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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

EIGHTH CIRCUIT PROTECTS SELLER'S RECLAMATION RIGHTS IN CHAPTER 11 DESPITE FLOATING LIEN ON BUYER'S INVENTORY: THE PLAN DRAFTING LESSONS OF PESTER REFINING

A vendor who sells goods in the ordinary course of business to an insolvent buyer shortly before the buyer files a bankruptcy petition may be protected by the right of reclamation afforded under UCC Section 2-702. If certain requirements are met, Section 546(c) of the Bankruptcy Code will insulate the vendor's reclamation rights from the avoiding powers of a trustee or debtor in possession. So long as the seller makes a written demand for reclamation within ten days after receipt of the goods by the buyer, Section 546(c) requires that the court protect the right to reclaim by either ordering the return of the goods, granting the seller's claim administrative priority under Sec-

tion 503(b) of the Bankruptcy Code, or securing the seller's claim by a lien.

Section 2-702(3) of the UCC provides that a seller's right to reclaim is "subject to the rights of a buyer in the ordinary course or other good faith purchaser." Courts have held that a secured creditor of the buyer who has a security interest in all the buyer's inventory may qualify as such a good faith purchaser. That is, the presence of a floating lien on the buyer's inventory could adversely affect the rights of the reclaiming seller because its reclamation rights are "subject to" the rights of the lienor. However, as illustrated in the opinion of the court of appeals in *In re Pester Refining Co.*,¹ the extent to which the presence of a floating lien on the buyer's inventory impacts on the seller's right to reclaim, even when the floating lienor is undersecured, may depend on the provisions of the chapter 11 reorganization plan that deal with treatment of the secured creditor's claim.

The Facts

Ethyl Corporation delivered 6,000 gallons of a gasoline additive

¹ *In re Pester Ref. Co.*, 964 F.2d 842 (8th Cir. 1992).

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in a railroad tank car and twelve fifty-five gallon drums of an antioxidant to the refinery of Pester Refining Co. on February 19 and 22, 1985. Ethyl billed Pester \$126,995 for these credit sales, but did not receive payment because Pester filed a chapter 11 petition on February 25. Only two days later, Ethyl made a written demand for reclamation of the goods under Section 2-702 of the UCC and Section 546(c) of the Bankruptcy Code.

Although the goods were still in Pester's possession and were identifiable at the time of the reclamation demand, they were also subject to perfected security interests of several secured creditors of Pester whose secured claims exceeded the value of all of Pester's assets. The total amount owed to secured creditors with liens on the debtor's assets, including its inventory, exceeded \$42 million. Pester refused to return the goods and Ethyl filed a complaint commencing an adversary proceeding for reclamation under Section 546(c) of the Bankruptcy Code.

More than a year after commencement of the chapter 11 case, and while Ethyl's reclamation proceeding was still pending, the bankruptcy court confirmed a plan of reorganization for Pester and affiliated debtor companies. The plan provided that each reclaiming seller shall have the choice of either settling or pursuing its reclamation claim. Ethyl did not settle its claim.

After the trial of the adversary proceeding, the bankruptcy court

upheld Ethyl's right of reclamation, entered judgment in the amount of \$126,995, and directed that Ethyl could pursue its judgment remedies under state and federal law in the event that Pester did not pay. The district court affirmed this ruling and Pester appealed.

The Statutory Framework

The court of appeals noted that the seller's right to reclaim goods delivered to an insolvent buyer, as recognized under common law and the pre-UCC Uniform Sales Act, was available only if the seller could prove that the buyer fraudulently induced delivery by misrepresenting its solvency. The Uniform Commercial Code expanded the common-law remedy by allowing reclamation without the need to prove a misrepresentation of solvency in a narrow class of cases. Specifically, UCC Section 2-702(2) provides that "[W]here the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten (10) days after the receipt."² However, since the seller, by delivering the goods on unsecured credit, clothed the buyer with apparent authority to deal with the goods as its own, UCC Section 2-702(3) adds that "[t]he seller's right to reclaim under subsection (2) is subject to the rights of

² 964 F.2d at 844, quoting from U.C.C. § 2-702(2).

a buyer in ordinary course or other good faith purchaser."³

As the court pointed out, "[s]ince most secured creditors are good faith purchasers under the UCC, [Section 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."⁴

The right to reclaim under the Uniform Commercial Code was the subject of much controversy and had caused great uncertainty regarding its effect under the pre-1979 bankruptcy laws, resulting in nearly two decades of litigation between bankruptcy trustees and vendors. Congress responded with Section 546(c) of the Bankruptcy Code:

(c) . . . [T]he 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 before ten 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."⁵

The court observed that Section 546(c) recognizes, with some limitations, the seller's state law right to reclaim goods under UCC Section 2-702, but also grants the bankruptcy judge broad power to substitute a lien or an administrative expense priority claim for the seller's right to reclaim possession. "This remedial discretion allows the court to leave the goods in the debtor's possession to facilitate Chapter 11 reorganization. It also provides flexibility in enforcing secured creditors' superior rights."⁶

Ethyl's Right to Reclaim in the Face of Floating Liens

The court found that Ethyl satisfied the statutory prerequisite for reclamation under Section 546(c) and the Uniform Commercial Code. Ethyl sold the goods in the ordinary course of business, Pester received the goods while insolvent, Ethyl demanded the return of the chemicals in writing within ten days after Pester received them, and Pester was still in possession of the chemicals

³ U.C.C. § 2-702(3) refers to the rights of a good-faith purchaser under U.C.C. § 2-403.

⁴ 964 F.2d at 845.

⁵ 11 U.S.C. § 546(c).

⁶ 964 F.2d at 845.

when it received Ethyl's reclamation demand.

However, the court also found that Ethyl's right to reclaim is subject to the rights of good-faith purchasers. When Pester received the chemicals from Ethyl, it owed \$42 million to secured creditors with perfected security interests in Pester's assets, including the chemicals. "It is undisputed that these secured creditors were good faith purchasers, and that their security interests were undersecured when Pester filed its petition for Chapter 11 protection."⁷

Pester took the position that the presence of these secured creditors with superior rights as "good faith purchasers" extinguished Ethyl's right of reclamation entirely. Rejecting that argument as doing "obvious violence to the statutory language," the court of appeals wrote that "[i]n the UCC context, when the right to reclaim is 'subject to' the rights of secured creditors, that means the right is subordinate or inferior to the security interests, not that it is automatically and totally extinguished. . . . Therefore, after the secured creditors' superior interests have been satisfied or released, the reclaiming seller retains a priority interest in any remaining goods, and in any surplus proceeds from the secured creditor's foreclosure sale."⁸ Accordingly, the court agreed with the district court's holding that Ethyl's right to reclaim was

not extinguished merely because Pester had secured creditors with perfected security interests in the chemicals Ethyl sought to reclaim.

The court found support in the decision of the Court of Appeals for the Fifth Circuit in *United States v. West Side Bank*.⁹ In that nonbankruptcy case, a timely reclamation demand was made by the seller, but a secured creditor of the buyer foreclosed and sold all the buyer's assets, including the goods subject to reclamation. The Fifth Circuit held that the reclaiming seller retained a priority interest in any surplus proceeds traceable to the goods explaining that "this result is appropriate under the UCC whether the reclamation right is viewed as an Article 2 limitation on the secured party's right to dispose of collateral, as an Article 9 junior security interest, or as the debtor's ownership interest in traceable proceeds."¹⁰ The court of appeals in *Pester* noted that "[t]o our knowledge, although the case law is inconsistent in other respects, *Westside Bank's* interpretation of the 'subject to' language in [UCC § 2-702(3)] has been followed in every reported bankruptcy decision that has considered the question."¹¹

⁹ 732 F.2d 1258 (5th Cir. 1984).

¹⁰ 964 F.2d at 846.

¹¹ *Id.* at 846. Pester argued, however, that the decision in *In re Coast Trading Co.*, 744 F.2d 686 (9th Cir. 1984), supported its position that the mere presence of a secured creditor with a security interest in the goods extinguishes the seller's right to reclaim. "But *Coast Trading* is distinguishable from the above-cited cases in one critical respect—the seller had drop-shipped the goods

⁷ *Id.*

⁸ *Id.* at 846.

Is the Right Worthless?

After concluding that Ethyl's right to reclaim was subordinate to the security interests of Pester's creditors, but was not extinguished, the court was confronted with another problem. "Determining that Ethyl's right to reclaim exists is easier than determining what it is worth."¹² Pester argued that Ethyl's reclamation right was worthless because the debt owed to Pester's secured creditors exceeded the value of all of its assets when the chapter 11 proceeding was commenced. It was Ethyl's position that it had the right to recover its entire reclamation claim from any assets of the reorganized debtor because the superior secured creditors' claims were satisfied under the confirmed chapter 11 plan of reorganization. The court of appeals rejected both of these positions "as inconsistent with the delicate balance codified in § 546(c) of the Code."¹³

The court again began its analysis by focusing on state law. The court noted that foreclosure on the goods by an undersecured creditor who then uses the entire proceeds to pay down its secured debt has the effect, under the UCC, of extinguishing the seller's reclamation right. After

all the goods that were sold by the seller and subject to reclamation are foreclosed upon by the floating lienor, the seller has nothing more than an unsecured claim for the purchase price. However, if the secured creditor releases its security interest in those goods, the seller may enforce its right to reclaim. "In other words, in the non-bankruptcy context, the secured creditor's decision with respect to its security interest in the goods will determine the value of the seller's right to reclaim."¹⁴ Based on the purpose of Section 546(c), which was the partial recognition of UCC Section 2-702, the court reasoned that the treatment of the seller's reclamation rights should depend on the treatment of the secured creditor's claim in the chapter 11 case.

Thus, Pester's argument—that the claim is worth nothing because the secured creditors were undersecured at the outset—ignores the freedom of secured creditors in nonbankruptcy contexts to relinquish all or part of their security interests. And Ethyl's argument—that the claim is worth full value because the secured creditors have been satisfied—ignores the possibility that they were satisfied by *the goods to be reclaimed*, rather than by other Pester assets, in which case the right to reclaim would be extinguished (rendered valueless) under state law.¹⁵

to the buyer's customer, so they were not in the buyer's possession when reclamation was demanded. Factually, this puts *Coast Trading* in the mainstream of UCC cases holding that the seller may only reclaim goods in the buyers' possession." 964 F.2d at 846.

¹² 964 F.2d at 847.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.* The court noted that this distinction was recognized in *In re Video King of Ill., Inc.*, 100 B.R. 1008 (Bankr. N.D. Ill. 1989), although only in dicta in a pretrial opinion denying cross motions for summary judgment.

The court of appeals rejected a literal application of Section 546(c) that was adopted by the bankruptcy court in its reasoning that Ethyl must be given either a lien or administrative expense priority. If a seller has a right of reclamation, Section 546(c)(2), read literally, permits the court to deny actual reclamation *only* if the court grants the claim administrative priority or secures the claim by a lien.

When there are goods or traceable proceeds available to reclaim, the alternative remedies in § 546(c)(2) provide needed flexibility. But when the secured creditors have satisfied their claims *out of the goods to be reclaimed*, granting § 546(c)(2) relief would afford the reclamation seller something it does not have under the UCC—a priority interest in the buyer's assets other than the goods to be reclaimed. . . . Nothing in the text or legislative history of § 546(c) suggests that Congress intended to expand the state law rights of reclamation sellers at the expense of the bankrupt's unsecured creditors. In this situation, the bankruptcy court does not 'deny reclamation' in recognizing that the reclamation right no longer has value; therefore, the alternative remedies of § 546(c)(2) do not come into play.¹⁶

Plan Provisions Control

Since Ethyl's right of reclamation existed when the chapter 11 petition was filed, but was subject to being rendered valueless by the actions of Pester's secured creditors, the court

focused on the provisions of Pester's confirmed reorganization plan to determine the manner in which various classes of creditors shared in the debtor's assets.

The plan provided for the transfer of Pester's refinery assets, including the chemicals subject to Ethyl's reclamation rights, to another entity in exchange for fifty-four self-service gas stations. The plan also restructured Pester's debts. Although the parties and the bankruptcy court focused on the provisions of the plan dealing with reclamation creditors, the court of appeals focused more on the plan's treatment of secured creditors who had superior rights in the chemicals Ethyl sought to reclaim. "If the plan *in fact* satisfied the claims of those creditors with the chemicals, or their proceeds, then Ethyl's right to reclaim would be valueless."¹⁷

Under the plan, secured creditors released their liens on Pester's assets, including any chemicals. This was an essential provision since those assets were being conveyed to another entity. Their secured claims were deemed satisfied by the plan and they waived any deficiency claims, in exchange for cash, notes, and stock from nine sources. Most significantly, the distribution to secured creditors included any proceeds from a pending lawsuit after the first \$300,000 is paid to the settling reclamation creditors.

¹⁶ 964 F.2d at 847.

¹⁷ 964 F.2d at 848.

From the terms of the plan, the court concluded that the secured creditors elected to release their security interests in the chemicals delivered by Ethyl in exchange for payments from sources other than the proceeds from those chemicals. "Because the secured creditors released their superior liens and satisfied their claims from unrelated assets and income sources, the bankruptcy court properly valued Ethyl's right to reclaim at the full invoice price of the chemicals."¹⁸

The court of appeals also rejected Pester's argument that Ethyl was estopped from asserting any right it had to the alternative remedies allowed by Section 546(c) because the confirmed plan, as explained in the disclosure statement approved by the bankruptcy court under Section 1125 of the Bankruptcy Code, expressly excluded reclamation claimants from administrative expense priority. To the contrary, the appellate court agreed with the bankruptcy court's analysis of these documents, noting that the plan expressly provided that reclamation claimants who did not settle their claims "will receive payment in full

of the amount finally determined to be due by Court order."¹⁹ In fact, the plan expressly contemplated the bankruptcy court judgment after sustaining Ethyl's reclamation claim.

Postconfirmation Interest

Ethyl sought postjudgment interest from the date of confirmation of the plan of reorganization, but the bankruptcy court denied the request because UCC Section 2-702 does not provide for the payment of interest. The court of appeals, however, noted that issues regarding postjudgment interest in federal suits are governed by federal law, not state law, even if the action is otherwise governed by state law. A federal statute provides that "interest shall be allowed on any money judgment in a civil case recovered in a district court."²⁰ The court of appeals held that, because a bankruptcy court is part of the district court, this statute applies in bankruptcy proceedings.

The court of appeals agreed with the bankruptcy judge's finding that most decisions of other courts have denied interest on reclamation claims in bankruptcy cases, but distinguished those decisions as involving preconfirmation judgments granting relief under Section 546(c) for possession of the goods, administrative priority, or a lien. In this case, the bankruptcy court entered a postconfirmation money judgment enforcing the provisions of the plan

¹⁸ *Id.* The court of appeals rejected Pester's argument that the district court erred in valuing the chemicals at Ethyl's invoice price, instead of a lower fair market value. "The court's finding that Ethyl's invoice prices were the fair market prices for the chemicals is not clearly erroneous. A reclaiming seller under § 546(c) is entitled to more than the 'garage sale' price its goods would bring if resold not in the ordinary course of business." See *In re Performance Papers, Inc.*, 119 B.R. 127, 130 (Bankr. W.D. Mich. 1990), 964 F.2d at 848 n.8.

¹⁹ 964 F.2d at 849.

²⁰ 28 U.S.C. § 1961.

that stated that “reclamation claimants will receive payment in full of the amount finally determined to be due by Court order,” and that the judgment would be enforced by “remedies available . . . under state and federal law.”²¹ Under these circumstances, the court of appeals held that the plan did not contain provisions overriding the normal federal postjudgment interest provisions of 28 USC Section 1961.

However, the court of appeals, observing that the plan was silent on the interest issue, held that Ethyl was not entitled to interest from the date of confirmation. “Here, the Plan did not award Ethyl a judgment on its claim; the Plan only saved Ethyl’s claim from discharge under § 1141(d)(1)(A).”²² The court concluded that the plan provision calling for “payment in full of the amount finally determined to be due by Court order” contemplated that postjudgment interest would accrue on that court order. Accordingly, Ethyl was entitled to interest from September 19, 1990, the date of the money judgment, and not from March 21, 1986, the date on which the plan was confirmed.

Conclusion

The lessons of the *Pester* case go well beyond the particular facts of that case. The decision serves as a warning that the formulation of a chapter 11 reorganization plan—especially regarding treatment of se-

cured creditors—could have a significant impact on the seller’s right to reclaim when faced with superior rights of a secured creditor with a floating lien on the debtor’s inventory. If the plan provides that identifiable proceeds of the inventory—whether in the form of accounts receivable, segregated cash collateral, or new inventory purchased with cash collateral on consent or with court approval—are to be used to pay down the debt of the undersecured floating lienor, *Pester* appears to tell us that the seller’s right to reclaim under Section 546(c) would be extinguished and the vendor would be treated as an unsecured nonpriority creditor. However, if the plan provides for release of the floating lien, coupled with a lien on other assets that are not proceeds, payment from future operations of the business in general, or the issuance to the secured creditor of debt or equity securities, the reclaiming seller may be entitled to at least administrative expense priority as a requirement for confirmation.²³ In any event, the reasoning of the *Pester* decision must be kept in mind by debtors and other plan proponents when formulating and negotiating the terms of a plan of reorganization while faced with both undersecured inventory lienors and reclaiming sellers.

²³ See 11 U.S.C. § 1129(a)(9), which mandates, as a requirement for confirmation of a chapter 11 plan, full cash payment to each administrative expense priority claimant on the effective date of the plan, unless the claimant agrees to a different treatment.

²¹ 964 F.2d at 849.

²² 964 F.2d at 849.