TRAP IN THE BANKRUPTCY REFORM ACT OF 1994: LULLING RECLAIMING SELLERS TO SLEEP**

The vendor that delivers goods to an insolvent buyer shortly before the buyer's bankruptcy often attempts to protect its rights by making a written demand for reclamation of the goods. The rights of such a reclaiming vendor depend on an interesting interplay between state law and federal bankruptcy law. In a clumsy attempt by Congress to expand the rights of reclaiming sellers in 1994—apparently ignoring the carefully crafted interdependence of federal and state law on this subject—the Bankruptcy Code was amended in a way that could be seriously misleading to a vendor attempting to protect state-created reclamation rights.

Under common law, an unpaid seller who was defrauded into extending unsecured credit to a buyer

had the right to rescind the sale and recover the goods. The mere purchase of goods on credit was considered to be an implied representation that the buyer was solvent and able to pay for the goods. Accordingly, when a buyer ordered goods on credit while insolvent, the seller had the right to rescind on the grounds of fraud upon discovery of the insolvency.<sup>1</sup>

### **Section 2-702(2) of the UCC**

The Uniform Commercial Code (UCC) recognizes—with certain procedural restrictions—the common-law right to rescind sales to insolvent buyers and to reclaim the goods sold. Specifically, Section 2-702(2) of the UCC provides as follows:

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

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\* Benjamin Weintraub Distinguished Professor of Bankruptcy Law, Hofstra University School of Law, Hempstead, N.Y.; Counsel to the firm of Fried, Frank, Harris, Shriver & Jacobson, New York, N.Y.; Reporter to the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States; member of the National Bankruptcy Conference. The views expressed in this article are the author's own.

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<sup>1</sup> See *Gordon v. Spalding*, 268 F.2d 327 (5th Cir. 1959); Braucher, "Reclamation of Goods From a Fraudulent Buyer," 65 Mich. L. Rev. 1281-1284 (1967).

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.

It is important to notice that, under the UCC, the seller, whether or not actually defrauded by the buyer, will not be able to exercise any right to reclaim goods unless either (1) a demand for reclamation was made within ten days after the insolvent buyer's receipt of the goods or (2) the buyer made a written misrepresentation of solvency within three months before delivery of the goods.

### The Seller vs. The Trustee

Assume that the seller delivers goods to a buyer on credit. Within ten days after delivery, the seller discovers that the buyer is insolvent and demands the return of the goods. Pursuant to the UCC, the seller has the right to reclaim the goods. However, assume further that the buyer files a bankruptcy petition before the seller makes the reclamation demand or takes possession of the reclaimed goods. Is the seller's right to reclaim the goods effective against the trustee in bankruptcy?

This issue had been litigated extensively under the former Bankruptcy Act because of confusion over how UCC § 2-702 and the Bankruptcy Act worked together. Trustees argued that Section 2-702 created a statutory lien that first became effective upon the buyer's insolvency, thereby creating an invalid

statutory lien.<sup>2</sup> It had also been argued that Section 2-702 was an improper interference with the priority rules under the former Bankruptcy Act.<sup>3</sup> Despite these arguments, most courts had held that the seller's right to reclaim was effective against the trustee under the former Act because it created a valid right of rescission.<sup>4</sup> Several courts, however, refused to allow the unpaid seller to reclaim.<sup>5</sup>

### The Original Bankruptcy Code

The Bankruptcy Code, as originally enacted in 1978, cleared up this confusion with respect to the rights of the unpaid seller by adopting, in part, Section 2-702 of the UCC. Specifically, the Bankruptcy Code provides that, if certain requirements are met, the trustee's avoiding powers are subject to any reclamation rights of the seller who sold goods to the debtor in the ordinary course of business while the debtor was insolvent.<sup>6</sup> The seller's right to reclaim may

<sup>2</sup> See 11 USC § 545(1); former Bankruptcy Act § 67(c)(1)(A).

<sup>3</sup> See, e.g., Weintraub & Edelman, "Seller's Right to Reclaim Property Under Section 2-702(2) of the Code Under the Bankruptcy Act: Fact or Fancy," 32 Bus. Law. 1165 (1977).

<sup>4</sup> See, e.g., *In re Federal's Inc.*, 553 F2d 509 (6th Cir. 1977); *In re Telemart Enters., Inc.*, 524 F2d 761 (9th Cir. 1975), cert. denied, 424 US 969 (1976).

<sup>5</sup> See *In re Wetson's Corp.*, 17 UCC Rep. Serv. (Callaghan) 423 (SDNY 1975); *In re Giltex*, 17 UCC Rep. Serv. (Callaghan) 887 (SDNY 1975).

derive from common law or from a statute, such as the UCC.

The Bankruptcy Code's recognition of the vendor's right to reclaim does not mean that the vendor will actually get back the goods. The bankruptcy court is given a choice with respect to the treatment of the seller's right to reclaim goods when a timely reclamation demand is made.<sup>7</sup> The court may grant the seller's request for possession of the goods. Alternatively, the court may deny reclamation and grant the seller's claim administrative expense priority.<sup>8</sup> A third way to treat the right of reclamation is to grant the seller a lien on the goods or on some other property of the estate. The reason for allowing the court to deny reclamation by giving the seller an administrative expense priority or lien is to accommodate a debtor in possession who requires the use of the goods in reorganization cases. Permitting the debtor to use the goods purchased on credit may benefit the estate or increase the likelihood of a successful rehabilitation.

### Limitations on Reclamation

Most important to this discussion, however, are the strict limitations on the Bankruptcy Code's protection of the seller's right to reclaim in bankruptcy. First, the sale of goods must

have been in the ordinary course of the seller's business. Second, *as originally enacted*, the Bankruptcy Code provided that the seller may not reclaim goods unless reclamation is demanded in writing within *ten days* after the debtor received the goods. This requirement was based on the ten-day demand requirement found in Section 2-702 of the UCC. Although Section 2-702 relieves the seller of the ten-day demand rule if the buyer made a written misrepresentation as to solvency within three months, the Bankruptcy Code has never adopted this part of Section 2-702. In essence, despite any written misrepresentation, the seller's right to reclaim is lost against a debtor in bankruptcy if a reclamation demand is not made within the time set forth in Section 546(c)(1).<sup>9</sup>

The combination of the Bankruptcy Code, as originally enacted, and the UCC has led to the clear conclusion that a vendor *must* make a written reclamation demand within the ten-day period in order to preserve its state law reclamation rights.

### Amended Section 546(c) of the Bankruptcy Code

So what is the problem? The problem is that Congress, in an apparent attempt to give reclaiming sellers a little more slack, amended Section 546(c) of the Bankruptcy Code as part of the Bankruptcy Reform Act of 1994. In essence, Section 546(c)(1)

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<sup>6</sup> 11 USC § 546(c).

<sup>7</sup> This choice is set forth in 11 USC § 546(c)(2).

<sup>8</sup> See 11 USC §§ 503(b), 507(a)(1).

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<sup>9</sup> 11 USC § 546(c)(1).

mand for reclamation within ten days after delivery of the goods unless a written misrepresentation of solvency was given to the vendor within three months prior to the delivery of the goods. In the above hypothetical, it appears that the vendor would not have any reclamation rights if it demands reclamation after the expiration of the UCC's ten-day period following the delivery of the goods, that is, February 11, unless it can produce a writing containing a misrepresentation of solvency within the past three months. In the absence of such a written misrepresentation, the fact that bankruptcy intervened on February 5 should not matter—the ten-day provision under Section 2-702 of the UCC still limits the seller's rights.

This analysis of the 1994 amendment to Section 546(c) has not yet been sufficiently tested in the courts. In any event, attorneys should advise their vendor clients to always, whenever possible, adhere to the ten-day time limit under the UCC and to avoid being lulled to sleep by the 1994 amendments to Section 546(c). Of course, if the ten-day period is missed, make the written reclamation demand within the new twenty-day period nonetheless, but be prepared to be in the difficult position of trying to persuade the judge to re-write the reclamation provisions of the Bankruptcy Code, or to interpret it in a manner that is inconsistent with its literal reading.