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# Supplier Tactics for Dealing with Financially Distressed Corporate Customers

John A. Pearce II\* and Ilya A. Lipin\*\*

## I. THE SUPPLIERS' FINANCIAL PREDICAMENT

When a corporation declares bankruptcy, its suppliers often suffer severe economic losses. These losses result when the bankrupt firm: (1) fails to honor its contractual obligations to its supplier,<sup>1</sup> (2) gains permission to modify its contract with its supplier,<sup>2</sup> (3) refuses to pay its supplier, (4) rejects its supplier's request for reclamation of goods, (5) forces the supplier to finance the bankruptcy restructuring,<sup>3</sup> (6) repudiates a prepayment plan to a supplier,<sup>4</sup> or (7) enforces a supplier's obligations under the contract during the bankruptcy.

In all of these situations, the profitability of a supplier suffers when accounts receivable become uncollectible or when goods become unrecoverable due to a customer's bankruptcy.<sup>5</sup>

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1. *Union Hopes to Prevent Comair From Breaking Contract With Flight Attendants*, AIRLINE INDUS. INFO. 1 Mar. 9, 2006, available at [http://findarticles.com/p/articles/mi\\_m0CWU/is\\_2006\\_March\\_9/ai\\_n16101923/?tag=content;col1](http://findarticles.com/p/articles/mi_m0CWU/is_2006_March_9/ai_n16101923/?tag=content;col1).

2. Sarah O'Connor, Anousha Sakoui & Daniel Thomas, *Shoe Chains Give Vote to Creditors*, FIN. TIMES (Jan. 27, 2009) <http://www.ft.com/cms/s/0/b10c5632-ec11-11dd-8838-0000779fd2ac.html#axzz1mckbhRyg>.

3. *Aleris Tops Creditors in Court*, BANK LOAN REP. Mar. 23, 2009, available at <http://www.highbeam.com/doc/1G1-196137850.html>.

4. Marty Orgel, *Not worth the plastic they are printed on*, MARKETWATCH.COM (Mar. 3, 2008), <http://www.marketwatch.com/story/bankruptcies-often-leave-consumers-holding-worthless-gift-cards>.

5. See Kristian Park, *The Monitoring of Supply Chain Risk Should Increase Across the Corporate Radar*, ALLBUSINESS.COM, May 2011, at 26, available at <http://www.allbusiness.com/company-activities-management/operations-quality-control/15725501-1.html> (stating that "[t]hroughout the recession many companies believed the biggest threat to their supply chains to be the potential

The recession that began in December 2007 led to thousands of corporate bankruptcies. According to the Administrative Office of the U.S. Courts, there were 43,546 bankruptcy filings involving business debts in 2008, a fifty-four percent increase over 2007.<sup>6</sup> The filings from July 1, 2008, through June 30, 2009, show 55,021 business bankruptcies, which is a sixty-three percent increase over the prior year.<sup>7</sup> Boscov's, Linens-n-Things, Eddie Bauer, Sharper Image, Steve & Barry's, KB Toys, Circuit City, and Bombay Co. are just few of the well-known businesses that filed for bankruptcy protection in the first nineteen months of the recession.

The bankruptcy of suppliers following the financial failures of large corporations is exemplified by the United States automobile manufacturing industry. In the first nine month of 2009 alone, there were forty-seven bankruptcy filings of principal suppliers to the automobile industry, after the bankruptcies of General Motors and Chrysler,<sup>8</sup> and the financial difficulties of Ford Motor.<sup>9</sup> The largest of these companies, all with recent annual revenues in excess of \$1 billion, are Lear, Visteon, Smurfit-Stone Container, Cooper-Standard Holdings, Hayes Lemmerz, Metaldyne, and Mark IV Dayco Products.<sup>10</sup>

The damaging effects of the 2007-2009 recession lingered into late 2011<sup>11</sup> and business bankruptcy rates continued to rise. From July 1, 2009, through June 30, 2010, there were 59,608 business bankruptcy filings, an increase of 8.3% from the prior year.<sup>12</sup> Failures to meet corporate obligations are predicted to rise by 2014,<sup>13</sup> setting off a new wave of

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insolvency of a third party business partner”).

6. U.S. Courts Bankruptcy Statistics, <http://www.uscourts.gov/statistics/Bankruptcystatistics.aspx> (last visited Mar. 24, 2012).

7. *Id.*

8. See Neil King Jr. & Sharon Terlep, *GM Collapses into Government's Arms*, WALL ST. J., Jun. 2, 2009, at A1, available at <http://online.wsj.com/article/SB124385428627671889.html> (approximating that the bailout of GM and Chrysler LLC cost the taxpayers more than \$62 billion).

9. See *Restoring Credit to Manufacturers: Testimony of the Motor & Equipment Manufacturers Association Before the Senate Committee on Banking, Housing, and Urban Affairs Economic Policy Subcomm.*, 110th Cong. 1 (2009), available at [http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=e4610997-7941-4358-8b4b-1b4c89c7e42c](http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=e4610997-7941-4358-8b4b-1b4c89c7e42c).

10. See BILL CANIS & BRENT D. YACOBUCCI, CONG. RES. SERVICE, R41151, THE U.S. MOTOR VEHICLE INDUSTRY: CONFRONTING A NEW DYNAMIC IN THE GLOBAL ECONOMY (2010), available at <http://www.fas.org/sgp/crs/misc/R41154.pdf> (stating that “[i]t is estimated that as many as 200 other suppliers liquidated their operations in 2009”).

11. Motoko Rich, *Feeble Job Numbers Show Recovery Starting to Stall*, N.Y. TIMES, July 9, 2011, at A1 (referencing economic data and stating that “economic recovery is stumbling”). See also Dan Shingler, *Manufacturers Still Skeptical*, CRAIN'S CLEVELAND BUS., Jan. 18, 2010, at 1 (referencing fears of double dip recession and its effect on suppliers).

12. See U.S. Courts Bankruptcy Statistics, *supra* note 6.

13. See Michael J. de la Merced, *A Forecast of a Lower Rate for Defaults*, N.Y. TIMES, Feb. 17, 2011, at B10 (noting predictions that corporate default rates will rise by 2014).

financial pressures on suppliers and their business customers. Thus, suppliers will benefit from being proactive in their use of legal tools to increase the probability of collecting receivables from their customers.<sup>14</sup>

After a company declares bankruptcy, its suppliers are forced into the position of trying to recover payments that are legally owed to them. For example, in November of 2008, Circuit City filed for bankruptcy protection. The bankruptcy documents show that Circuit City owed \$650 million to suppliers, with electronics manufacturers Sony, Zenith, Toshiba, Garmin, and Nikon among the creditors.<sup>15</sup> Circuit City also owed \$119 million to Hewlett-Packard, and \$116 million to Samsung Electronics.<sup>16</sup>

When bankruptcy causes liquidation of the company, creditors usually recover only a portion of the original amount owed to them, if anything. For instance, in KB Toys 2008 bankruptcy, unsecured creditors expected to receive less than \$0.10 on the dollar of what they were owed contractually.<sup>17</sup> In the 2009 liquidation of Copia, the liquidation plan provided unsecured creditors with only \$0.13 on the dollar and secured creditors, such as bondholders, only received partial recovery proceeds.<sup>18</sup> Similarly, Chrysler's 2009 bankruptcy was financially devastating for the bondholders who were owed \$6.9 billion by the carmaker, but collected only \$0.29 on the dollar under the Chapter 11 agreement.<sup>19</sup>

Such large corporate failures can lead to hundreds of tier-2 supplier bankruptcies.<sup>20</sup> Financial problems of large automotive companies had a

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14. See Melinda Vajdic, *A Shrinking Supply Chain*, CRAIN'S CHICAGO BUS., Dec. 6, 2010, at 22 (suggesting suppliers begin "honing [in] strategies to become flexible and innovative enough to deal with whatever their mega-clients dish out next").

15. Mark Clothier & Dawn McCarty, *Circuit City, Electronics Retailer, Seeks Bankruptcy*, BLOOMBERG (Nov. 10, 2008), <http://www.bloomberg.com/apps/news?sid=aXeltuiAOyys&pid=20601087>.

16. *Id.*

17. Peg Brickley, *KB Toys Faces Liquidation*, WALL ST. J. (Dec. 11, 2008), <http://online.wsj.com/article/SB122901585422798605.html>.

18. Steve Hart, *Judge to Review Objections to Copia Liquidation*, PRESS DEMOCRAT, Aug. 14, 2009, available at <http://www.pressdemocrat.com/article/20090814/business/908149919?Title=Judge-to-review-objections-to-Copia-liquidation>. Copia is also known as the American Center for Wine, Food and the Arts.

19. Marie Leone, *How Chrysler Spruced Up Bankruptcy*, CFO.COM (Aug. 7, 2009), [http://www.cfo.com/article.cfm/14201952/c\\_14200417](http://www.cfo.com/article.cfm/14201952/c_14200417).

20. Direct suppliers of parts to an original equipment manufacturer (OEM) are tier-1 suppliers. Suppliers that provide parts or components to tier-1 suppliers, to combine, repackage, or to simply forward to OEMs, are tier-2 suppliers. See Leigh Lones, *Increasing Liquidity in the Automotive Supply Chain*, COMM. FACTOR, 10, (Spring 2011) (stating that "Tier One suppliers provide full design, assembly and engineering support. They sell finished components, such as transmissions, seats and instrument panels, directly to car companies, known in the industry as Original Equipment Manufacturers (OEMs). Tier One is comprised mostly of large companies such as Delphi or Johnson Controls. Tier Two companies mostly sell products to Tier One. An example of a typical Tier Two

devastating impact on their suppliers, and on their second tier suppliers.<sup>21</sup> For instance, Visteon, a former division of Ford, was one of the largest auto suppliers that filed for bankruptcy protection after the production cutbacks by Chrysler and General Motors eroded its financial stability.<sup>22</sup> Visteon stated that its failure would have a ripple effect and put a financial strain on many of its suppliers.<sup>23</sup>

Unable to collect from automotive companies such as General Motors, many suppliers nearly have burned through their cash reserves.<sup>24</sup> Banks are retreating from auto-industry lending and private lenders are refusing to increase credit for many shaky parts makers due to risks.<sup>25</sup> The Obama administration responded by establishing a \$5-billion fund to assist struggling automotive suppliers through the Troubled Asset Relief Program ("TARP"). The terms of the program stated the General Motors was to receive \$2 billion and Chrysler \$1.5 billion.<sup>26</sup> Further, each company had to contribute an amount equal to five percent of their receipts and if necessary could access the remaining \$1.5 billion at a later date.<sup>27</sup> The benefit of the program was to guarantee that suppliers would be paid for their deliveries without additional wait for payments, thus restoring the flow of credit in a critical sector that employs more than 500,000 American workers.<sup>28</sup> However, the program was criticized because it permitted General Motors and Chrysler to decide which suppliers would benefit from the program and receive the payments. Thus, some suppliers may not receive any payments from the program that was designed to help them. As a result, very little of the set aside money benefited the industry's

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company would be one that supplies component parts, such as transmission gears, electronics, speedometers and seat covers, to the Tier One suppliers. Tier Three suppliers generally provide smaller components and some tooling and dies to Tier Two companies. In practice, they sell to both Tier One and Tier Two.").

21. Society of Automotive Analysts, *SAA Analysts Warn of Increased Supplier Bankruptcies, Further Image Damage in Wake of Chrysler Bankruptcy*, REUTERS (May 1, 2009), <http://www.reuters.com/article/2009/05/01/idUS152206+01-May-2009+PRN20090501>.

22. Jeffrey McCracken & Andrew Grossman, *Auto Supplier Visteon Plans Chapter 11 Filing in U.S.*, WALL ST. J., May 28, 2009, at B1. At the end of 2008, Visteon employed 11,000 salaried workers and 22,500 hourly workers world-wide. The company also had \$893 million in unfunded pension obligations.

23. Martha Graybow & Jessica Hall, *Visteon Gets Bankruptcy Court OK to Pay Wages*, REUTERS (May 29, 2009), <http://www.reuters.com/article/businessNews/idUSTRE54S56W20090529>.

24. Rick Barrett, *For GM Suppliers, Struggles Remain*, JOURNAL SENTINEL (July 10, 2009), available at <http://www.jsonline.com/business/50505737.html>.

25. Jesse Snyder, *Supplier Woes Will Worsen Before They Improve*, AUTOMOTIVE NEWS, Aug. 3, 2009, at 12A.

26. Nick Bunkley, *Aid Program for Suppliers Starts With \$3.5 Billion in Loans to G.M. and Chrysler*, N.Y. TIMES, Apr. 9, 2009, at B4.

27. *Id.*

28. Bunkley, *supra* note 26, at B4.

suppliers.<sup>29</sup>

This article consists of seven parts. Part I provides an introduction and explanation as to how customers' financial distress and bankruptcy can affect suppliers' ability to obtain full payment for goods sold. Part II describes how the Bankruptcy Code is relevant to suppliers and how customers faced with an inability to pay their obligations as they become due use it to gain an advantage over their suppliers. Part III offers an extensive discussion of the supplier remedies under BAPCPA, such as reclamation and administrative priority status, while Part IV details the remedies available to suppliers under state law. Tactics that may improve the leverage of the supplier when dealing with the financially distressed customers are proposed in Part V. Part VI suggests innovative methods to receive full payment from customers. Lastly, Part VII discusses unsettled issues of importance to suppliers that remain after the enactment of BAPCPA.

## II. THE BANKRUPTCY CODE'S RELEVANCE TO SUPPLIERS

The Bankruptcy Code provides for two types of bankruptcies that most often have consequences for creditors, including suppliers: Chapter 7 and Chapter 11.<sup>30</sup>

A case under Chapter 7 is one of liquidation.<sup>31</sup> The goal of Chapter 7 is to provide debtors with the opportunity for a "fresh start" by discharging most of their debts, and to provide for the equitable distribution of debtor's non-exempt assets among the creditors, which include the suppliers. Since the corporate debtor cannot receive a discharge under Chapter 7, the goal is to provide for liquidation and distribution of debtor's corporate assets to its suppliers.<sup>32</sup> In liquidation, the bankruptcy trustee administers the case, liquidates all the nonexempt assets, and distributes the proceeds from the

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29. Brian Albright, *OEM Bankruptcies Hinder Parts Availability*, AFTERMARKET BUS., Aug. 1, 2009, at 36.

30. 11 U.S.C. § 101(10) (2006). ("The term 'creditor' means: (A) entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor; (B) entity that has a claim against the estate of a kind specified in § 348(d), § 502(f), § 502(g), § 502(h) or § 502(i) of the bankruptcy code; or (C) entity that has a community claim."). *See id.* § 101(13) ("The term 'debtor' means person or municipality concerning which a case under bankruptcy code has been commenced."). *See id.* § 101(15) ("The term 'entity' includes person, estate, trust, governmental unit, and United States trustee.").

31. 11 U.S.C. §§ 701 et seq. (2006). *See* 2 ALAN N. RESNICK & HENRY J. SOMMER, COLLIER BANKRUPTCY MANUAL P 700.01 (Matthew Bender, 3d ed. rev. 2009) (stating that "[l]iquidation is a form of relief afforded by the bankruptcy laws that involves the collection, liquidation and distribution of the nonexempt property of the debtor and culminates in the discharge of the liquidation debtor").

32. 11 U.S.C. § 727(a)(1) (2006).

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liquidation in accordance with priority status of liens and bankruptcy law. For suppliers at the bottom of the priority list this means receiving pennies on the dollar. Filing of Chapter 7 also means stay of collection actions against the debtor or debtor's property.<sup>33</sup> During the automatic stay, or until it is lifted by the bankruptcy court, the suppliers may not initiate or continue lawsuits to collect moneys due.

A case under Chapter 11 is one of reorganization and is primarily focused on business debtors.<sup>34</sup> The bankruptcy petition may be filed voluntarily by the debtor or forced on the firm by its creditors, which include suppliers.<sup>35</sup> Under Chapter 11, the debtor continues to operate its business as a debtor in possession ("DIP")<sup>36</sup> and is placed in the position of a fiduciary with rights and powers of the Chapter 11 trustee.<sup>37</sup> The hallmark of Chapter 11 is flexibility, where the DIP is offered a considerable discretion in the operation of its business,<sup>38</sup> in exchange for entering into a contractual plan with suppliers regarding repayment of debt. Under the plan, suppliers are compensated pursuant to the terms either negotiated with other creditors or imposed by the court. The plan presents an opportunity for restructuring the business with the goal to preserve jobs, pay suppliers, and reduce the disturbance that can result from termination of a business.<sup>39</sup>

The filing of a Chapter 11 case causes all of the debtor's property to become property of the bankruptcy estate.<sup>40</sup> Again, after filing, the automatic stay protects the debtor and debtor's property from collections of prepetition claims.<sup>41</sup> This means that suppliers may not collect their prepetition dues from the DIP, unless they get the permission of the bankruptcy court which may lift or modify the automatic stay.

In addition, filing under Chapter 11 provides DIP with various powers. The DIP has the power to use, sell, or lease property of the

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33. 11 U.S.C. § 362 (2006). *See id.* § 362(b) for exceptions to automatic stay.

34. 11 U.S.C. §§ 1101 et seq. (2006). *See* RESNICK & SOMMER, *supra* note 31, at 1101.01.

35. 11 U.S.C. §§ 301, 303 (2006).

36. 11 U.S.C. § 1107 (2006). *See* 11 U.S.C. § 1104 (2006), which allows the court to appoint a trustee other than DIP.

37. 11 U.S.C. § 1107 (2006). *See* 11 U.S.C. § 1106(a)(2)–(4) (2006) for exclusions and exceptions relating to investigatory powers.

38. RESNICK & SOMMER, *supra* note 31, at 1100.01 (noting that "[t]he hallmark of chapter 11 is flexibility. The debtor in possession is offered considerable discretion in the operation of the business, constrained generally only by a business judgment rule").

39. *Id.*

40. 11 U.S.C. § 541 (2006). *See* 11 U.S.C. § 541(b) (2006) for property excluded from the definition.

41. 11 U.S.C. § 362 (2006).

estate,<sup>42</sup> but is required to provide adequate protection to entities with interests in the property.<sup>43</sup> The DIP may obtain financing for post-petition operations, which may include entering into new agreements where liens will take priority over preexisting obligations.<sup>44</sup> The DIP also has the power to assume or reject contracts and leases.<sup>45</sup> The rejection of an executory contract leaves the supplier with various state law remedies, which are hard to enforce against an insolvent buyer. If the trustee assumes the contract, then the supplier will have to perform in accordance with the terms of the agreement.<sup>46</sup> For suppliers these Chapter 11 provisions mean that the DIP may change or break their contracts, change the supplier's pre-petition priority status, continue to use supplier's property throughout the bankruptcy, and risk never being compensated for goods sold.

### III. SUPPLIER REMEDIES UNDER BAPCPA

In October 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") was enacted to amend the Bankruptcy Code. The BAPCPA provides additional remedies for the creditor-supplier under sections 503(b)(9) and 546(c) that did not exist under the prior law. To minimize the economic harm caused by customer's bankruptcy, an unpaid supplier must assert certain rights provided by the BAPCPA.

#### A. RECLAMATION

Reclamation is the right of a seller to recover possession of goods delivered to an insolvent buyer.<sup>47</sup> The BAPCPA has significantly extended the reclamation period for goods that were shipped to a bankrupt debtor.

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42. 11 U.S.C. § 363 (2006). *See also* RESNICK & SOMMER, *supra* note 31, at 1100.01 (stating that "[t]he debtor in possession is given the ability to use, sell, or lease property of the estate, even if the property is subject to the interest of another entity, and even if this interest is a lien or security interest which would follow proceeds under applicable nonbankruptcy law").

43. 11 U.S.C. § 361 (2006).

44. 11 U.S.C. § 364 (2006).

45. 11 U.S.C. § 365 (2006). *See* RESNICK & SOMMER, *supra* note 34, at 1101.01 (noting that "[t]he debtor in possession may also rationalize its business through the assumption or rejection of executory contracts or leases; by assumption, the estate becomes fully liable for any pre-petition contracts, and by rejection the estate breaches the contract and may treat the damages as arising prepetition").

46. *In re* R. F. Cunningham & Co., 2006 WL 3791329, at 3 (Bankr. E.D.N.Y. 2006). The trustee in this situation has to ensure that buyer performs in accordance with the contract by making the required payments to the supplier. At the consummation of the deal, the supplier will remove itself from the insolvency proceeding because the supplier obtained payments and is no longer affected by either Chapter 7 or Chapter 11 bankruptcies. *Id.*

47. *In re* Dana Corp., 367 B.R. 409, 414 (Bankr. S.D.N.Y. 2007).



Prior to BAPCPA, suppliers relied on the Uniform Commercial Code (“UCC”) for remedies pertaining to shipment of goods to a bankrupt debtor. Suppliers specifically depended on section 2-702, which allowed them to stop shipment or reclaim goods shipped within ten days of insolvency.<sup>48</sup>

Reclamation under BAPCPA’s section 546(c) does not preclude supplier to pursue other nonbankruptcy remedies.<sup>49</sup> Under section 546(c) suppliers have forty-five days to reclaim goods that they have sold and shipped in their ordinary course of business to a bankrupt debtor.<sup>50</sup> The reclamation demand must be made in writing within forty-five days of the receipt of goods.<sup>51</sup> However, if the forty-five day period has not expired as of the filing of the bankruptcy case, the supplier will have an additional twenty days to demand reclamation after the bankruptcy filing date.<sup>52</sup> As a result of section 546(c), a supplier now has the ability to reclaim goods up to forty-five days’ worth of shipments, if not paid for and in the possession of the debtor, in contrast to ten days’ worth.<sup>53</sup> This section of BAPCPA is particularly beneficial to suppliers who ship products that turn over at a

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48. U.C.C. § 2-702 (West 2012).

49. The non-bankruptcy remedies may be subjected to the trustee’s avoidance powers and automatic stay of 11 U.S.C. § 362 (2006). The seller may stop goods in transit. *See In re Nat’l Sugar Refining Co.*, 27 B.R. 565, 568 (Bankr. S.D.N.Y. 1983) (stating that “[w]hen the buyer is insolvent and thus impaired in fulfilling its contractual obligation to pay, the seller rather than deliver the goods and seek to recover on the price . . . may withhold or stop in transit the delivery of the goods—*i.e.*, suspend his performance”); *In re Fabric Buys*, 34 B.R. 471, 475 (Bankr. S.D.N.Y. 1983) (holding that a “buyer’s attempt to receive goods on credit while insolvent renders the sale voidable and triggers the seller’s right to stop the goods in transit”); *In re Marin Motor Oil, Inc.*, 740 F.2d 220, 225 (3d Cir. 1984) (noting that the right to stop goods in transit is considered to be a “different right”); *In re Mayer Pollack Steel Corp.*, 157 B.R. 952, 960 (Bankr. E.D. Pa. 1993) (noting that “[c]aselaw precedents, as well as the terms of 11 U.S.C. § 546(c)(2), clearly indicate that the right to reclamation is not absolute. Thus, where a seller’s right to reclamation is superseded by the superior rights of a secured creditor or where the goods have been sold to a good faith purchaser before the reclamation demand is received, the seller may be awarded, at the court’s discretion, either an administrative claim or a lien.”).

50. *See* 11 U.S.C. § 546(c) (2006). This provision of the bankruptcy code states that: “(1) Except as provided in subsection (d) of this section and in § 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 §§ 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 § 503(b)(9).” *Id.*

51. 11 U.S.C. § 546(c) (2006).

52. 11 U.S.C. § 546(c)(1)(B) (2006).

53. Lynne Xerras, *BAPCPA Spells Relief For Certain Trade Creditors in Chapter 11*, 7 BANKRUPTCY AND CREDITORS’ RIGHTS 2 (2006).

slow rate.<sup>54</sup>

Suppliers must be aware of the law surrounding reclamation in bankruptcy. A timely written demand must be made even if the debtor has made misrepresentations regarding its solvency.<sup>55</sup> This demand must be an explicit desire to reclaim goods,<sup>56</sup> and must be made by the seller and not third parties.<sup>57</sup> The condition and location of goods is also important. The seller must identify the goods sought in debtor's possession.<sup>58</sup> Goods that were converted into a finished product may not be reclaimed.<sup>59</sup> Further, reclamation does not apply to proceeds.<sup>60</sup> Thus, if supplier's widgets were installed into a car of an insolvent automobile manufacturer, the supplier does not have a reclamation rights as to the widgets installed or to the proceeds.

### 1. *In re Advanced Marketing Services Inc.*

Under BAPCPA, the supplier's legal right to reclamation of goods is subject to floating and post-petition liens.<sup>61</sup> The statutory language of section 546(c) expressly makes reclamation rights "subject to the prior rights of a holder of a security interest in the goods or the proceeds thereof."<sup>62</sup>

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54. Xerras, *supra* note 53, at 2.

55. RESNICK & SOMMER, *supra* note 31, at 546.04. See *Oakland Gin Co. v. Marlow (In re Julien Co.)*, 44 F.3d 426, 432 (6th Cir. 1995) (noting the use of the demand); *In re Marin Motor Oil, Inc.*, 740 F.2d 220, 224 (3d Cir. 1984) (stating that "Section 546(c) unambiguously provides that the seller may not reclaim goods from the trustee in bankruptcy unless he first "demands in writing reclamation of such goods before ten days after receipt of such goods by the debtor").

56. *In re Marin Motor Oil, Inc.*, 740 F.2d 220, at 224. See *In Re Helms Veneer Corp.*, 287 F. Supp. 840, 844 (W.D. Va. 1968) (where the court held that simply demanding payment for goods did not constitute a written demand for reclamation).

57. *In re Julien Co.*, 44 F.3d 426, 432, n.4 (holding that 11 U.S.C. § 546 "clearly states that the 'seller' must make the written demand, not a warehouseman or bailee of the seller").

58. RESNICK & SOMMER, *supra* note 31, at 546.04 (stating that "[t]he seller must establish that the goods to be reclaimed are in the debtor's possession when reclamation was sought, and the goods must be identifiable").

59. *In re Wheeling-Pittsburgh Steel Corp.*, 74 B.R. 656, 658 (Bankr. W.D. Pa. 1987) (noting that "fungible goods may be reclaimed if the seller can trace the goods from its possession into an identifiable mass that contains goods of like kind and grade").

60. *In re MGS Mktg.*, 111 B.R. 264, 267 (B.A.P. 9th Cir. Cal. 1990).

61. 11 U.S.C. § 546(c) (2007). See *In re Dairy Mart Convenience Stores Inc.*, 302 B.R. 128, 134 (Bankr. S.D.N.Y. 2003) (noting that "[w]hile, the right to reclamation is subordinate to that of a good faith purchaser, it is not automatically extinguished"); *Auto Auction Assocs. of Mont., Inc. v. Incredible Auto Sales LLC (In re Incredible Auto Sales LLC)*, 2007 Bankr. LEXIS 1024 (Bankr. D Mont. Mar. 26, 2007); *In re Dana Corp.*, 367 B.R. 409, 418 (Bankr. S.D.N.Y. 2007).

62. 11 U.S.C. § 546(c) (2007). See Xerras, *supra* note 53, at 213 (noting that the "language essentially eliminates any ability of a vendor to challenge that a lender is not a 'good-faith' purchaser as that term is used in Article 2-702 of the Uniform Commercial Code such that the rights of an under-

The provisions of section 546(c) were first interpreted in Advanced Marketing Services Inc. (“AMS”) Chapter 11 case.<sup>63</sup> The insolvent buyer, AMS, was a wholesaler of general interest goods to membership warehouse clubs, certain specialty retailers, e-commerce companies, traditional bookstores and bookstore chains.<sup>64</sup> Simon & Schuster, Inc. (“S&S”) was one of the largest third-party publishers from whom AMS acquired books.<sup>65</sup>

The same day AMS filed for bankruptcy, S&S sent a reclamation demand to AMS.<sup>66</sup> Thereafter, S&S filed a complaint seeking to reclaim approximately \$5 million in goods<sup>67</sup> and a motion for a temporary restraining order (“TRO”).<sup>68</sup> At the time of the TRO hearing, approximately \$800,000 of inventory subject to S&S’s reclamation claim remained in AMS’s possession.<sup>69</sup>

S&S was trying to reclaim goods that were subject to both pre- and post-petition liens established to the same lender.<sup>70</sup> S&S was a party to pre-petition Loan and Security Agreement entered into in 2004 (“Senior Facility”), where Wells Fargo Foothill, Inc. (“Foothill”) was an agent for the lenders (“Senior Lenders”).<sup>71</sup> The Senior Facility was an asset-based lending agreement, which provided for a revolving line of credit (“Revolving Loans”) up to \$90-million maximum commitment.<sup>72</sup> AMS’s obligations under the Senior Facility were secured by a floating lien on

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secured lender to assert a lien in the goods sold by the vendor are superior”). See *In re Reliable Drug Stores, Inc.*, 70 F.3d 948, 950 (7th Cir. Ind. 1995) (noting that “[a] reclamation claim is ‘subject to’ the interests of good faith purchasers”).

63. *Simon & Schuster, Inc. v. Advanced Mktg. Servs.* (*In re Advanced Mktg. Servs.*), 360 B.R. 421, 421 (Bankr. D. Del. 2007).

64. *Advanced Mktg. Servs.* 360 B.R. at 424 (noting that the warehouse clubs included Costco Wholesale Corporation, SAM’s Club, and BJ’s Wholesale Club).

65. *Id.*

66. *Id.* AMS filed voluntary petition for relief under Chapter 11 of the Bankruptcy Code on December 29, 2006. That same day, S&S sent a reclamation demand to AMS. *Id.*

67. *Id.* The Complaint for Reclamation of Goods Pursuant to § 546(c) and Related Relief (“Complaint”) filed on January 5, 2007, sought (i) reclamation of goods in aggregate amount of approximately \$5 million that S&S alleges were received pre-petition by AMS (the “Goods”), (ii) immediate payment to S&S of certain administrative expense claims, and (iii) accounting of the Goods. *Id.*

68. *Id.* at 424. (noting that the motion for TRO filed on January 11, 2007, sought an order directing AMS (i) to stop selling the Goods, (ii) to segregate the Goods from any other inventory in AMS’s possession, (iii) to provide S&S with an accounting of Goods, and (iv) to provide S&S access to the Goods for inspection).

69. *Id.* The TRO hearing was held on January 17, 2007. Order denying TRO was issued on January 22, 2007. *Id.*

70. *Id.* at 426.

71. *Id.* at 424.

72. *Id.* The availability of Senior Facility was determined by a formula based upon AMS’s accounts receivable and inventory subject to adjustment and reserves established by Foothill and Senior Lenders. *Id.*

substantially all of its assets, including inventory.<sup>73</sup> This means that Senior Lenders' first priority security interest extended to the Goods that S&S desires to reclaim.

There were numerous restrictions on AMS's ability to access their cash since virtually all of the AMS's cash from operations was swept daily into an account controlled by Foothill and applied to outstanding loans, and then re-advanced as loans in accordance with the borrowing formula.<sup>74</sup> At the time of the bankruptcy petition, the principal amount for Revolving Loans exceeded \$41.5 million.<sup>75</sup> On the date of the bankruptcy petition, AMS sought an interim order for post-petition financing, which the Court granted (the "Interim DIP Order").<sup>76</sup> Pursuant to this order, AMS was able to continue to receive financing from Foothill and other Senior Lenders, including cash advanced and other extensions of credit, but in an aggregate principal amount of \$75 million (the "DIP Loan").<sup>77</sup> The terms of the post-petition agreement did not extinguish AMS's obligations under the Senior Facility or discharge any related security interests.<sup>78</sup>

The court denied S&S's application for a TRO.<sup>79</sup> The Court found that (1) goods S&S attempted to reclaim were subject to prior secured liens, (2) S&S was unable to establish a likelihood of success on the merits of its reclamation claim, (3) S&S failed to establish the existence of any irreparable harm, and (4) S&S failed to establish the balance of equities to support granting of an injunction.<sup>80</sup> In particular, the Court stated that the goods S&S supplied to AMS became subject to pre-petition and post-

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73. *Advanced Mktg. Servs.* 360 B.R. at 424.

74. *Id.* at 424–25.

75. *Id.* at 424. Senior Lenders assert and the Debtors have agreed that as of the Petition Date the Debtors were obligated to the Senior Lenders for the principal amount drawn on Revolving Loans plus accrued and unpaid interest and certain additional unpaid fees in an amount not less than \$41,514,347.58. *Id.*

76. *Id.* at 425 (Bankr. D. Del. 2007).

77. *Id.*

78. *Id.* (noting that the DIP Loan was secured by a lien on all of the AMS's pre-petition, present and future assets. This DIP Loan was senior to all other liens other than validly perfected Pre-Petition Liens. Senior Lenders were granted a superpriority administrative expense claim senior to all other administrative claims. Further, the DIP Loan Agreement provided that Pre-Petition Liens granted to the Senior Lenders continue in full force and effect, and secure repayment of all obligations owed to the lenders under the DIP Loan Agreement.).

79. In issuing its decision, the Court followed the temporary restraining order ("TRO") standard prescribed in *Novartis Consumer Health, Inc. v. Johnson & Johnson-Merck Consumer Pharms. Co.*, 290 F.3d 578, 586 (3d Cir. 2002). In order to issue TRO, the Court must be convinced that the following factors are met: "(1) the likelihood that the moving party will succeed on the merits; (2) the extent to which the moving party will suffer irreparable harm without injunctive relief; (3) the extent to which the nonmoving party will suffer irreparable harm if the injunction is issued; and (4) the public interest." *Id.*

80. *Advanced Mktg. Servs.*, 360 B.R. at 429.

petition liens and claims.<sup>81</sup> The Court relied on section 546(c) which states that the supplier's rights are "subject to the prior rights of a holder of a security interest in such goods or proceeds thereof."<sup>82</sup> Accordingly, the Court held that Senior Lenders' pre-petition and post-petition liens on the AMS's inventory are superior to S&S's reclamation claim.<sup>83</sup>

## 2. *In re Dana Corp.*

Another bankruptcy court provided further interpretation and application of section 546(c) in *In re Dana Corp.*<sup>84</sup> Dana Corporation ("Dana") and its non-debtor affiliates ("Dana Companies") are manufacturers and suppliers of modules, systems and components for original equipment manufacturers and service customers in automotive industry.<sup>85</sup> Dana and its forty domestic direct and indirect subsidiaries ("Debtors") filed a voluntary petition for Chapter 11.<sup>86</sup> Within a month, the Court issued a Reclamation Order establishing procedures for resolving reclamation claims.<sup>87</sup> Over 450 creditor-suppliers sent letters to the Debtors asserting their reclamation rights and demanding return of previously shipped goods in an aggregate amount of more than \$297 million.<sup>88</sup> In response, the Debtors asserted that reclamation rights are subject to superior rights of a security interest holder on the reclamation goods ("Prior Lien Defense"), which rendered all of the reclamation rights valueless.<sup>89</sup>

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81. *Advanced Mktg. Servs.*, 360 B.R. at 426.

82. *Id.*

83. *Advanced Mktg. Servs.*, 360 B.R. at 426. The Court stated that by this reason alone S&S failed to establish any likelihood of success in establishing a valid reclamation claim under § 546(c). *Id.*

84. *In re Dana Corp.*, 367 B.R. 409, 409 (Bankr. S.D.N.Y. 2007).

85. *Id.* at 410 (noting that Dana and Dana Companies manufactured and supplied modules, systems and components for original equipment manufacturers and service customers in cars, vans, sport-utility vehicles, trucks, and a wide variety of off highway vehicles. The Dana Companies operated in approximately twenty-five states, as well as in Mexico, Canada, eleven countries in Europe and fourteen countries elsewhere in the world. As disclosed in Dana's Form 10-K filed on April 27, 2006, in 2005 the Dana Companies recorded revenue of approximately \$8.7 billion and had assets of approximately \$7.4 billion and liabilities totaling \$6.8 billion.).

86. *Id.* at 410 (stating that Dana filed bankruptcy on March 3, 2006).

87. *Id.*

88. *Id.* at 410–411.

89. *Id.* at 411 (stating that in the Debtors' opinion, the holding of *In re Dairy Mart Convenience Stores Inc.*, 302 B.R. 128, 134–36 (Bankr. S.D.N.Y. 2003), language of § 546(c), and the existence of prior liens on the reclaimed goods rendered otherwise valid reclamation claims valueless and entitled them only to general unsecured claims).

Prior to bankruptcy, Dana borrowed money to support its operations (“Prepetition Credit Facility”).<sup>90</sup> Under the Prepetition Credit Facility agreement, each creditor received a security interest in Dana’s equipment, inventory, accounts, and certain other current assets.<sup>91</sup> When Dana declared bankruptcy, borrowings under the Prepetition Credit Facility equaled \$381 million, while the value of Dana’s assets exceeded the value of pre-petition indebtedness.<sup>92</sup> On the date of bankruptcy filing, Dana entered into interim agreement for post-petition financing that allowed it to pay off its prior debts.<sup>93</sup> Thereafter, the Bankruptcy Court entered its Final DIP order, which approved DIP facility financing.<sup>94</sup> The Final DIP Order authorized the Debtors to refinance the Prepetition Indebtedness with the proceeds of the DIP Facility.<sup>95</sup> Pursuant to the terms and conditions of the DIP Facility and the Final DIP Order, the Debtors repaid the Prepetition Indebtedness in full using funds borrowed under the DIP Facility.<sup>96</sup>

In response to the reclamation demands made by suppliers, Dana asserted a Prior Lien Defense and claimed that any rights to reclamation of goods are worthless. Further, Dana contended that because the pre-petition indebtedness exceeded the value of each individual reclamation claim and because goods subject to reclamation claims were disposed as part of the transaction to repay the prior claims of lien holders, the reclamation claims are valueless.<sup>97</sup>

In response to Dana’s assertions, the suppliers filed opposition responses claiming the pre-petition secured debt was not paid with the proceeds of reclaimed goods, but instead with the proceeds of the DIP

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90. *In re Dana Corp.*, 367 B.R. at 412 (noting that under the Prepetition Credit Facility, Dana had access to \$400 million of revolving credit, of which up to a maximum \$100 million could be utilized for letters of credit).

91. *Id.*

92. *Id.* at 412.

93. *Id.* at 412–13. (stating that the Interim DIP Order issued by the Bankruptcy Court (1) authorized Debtor to obtain \$1.45 billion in secured post-petition financing, and (2) utilized the pre-petition lenders cash collateral and granted adequate protections to the pre-petition lenders. Under the DIP Facility and pursuant to the Interim DIP Order, the lenders (the “DIP Lenders”) were granted a valid, binding, continuing, enforceable, fully perfected first priority senior priming security interest in and lien (the “DIP Lien”) upon all prepetition and post-petition property of the Debtors, whether now existing or hereafter acquired, that is subject to the existing liens. Further, the Interim DIP Order stated that there was no cross-collateralization of pre-petition or post-petition liens).

94. *Id.* at 413 (noting that the Bankruptcy Court approved “the DIP Facility on a final basis and authorized the use of the Prepetition Lenders’ cash collateral and the granting of the DIP Lien and the Replacement Lien to the DIP Lenders and Prepetition Lenders, respectively.” Further, the Final DIP Order authorized the Debtors to refinance the Prepetition Indebtedness with the proceeds of the DIP Facility).

95. *Id.*

96. *Id.*

97. *Id.*

Loan. Suppliers argued that reclamation rights were only subject to a prior lien, that pre-petition debt was satisfied from a source other than the reclaimed goods, and that the reclaimed goods were liberated from the prior lien and reclamation claims must be valued in full.<sup>98</sup> In regards to the asserted Prior Lien Defense, the suppliers argued that their reclamation rights were not extinguished by the existence of prior lien, but only rendered subordinate to the prior lien, and that Prepetition Lenders were over secured; thus permitting the claimants to recover from any excess value.<sup>99</sup>

The court held for Dana and stated that the Prior Lien Defense asserted by Dana rendered suppliers' reclamation rights valueless.<sup>100</sup> The court stated that reclaiming suppliers do not have a right to compel a lien holder to satisfy its claim from other collateral.<sup>101</sup> Thus, 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.<sup>102</sup> The court analogized the current case to *In re Dairy Mart Convenience Stores, Inc.*, which held that sale of goods in satisfaction of pre-petition debt renders all reclamation claims for those goods valueless.<sup>103</sup>

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98. *In re Dana Corp.*, 367 B.R. at 413.

99. *Id.* at 418.

100. *Id.* at 421.

101. *Id.* at 419 (stating that reclamation is an *in rem* remedy, and reclaiming sellers have no right to compel a lienholder to satisfy its claim from other collateral). See *Galey & Lord Inc. v. Arley Corp. (In re Arlco, Inc.)*, 239 B.R. 261, 275 (Bankr. S.D.N.Y. 1999) (noting that "a party seeking reclamation . . . may not compel the application of marshaling against a good faith purchaser"); *Simon & Schuster, Inc. v. Advanced Mktg. Servs. (In re Advanced Mktg. Servs.)*, 360 B.R. 421, 427 (Bankr. D. Del. 2007) (ruling that "unsecured creditors cannot invoke the equitable doctrine of marshaling").

102. *Dana Corp.*, 367 B.R. at 419. See *Yenkin-Majestic Paint Corp. v. Wheeling-Pittsburgh Steel Corp. (In re Pittsburgh-Canfield Corp.)*, 309 B.R. 277, 287 (B.A.P. 6th Cir. 2004) (holding that "[r]eclaiming seller is not entitled to administrative expense priority or lien without showing that claim has value outside of bankruptcy"); see also *In re Dairy Mart Convenience Stores Inc.*, 302 B.R. 128, 134 (Bankr. S.D.N.Y. 2003); *Allegiance Healthcare Corp. v. Primary Health Sys. (In re Primary Health Sys.)*, 258 B.R. 111, 117 (Bankr. D. Del. 2001); *In re Leeds Bldg. Prods.*, 141 B.R. 265, 270 (Bankr. N.D. Ga. 1992). See C. RICHARD MCQUEEN & JACK F. WILLIAMS, *TAX ASPECTS OF BANKR. L. AND PRACT.*, § 7:11 (3d ed. 2006) (stating that "[t]he reality is that, in most cases, asset-based financing provides a prior perfected lien on most goods such that the right of reclamation is rendered moot").

103. *In re Dana Corp.*, 367 B.R. 409, 419 (Bankr. S.D.N.Y. 2007). See *Dairy Mart Convenience Stores, Inc.*, 302 B.R. at 135-136 ("[w]here the claim of a prepetition secured lender with a floating lien on inventory is paid out of the proceeds of a post-petition credit facility supported by a new floating lien on inventory, the reclaimed goods securing the pre-petition lender's debt effectively have been disposed in satisfaction of that debt. Such a sale of goods in satisfaction of prepetition secured debt renders all reclamation claims for those goods valueless.").

### 3. *In re Incredible Auto Sales*

In *Auto Associates of Montana v. Incredible Auto Sales LLC*, a Montana bankruptcy court resolved a proceeding involving reclamation claims against insolvent debtor-seller of used automobiles and provided its interpretation of section 546(c).<sup>104</sup> The parties to the bankruptcy proceeding were insolvent debtor Incredible Auto Sales LLC (“Incredible”), reclaiming supplier Auction Associates of Montana, Inc. (“AAM”), and Incredible’s floor plan lender Hyundai Motor Finance Company (“HMFC”).<sup>105</sup>

Incredible was a retail and wholesale dealer of automobiles that purchased a number of vehicles from supplier AAM.<sup>106</sup> These vehicles were sold by AAM and purchased by Incredible in the ordinary course of business during the forty-five day period prior to Incredible’s filing for bankruptcy.<sup>107</sup> Incredible took possession of all the vehicles, displayed them on its retail lot, and offered them for sale to customers.<sup>108</sup> AAM transferred original certificates of title to Incredible for all but one vehicle.<sup>109</sup> Incredible tendered a payment for several vehicles sold, which was returned for insufficient funds.<sup>110</sup> Thereafter, Incredible notified AAM that it also was unable to pay for the remainder of the vehicles.<sup>111</sup>

As Incredible’s floor lender, HMFC held a security interest in all of Incredible’s used vehicle inventory.<sup>112</sup> The terms of the floor plan stated that Incredible had to pay for vehicles with its own funds.<sup>113</sup> Upon receipt

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104. *Auto Auction Assocs. of Mont., Inc. v. Incredible Auto Sales LLC (In re Incredible Auto Sales LLC)*, 2007 Bankr. LEXIS 1024, at \*31 (Bankr. D Mont. Mar. 26, 2007).

105. *Incredible Auto Sales LLC*, 2007 Bankr. LEXIS 1024, at \*2–5 (noting that the Incredible filed for bankruptcy protection of Chapter 11 on October 17, 2006).

106. *Incredible Auto Sales LLC*, 2007 Bankr. LEXIS 1024, at \*3.

107. *Id.* (noting that AAM sold seven used vehicles to Incredible pre-petition. In early October 2006, Incredible purchased the Subject Vehicles through AAM). *See id.* at \*6 (stating that “[w]hen AAM sold the Subject Vehicles to Incredible, it did so in the ordinary course of business at a time when Incredible was insolvent, all of which occurred within forty-five days of the commencement of the case”).

108. *Id.* at \*5.

109. *Id.*

110. *Id.* (noting that tendered checks by Incredible for three cars were returned for insufficient funds).

111. *Id.*

112. *Id.* at \*3–7 (noting that HMFC holds a properly perfected security interest in “[a]ll inventory of new and used motor vehicles and other personal property held for sale or lease including, but not limited to, display or demonstration items, returns and repossessions, and accessories and additions thereto.” HMFC’s security interest is evidenced by Inventory Loan and Security Agreement and three financing statements filed with the Montana Secretary of State’s office.).

113. *Id.* at \*7.



of vehicles' certificates of title, Incredible would fax the copies to HMFC, which in return would fund the entire purchase for vehicles bought at an auction, and eighty percent for vehicles bought directly from the seller.<sup>114</sup>

On the same date Incredible filed for bankruptcy, AAM timely filed a reclamation claim for vehicles sold to Incredible.<sup>115</sup> HMFC asserted that its security interest in Incredible's inventory is superior to AAM's reclamation rights.<sup>116</sup> Shortly after the filing for bankruptcy, the court granted a joint motion for HMFC and AAM to sell the used vehicles sold by AAM to Incredible at the auction to prevent their future depreciation in value and thereafter distribute the proceeds in accordance with the court's decision.<sup>117</sup> The net proceeds from the sale of vehicles were insufficient to pay either AAM or HMFC the full amount of their respective claims.<sup>118</sup>

The bankruptcy court had to decide who had the security interest in the goods, whether that security interest attached, and who was entitled to the proceeds of vehicle sale.<sup>119</sup> Like the courts in *Advanced Marketing Services* and *In re Dana*, this court also based its decision on the expressed language of section 546(c) which reads "subject to the prior rights of a holder of a security interest in such goods or proceeds thereof."<sup>120</sup> This bankruptcy court stated that floor plan lenders, like HMFC, are capable of possessing pre-petition or post-petition inventory liens and holding superior rights to reclamation holders.<sup>121</sup>

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114. *Incredible Auto Sales LLC*, 2007 Bankr. LEXIS 1024, at \*7.

115. *Id.* at \*6 (stating that "AAM provided a timely written demand to Incredible for reclamation of the Subject Vehicles.").

116. *Id.* at \*3, \*14–15 (noting that in its claims AAM contends (1) its reclamation claims are superior to HMFC perfected inventory flooring loan; (2) course of performance and course of dealings establish that the auction transactions were never completed as full payment was not made so HMFC's security interest could never attach; (3) Incredible's misconduct, i.e., its knowledge that the proffered checks were worthless, prevented Incredible from obtaining rights in the vehicles; (4) that HMFC did not act in good faith as HMFC was not merely enforcing its rights but restructuring how it dealt with Incredible. In response, HMFC contends that (1) its inventory flooring loan is superior to AAM's reclamation claims and (2) its security interest attached to the above described vehicles because Incredible obtained rights in the vehicles securing its inventory flooring lien.)

117. *Incredible Auto Sales LLC*, 2007 Bankr. LEXIS 1024, at \*8–9 (Bankr. D Mont. Mar. 26, 2007) (stating that the parties' substantive rights were unaffected by the sale of the vehicles. To the extent either party had a right in the vehicles sold, such party now had the rights in the sale proceeds).

118. *Id.* at \*9.

119. *Id.* at \*20–21 ("[T]he issue becomes whether the debtor has rights in the collateral, as the Court based on the stipulated facts concludes that value has been given and Debtor has authenticated a security agreement describing the collateral. If Incredible . . . has rights in the collateral . . . then [HMFC's] flooring security interest will be superior to AAM's reclamation claim"). See Deborah Thorne, *Reclamation under the New § 546(c)(1): Illusory Remedy as Ever: In re Dana Corp. and Incredible Auto Sales LLC*, 26 ABI J. 5 (2007).

120. See Thorne, *supra* note 119.

121. *Incredible Auto Sales LLC*, 2007 Bankr. LEXIS 1024, at \*19–20 (Bankr. D Mont. Mar. 26, 2007) (noting that "[f]looring lenders for businesses with perfected security interests in pre and post-

The court stated that the lender HMFC was entitled to all of the proceeds of the vehicles, except one vehicle for which the certificate of title was not provided. The court held for HMFC due to its security interest in the vehicles, because AAM delivered titles for the vehicles, and because Incredible tendered checks and took possession of the vehicles sold.<sup>122</sup> The court ruled that HMFC had a security interest that attached to Incredible's inventory, where the certificates of title were delivered.<sup>123</sup> This included the used vehicles that Incredible purchased from AAM, except for the vehicle for which certificate of title was not delivered.<sup>124</sup> Thus, HMFC's lien on vehicles for which it received title was superior to reclamation claims asserted by AAM.<sup>125</sup> As a result, the court stated that AAM was entitled to recover the proceeds from the sale of one vehicle for which the certificate of title was not provided, while HMFC was entitled to the remaining proceeds.<sup>126</sup>

#### 4. *Practice under New Section 546(c)*

The enactment of section 546(c) did not provide the anticipated expansion of supplier's rights. As a matter of practice, section 546(c) has not resulted in much benefit to suppliers due to their subordination to prior floating and post-petition liens on inventory.<sup>127</sup> The bankruptcy court decisions in *AMS*, *Dana*, and *Incredible Auto Sales* confirm that "sellers of goods should not expect the new section 546(c) and the forty-five-day reach-back to improve their position."<sup>128</sup> These cases show that supplier's reclamation rights are often worthless because the insolvent debtor's inventory is subject to prior floating liens on after-acquired property.<sup>129</sup>

The *AMS* case suggests that under the BAPCPA the reclamation became a "hollow remedy" when a debtor has a pre-petition secured claim that exceeds the value of the reclamation goods.<sup>130</sup> The *AMS* showed that

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petition inventory held superior rights to a seller's reclamation rights under the Uniform Commercial Code ("UCC") or the bankruptcy code. The Court looks to State law to determine the property rights of the respective parties").

122. *Incredible Auto Sales LLC*, 2007 Bankr. LEXIS 1024, at \*3, \*21, \*31-32.

123. *Id.* at \*20-21.

124. *Id.* See Thorne, *supra* note 119, at 2 (stating that "[w]here title had not passed, the security interest had not attached and AAM was entitled to reclaim its vehicles").

125. See Thorne, *supra* note 119, at 2.

126. *Incredible Auto Sales LLC*, 2007 Bankr. LEXIS 1024, at \*3, \*31-32.

127. Lee Harrington & Francis Morrisey, *Retail Reclamation Claims: "Give Me Back My Stuff (or at Least Pay Me For It)"*, AM. BANKR. INST., NORTHEAST BANKR CONF., 300-01 (2009).

128. See Thorne, *supra* note 119.

129. Harrington & Morrisey, *supra* note 127, at 313.

130. Bruce S. Nathan, *Reclamation Rights Under BAPCPA: The Same Old Story*, BUS.

BAPCA's new forty-five-day reclamation period is of limited utility because the insolvent buyer may not be in possession of the goods when the supplier seeks to enforce reclamation rights.<sup>131</sup> In *AMS*, S&S sought to reclaim goods sold immediately after the commencement of bankruptcy, at the hearing three weeks later only a fraction, \$800,000 out of \$5 million, of the S&S goods remained in AMS's possession.<sup>132</sup>

The *Dana* case demonstrated that suppliers must be wary of effects DIP financing might have on pre-petition debt. Even though suppliers' reclamation rights are subject to prior rights of a security interest holder, suppliers' opportunity for successful reclamation of goods may be further reduced by unfavorably drafted DIP agreement. *Dana* suggests that to preserve reclamation rights, suppliers need to object in a timely fashion to provisions inconsistent with their reclamation rights in DIP orders that debtors and other post-petition lenders present to bankruptcy courts for approval.<sup>133</sup>

The *Incredible Auto Sales* case affirmed that bankruptcy courts in different circuits are interpreting section 546(c) similarly. Further, the court confirmed that suppliers cannot reclaim their goods when their reclamation rights are subordinate to those of secured lenders. The court held that supplier may receive some compensation for its goods, if supplier does not deliver the certificate of title of the goods sold to the insolvent debtor.<sup>134</sup>

Together these cases show that the enactment of BAPCPA's section 546(c) did not provide additional protection for the suppliers. Rather, the practical consequence of section 546(c) demonstrate that the burden is on the suppliers to protect themselves against potential losses during business transactions with insolvent debtors or buyers nearing insolvency. The burden is on the suppliers to do due diligence into buyer's prior financing arrangements with its past and current creditors. The suppliers are responsible for being certain that the goods sold are in the buyer's possession when the reclamation rights are ultimately served.<sup>135</sup>

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CREDIT, Apr. 2007, at 22–25.

131. Harrington & Morrisey, *supra* note 127, at 307.

132. *Id.* at 308.

133. Harrington & Morrisey, *supra* note 127, at 313.

134. *Auto Auction Assocs. of Mont., Inc. v. Incredible Auto Sales LLC (In re Incredible Auto Sales LLC)*, 2007 Bankr. LEXIS 1024, at \*3, 31–32 (Bankr. D Mont. Mar. 26, 2007)

135. Harrington & Morrisey, *supra* note 127, at 313.

## B. ADMINISTRATIVE PRIORITY STATUS UNDER SECTION 503(B)(9)

In addition to reclamation, suppliers also have the ability to seek a priority administrative expense under BAPCPA section 503(b)(9). Proper utilization of this section provides suppliers with an opportunity to improve the priority of their pre-petition claim. This means that a supplier will be able to increase the likelihood of full and faster payment for goods sold to a financially distressed buyer that files for bankruptcy protection.

### 1. *Application and Beneficial Aspects of Section 503(b)(9)*

The BAPCPA section 503(b)(9) provides an administrative priority status for “the value of any goods received by the debtor within twenty days” of the petition date that “were sold to the debtor in the ordinary course of business of such debtor’s business.”<sup>136</sup> The reason for allowing administrative priority status is to prevent debtors from acquiring goods on the brink of bankruptcy filing when the debtor knows it would be unable to pay for the purchased goods.<sup>137</sup> The application of section 503(b)(9) is only limited to goods,<sup>138</sup> where presumably the price is the value of the goods.<sup>139</sup> For the purposes of section 503(b)(9), the goods are defined by the U.C.C.<sup>140</sup> The provision applies to all suppliers, irrespective of whether the supplier delivers a reclamation demand.<sup>141</sup>

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136. 11 U.S.C. § 503(b)(9) (West 2012) (noting that “[a]fter notice and a hearing, there shall be allowed, administrative expenses, other than claims allowed under section 502(f) of this title [11 USCS § 502(f)], including . . . (9) 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 to the debtor in the ordinary course of such debtor’s business”).

137. COLLIER ON BANKR. P 503.16 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. Rev. 2011).

138. Accordingly, any claims for services or personal property other than goods are not within § 503(b)(9).

139. Judith Greenstone Miller & Jay L. Welford, *503(b)(9) Claimants – the New Constituent, A/K/A “The 500 Pound Gorilla,” at the Table*, 5 DEPAUL BUS. & COM. L.J. 487, 489 (2007) (stating that “[p]resumably, the invoice price of the goods (exclusive of interest, freight or other charges) would be applicable amount in valuing the claim, so long as it represents the price that was ordinarily used between the parties”).

140. *In re Samaritan Alliance, LLC*, 2008 Bankr. LEXIS 1830, at \*7 (Bankr. E.D. Ky. Jun. 20, 2008). Under U.C.C. § 2-103(k), the term “goods” means all things that are movable at the time of identification to a contract for sale. The term includes future goods, specially manufactured goods, the unborn young of animals, growing crops, and other identified things attached to realty as described in U.C.C. § 2-107. The term does not include information, the money in which the price is to be paid, investment securities under Article 8, the subject matter of foreign exchange transactions, or chooses in action. See Rudolph J. Di Massa Jr. & Matthew E. Hoffman, *UCC Definition of “Goods” Applies to §503(b)(9)*, AM. BANKR. INST. J., Sept. 2009 (providing insight on the definition of goods).

141. Miller & Welford, *supra* note 139, at 489. See Lisa Gretchko, *The Bankruptcy Reform Act One Year Later: A Disappointment for Trade Creditors*, 26 AM. BANKR. INST. J., 18, 18 (2007).

The section 503(b)(9) claim is particularly beneficial for suppliers because it ranks second on the bankruptcy priority list, and provides suppliers the same payment priority as debtor's professionals.<sup>142</sup> In most bankruptcy cases, administrative claims are paid in full.<sup>143</sup> Further, a remedy under section 503(b)(9) is independent of reclamation claim under section 546(c), which means that reclamation defenses available to insolvent debtors under section 546(c) do not apply.<sup>144</sup>

A supplier who exercises this right can be in a better position than unsecured creditors since the Chapter 11 reorganization plan cannot be confirmed unless all administrative expense claims are paid. Unsecured creditors typically receive only a fraction of their claims.

## 2. Negative Implications of Section 503(b)(9)

The application of section 503(b)(9) has its own drawbacks that impact suppliers. First, in order to obtain the administrative expense, the suppliers need to file a motion for allowance and payment of an administrative claim where they have the burden of proving that the claim is in fact administrative.<sup>145</sup> Failure to timely file may preclude recovery and the filing dates vary by jurisdictions.<sup>146</sup> This requires an engagement of counsel and payment of undesired legal fees.<sup>147</sup> Since section 503(b)(9) claims are adverse to general unsecured claims due to priority, suppliers with section 503(b)(9) claims cannot rely on the committee of unsecured creditors to protect their interests.<sup>148</sup> As a result, these suppliers must either defend their administrative claim alone or form their own ad hoc own committee.<sup>149</sup> Again, this imposes undesired legal expenses on the suppliers.

Second, even if the supplier is awarded a section 503(b)(9) administrative claim, it may not get paid. The bankruptcy estate may become administratively insolvent, in which case the awarded section

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142. 11 U.S.C. § 507(a)(2) (2010).

143. Stephen Selbst, *BAPCPA Turns Three*, COM. LENDING REV., Nov.-Dec. 2008, at 9-16 (noting that "[i]n most cases, administrative claims are paid in full, rather than pennies on the dollar for general unsecured claims").

144. 11 U.S.C. § 503(b)(9). See Gretchko, *supra* note 141, at 19.

145. *In re Collins & Aikman Corp.*, 384 B.R. 751, 759 (Bankr. E.D. Mich. 2008) (noting that "[a] creditor seeking administrative expense priority has the burden of proving that its claim is within section 503").

146. Miller & Welford, *supra* note 139, at 490. See *In re Ward Prod., LLC*, Case No. 06-50527 (Bankr. E.D. Mich. 2006) (exemplifying various filing dates).

147. Gretchko, *supra* note 141, at 19.

148. *Id.*

149. *Id.*

503(b)(9) claim will not be paid in full or at all.<sup>150</sup> Supplier's section 503(b)(9) claim itself affects the bankruptcy estate because it provides for another claim that needs to be paid, which may reduce the amount other claimants may receive.<sup>151</sup> The DIP financing orders may provide lenders with first-priority liens on all assets, which include the administrative claims.<sup>152</sup> As a result, suppliers with section 503(b)(9) claims will be paid after DIP lenders are paid.

Third, the payment of section 503(b)(9) claims may be delayed by the debtor or by the creditor committee. Under section 1129(a)(9) of the Bankruptcy Code, administrative claims are not required to be paid until the effective date of a Chapter 11 plan.<sup>153</sup> Although the case law requires the committee to act in the best interest of its constituency,<sup>154</sup> committees are often composed of unsecured creditors with personal agendas and interests. Thus, stalling by other creditors opposing the plan may delay any payments to the supplier with a valid section 503(b)(9) expense.

Fourth, supplier's aggressive actions to obtain administrative claim payments by seeking adequate assurance from the debtor or by pushing for conversion of the case from Chapter 11 to Chapter 7 often do not provide any additional benefits. Suppliers are unwilling to seek conversion because if the case is converted to Chapter 7 liquidation the obtained proceeds may not be sufficient to reach and pay any administrative claims.<sup>155</sup> For instance, in *In re Southern Prods., Inc.* an ad hoc committee filed a request

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150. Gretchko, *supra* note 141, at 19.

151. *Id.*

152. *Id.* at 44 (noting that “[a]lthough trade creditors argue that this favorable treatment should be limited to “new cash” from the lender, some courts overrule that objection. Aggressive administrative claimants might seek a carve-out from the secured creditor’s collateral or an assignment of other assets in order to ensure payment of the § 503(b)(9) claim. But the single trade creditor is often unwilling to finance that fight, or doesn’t have enough at stake to warrant the legal expense”).

153. 11 U.S.C. § 1129(a)(9) (2010). See *In re Global Home Prods., LLC*, 2006 Bankr. LEXIS 3608, at \*9–10 (Bankr. D. Del. Dec. 21, 2006) (stating that “Section 503 does not specify a time for payment of these expenses but administrative expenses must be paid in full on the effective date of the plan as provided in § 1129(a)(9)”).

154. *In re Haskell-Dawes, Inc.*, 188 B.R. 515, 519 (Bankr. E.D. Pa. 1995) (stating that “the creditors appointed to the creditors’ committee have a fiduciary obligation to act in the interests of the members whom they represent”); *In re Nationwide Sports Distribs., Inc.*, 227 B.R. 455, 463 (Bankr. E.D. Pa. 1998) (stating that the purpose of committees is to “represent the interests of unsecured creditors and to strive to maximize the bankruptcy dividend paid to that class of creditors”).

155. Gretchko, *supra* note 141, at 44–45 (stating that “[t]rade creditors might seek adequate assurance that their administrative claims will be paid, and if the debtor is unable to provide that assurance, then they might be able to push for conversion of the case. However, some trade creditors are loath to seek conversion of the bankruptcy case because that would result in a liquidation of the debtor and the trade creditor would lose a customer, let alone the risk that the liquidation proceeds are not sufficient to reach administrative claims. Also, these protections are theoretical, at best, to the single trade creditor that doesn’t want to pay the legal fees inherent in obtaining them”).

for payment of section 503(b)(9) claims.<sup>156</sup> The debtors opposed the motion for payment. Eventually, the case was converted to Chapter 7 and issues pertaining to payment of section 503(b)(9) claims were deferred until the trustee could discover whether the funds existed for payment of the administrative claims. When the trustee allowed claimants' claims, there was no money in the estate to pay them.<sup>157</sup> Accordingly, due to the incentives of better financial recovery, the suppliers are better off staying in Chapter 11.

Fifth, section 503(b)(9) only permits the allowance of an administrative expense claim where the supplier can demonstrate "that the debtor has received the goods, and not just their value."<sup>158</sup> In *In re Plastech Engineered Prods.*, a supplier sold goods to the debtor in the ordinary course of the debtor's business in the twenty days prior to debtor filing for Chapter 11 bankruptcy.<sup>159</sup> The supplier's invoices stated that the goods were sold to the debtor, were billed to the debtor, but were shipped to a third party with whom the debtor had a separate agreement.<sup>160</sup> The supplier's invoices also indicated that payment for the goods was to be made by the debtor directly to the supplier.

The supplier filed a motion requesting an order allowing section 503(b)(9) expense for goods sold to a debtor during twenty days before the bankruptcy petition.<sup>161</sup> The supplier argued that the value of the goods was received by the debtor and that the debtor had possession of the goods.<sup>162</sup> The debtor objected claiming that the goods were not received by the debtor as required by the statute, but were instead received by a third party.<sup>163</sup> The court held for the debtor and stated that section 503(b)(9)

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156. *In re Southern Prods., Inc.*, 2005 WL No. 05-61822 (Bankr. E.D. Mo.) (noting that in addition, Motion for Return of Goods under § 546(c) was also filed).

157. Gretchko, *supra* note 141 (stating that "[a]ccording to Deborah Kovsky-Apap of Pepper Hamilton LLP (the firm representing the ad hoc committee), the chapter 7 trustee eventually allowed the claimants' reclamation claims and their § 503(b)(9) claims, all as chapter 11 administrative claims—but as of Jan. 3, 2007, there has been no money in the estate to pay them!").

158. *In re Plastech Engineered Prods.*, 394 B.R. 147, 151 (Bankr. E.D. Mich. Oct. 7, 2008) (stating that "§ 503(b)(9) only permits the allowance of an administrative expense claim where the administrative expense claimant demonstrates that the debtor has received the goods, and not just their value").

159. *In re Plastech Engineered Prods.*, 394 B.R. at 151.

160. *In re Plastech Engineered Prods.*, 394 B.R. at 151. The debtor and third party had an agreement entitled Extended Enterprise Agreement, which also reflected that supplier would ship the goods it sold to the debtor directly to third party. The supplier was not a party to the Extended Enterprise Agreement and its other terms are not set forth in the record. There was no contract between supplier and third party. *Id.*

161. *Id.* at 149 (stating that the amount of § 503(b)(9) expense was \$104,676.32).

162. *Id.* at 149–150.

163. *In re Plastech Engineered Prods.*, 394 B.R. 147, 150 (Bankr. E.D. Mich. Oct. 7, 2008).

requires the debtor to receive goods, not just the value of such goods.<sup>164</sup> As a result of shipping the goods to the third party as requested by the debtor, the supplier could not receive the administrative expense priority status and diminished its chances of obtaining a full payment on its sale.

Sixth, section 503(b)(9) only applies to goods. In *In re Goody's Family Clothing, Inc.*, a debtor that operated approximately 350 family-apparel retail stores, filed for Chapter 11 bankruptcy.<sup>165</sup> During the twenty days prior to debtor's petition date, one of debtor's service providers submitted a bill for inspecting, ticketing, and repackaging apparel that the debtor purchased from other vendors.<sup>166</sup> The debtor objected asserting that the claim was misclassified because it was for the services provided and not for the goods sold.<sup>167</sup> The court held for the debtor and stated that the term "goods" does not encompass services, thus denying creditor's section 503(b)(9) claim.<sup>168</sup>

Seventh, a supplier may not compel an immediate payment of a section 503(b)(9) claim.<sup>169</sup> In *In re Global Home Prods., LLC.*, creditor-supplier, Industria Mexicana de Aluminio, S.A. de C.V. ("IMASA"), filed a motion for allowance and immediate payment of a section 503(b)(9) claim.<sup>170</sup> In their motion, IMASA argued that it is inequitable to delay the payment of administrative expense claim due to its priority.<sup>171</sup> The debtor opposed the motion and claimed the financing order prohibited the payment of the claims or expenses.<sup>172</sup> Debtor argued that they are only to pay administrative claims that are directly attributable to the operation of the business in the ordinary course of business and in accordance with the financing agreements, or by approval by the court and the DIP lender.<sup>173</sup> Debtor also argued that a payment of IMASA's administrative claim could constitute default under the financing agreements and violate provisions of

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164. *In re Plastech Engineered Prods.*, 394 B.R. at 152.

165. *In re Goody's Family Clothing, Inc.*, 401 B.R. 131, 133 (Bankr. D. Del. 2009).

166. *Id.* at 133 (noting that the bill amounted to \$63,118.50).

167. *In re Goody's Family Clothing, Inc.*, 401 B.R. at 133.

168. *Id.* at 137.

169. Selbst, *supra* note 143, at 13.

170. *In re Global Home Prods., LLC.*, 2006 Bankr. LEXIS 3608, at \*6 (Bankr. D. Del. Dec. 21, 2006) (noting that IMASA has requested allowance of its claims for the aluminum as an administrative expense claim in the amount of the full value of the goods and that Debtors make payment within three business days of the Court's entry of an order granting the Motion).

171. *In re Global Home Prods., LLC.*, 2006 Bankr. LEXIS 3608, at \*7 (noting that additionally, IMASA claimed that it is entitled to adequate protection of its interest in cash collateral).

172. *Id.* at \*8 (noting that Paragraph 1.2 of the Final Financing Order prohibits Debtors' use of loan proceeds for payment of claims not provided for in the financing agreements and budget without the Court's approval. Section 5.2 of the Ratification Agreement also restricts Debtors' use of DIP Financing proceeds to pay administrative claims).

173. *Id.*



the financing order.<sup>174</sup> The Debtor claimed that immediate payment of §503(b)(9) claims would expose the Debtor to financial risk by adversely affecting its borrowing ability.<sup>175</sup> Finally, the Debtor contended that §503(b)(9) does not require immediate payment and that it is silent on the issue of timing.<sup>176</sup>

When a claimant timely files a request for payment of an administrative expense under section 503(a), the timing of the payment of that administrative claim is left to the discretion of the court.<sup>177</sup> The court stated that three factors are considered in determining when to pay the administrative claim: (1) the prejudice to the debtors, (2) hardship to the claimant, and (3) potential detriment to other creditors.<sup>178</sup>

In denying IMASA's motion for immediate right to payment, the court found that IMASA would suffer little prejudice or hardship if administrative payment is deferred until confirmation of the plan.<sup>179</sup> The court also found that due to Debtors financial position and requirements of the DIP financial agreement, Debtors will suffer substantial hardship if the immediate payment on IMASA's section 503(b)(9) claim is presently allowed.<sup>180</sup>

In another case, *In re Bookbinders' Rest., Inc.*, a different bankruptcy court decided that a creditor who holds an allowed administrative expense under section 503(b)(9) is not entitled to an immediate payment of the allowed expense.<sup>181</sup> Bookbinder's Restaurant ("Bookbinder's") filed a voluntary petition under Chapter 11 and continued its operations, while the committee of unsecured creditors was appointed.<sup>182</sup> Bookbinder's five creditors, each of which supplied goods to Bookbinder's within twenty days of bankruptcy filing, requested the allowance of an administrative

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174. *In re Global Home Prods., LLC*, 2006 Bankr. LEXIS 3608, at \*8.

175. *Id.* at \*8–9 (Bankr. D. Del. Dec. 21, 2006)

176. *Id.* at \*9.

177. *Id.* at \*10–11. *In re Garden Ridge Corp.*, 323 B.R. 136, 143 (Bankr. D. Del. 2005) (noting the discretion); *Varsity Carpet Servs. v. Richardson (In re Colortex Indus.)*, 19 F.3d 1371, 1384 (11th Cir. 1994). See also *In re Continental Airlines, Inc.*, 146 B.R. 520, 531 (Bankr. D. Del. 1992) (stating that "[i]n making this determination, one of the chief factors courts consider is bankruptcy's goal of an orderly and equal distribution among creditors and the need to prevent a race to a debtor's assets").

178. *In re Global Home Prods.*, 2006 Bankr. LEXIS 3608, at \*12–13.

179. *Id.* at \*15–16.

180. *In re Global Home Prods.*, 2006 Bankr. LEXIS 3608, at \*15–16.

181. *In re Bookbinders' Rest., Inc.*, 2006 Bankr. LEXIS 3749, at \*5 (Bankr. E.D. Pa. Dec. 28, 2006).

182. The "Old Original Bookbinders" is well known in the region as a "landmark" restaurant located in Center City, Philadelphia. It is a not-for-profit corporation founded by the City of Philadelphia and the Greater Philadelphia Chamber of Commerce to promote economic development in the City, the restaurant began operated continuously from 1865 to 2001.

expense under section 503(b)(9).<sup>183</sup> The five creditors disagreed as to the timing of the payments of their administrative expenses under section 503(b)(9). One creditor agreed that expenses should be paid when all administrative expenses are paid and three other creditors agreed to defer the actual payment until the later date.<sup>184</sup> The fifth creditor, Blue Crab Plus Sfd. (“Blue Crab”), insisted on immediate payment of its allowed expense.<sup>185</sup>

Blue Crab argued that section 503(b)(9) requires debtor to treat administrative expenses in the same manner as administrative expenses arising from the post-petition delivery of goods and services,<sup>186</sup> and that Debtor was financially able to make the payment.<sup>187</sup> Bookbinder opposed the motion and argued that (1) payment of administrative expenses is within the discretion of the bankruptcy court; (2) monthly financial reports do not fully reflect operational reality, which is less liquid than it might appear; and (3) immediate payment to Blue Crab will impair its cash position and jeopardize its reorganization.<sup>188</sup>

The court exercised its discretion and ruled against Blue Crab. The court stated that section 503(b)(9) does not provide an explicit instruction for an immediate payment of administrative expenses to Blue Crab. To grant an automatic right to immediate payment of administrative expense to Blue Crab would expand the statutory provision and derogate the accepted principle that the timing of payment of an allowed administrative expense is within the court’s discretion.<sup>189</sup> Further, the Court stated that Blue Crab failed to present authority supporting the contention that a section 503(b) administrative interest holder has an unqualified legal entitlement to be

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183. *Bookbinders’ Rest., Inc.*, 2006 Bankr. LEXIS 3749, at \*3–4 (Bankr. E.D. Pa. Dec. 28, 2006).

184. *Id.* at \*5 (stating that “[o]ne of the five creditors, [U.S. Food Service, Inc.] agreed that its expense should be paid when the Debtor pays other administrative expenses in the case. Three of the five creditors [Killian’s Harvest Green, Fichera Foods, Inc. and OceanPro Industries, Ltd.] agreed to defer the actual payment of the allowed administrative expense for the time being, while reserving the right to request immediate payment at a later time”).

185. *Bookbinders’ Rest., Inc.*, 2006 Bankr. LEXIS 3749, at \*5.

186. *Id.* at \*6 (noting that at the hearing, Blue Crab argued that if the Debtor was paying its utility bills, it was equally obligated to pay its § 503(b)(9) administrative expenses).

187. *Id.* (noting that Blue Crab stated that Debtor’s monthly operating report stated that Debtor had over \$200,000, which was sufficient to pay Blue Crab’s claim of \$33,021.74).

188. *Bookbinders’ Rest., Inc.*, 2006 Bankr. LEXIS 3749, at \*7.

189. *Id.* at \*16 (noting that § 503(b)(9) does nothing more than “define a type of liability, previously treated as pre-petition claim, which is now accorded administrative expense status. The text of § 503(b)(9) neither states or even implies the allowance of the expense encompasses an unqualified right to immediate payment. Nor does the text of provision suggest that an administrative expense allowed under § 503(b)(9) is to be treated in a more favorable manner than any other allowed § 503(b) administrative expense.” The Court noted that it is unaware of existence of any legislative history that would support Blue Crab’s argument.). See H.R. Rep. No. 109-31 (2005) at 146.

paid at the same time as post-petition creditors that receive payments in the ordinary course of business.<sup>190</sup>

Because of these two cases, immediate right to payment does not exist and the timing of administrative claims payments remains in the discretion of the bankruptcy court.<sup>191</sup>

### 3. *Implications of Phar-Mor, Inc.*

The decision in *Phar-Mor, Inc.* addresses the supplier's rights to reclamation and administrative expense payments prior to passage of the BAPCPA. Although the court's decision was based on the pre-BAPCPA laws, it provides suppliers and creditors with relevant arguments for post-BAPCPA litigation.<sup>192</sup>

In, *Phar-Mor, Inc.*, the debtor ("Phar-Mor") filed for Chapter 11 bankruptcy in September 2001, but continued to operate its business as DIP. As a result, 141 of Phar-Mor's suppliers sent reclamation claims seeking to recover goods they had delivered to Phar-Mor on credit totaling over \$18 million. Phar-Mor proposed that each supplier be granted an administrative expense priority claim under section 503(b) in the amount of its allowed reclamation claim. All but one of Phar-Mor suppliers, McKesson, settled.

Phar-Mor's pre-petition debt amounted to \$103 million, which consisted of loan and security agreements with some of its lenders. Substantially all of Phar-Mor's assets, which included all reclamation goods and other inventory, secured this debt. As part of reorganization, the bankruptcy court authorized Phar-Mor to borrow \$135 million, which Phar-Mor utilized to repay pre-petition secured creditors,<sup>193</sup> thus extinguishing their secured interests. The new creditors, the DIP lenders, received super-priority status over remaining security interests, which included priority over any administrative expense claims, including one of McKesson.<sup>194</sup> After Phar-Mor paid its post-petition loan from the DIP lenders, expenses,

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190. *Bookbinders' Rest., Inc.*, 2006 Bankr. LEXIS 3749, at \*17. Post-petition creditors get paid in the ordinary course of business under 11 U.S.C. § 363(c)(1).

191. *Selbst*, *supra* note 143, at 13.

192. Lisa Gretchko, *Sixth Circuit's Phar-Mor Decision Breathes New Life into Reclamation Remedy*, 27 AM. BANKR. INST. J., 14, 54-55 (2008).

193. The bankruptcy court authorized Phar-Mor to borrow the \$135 million and gave the DIP Lenders super-priority status in an Interim Order issued on the petition date. Phar-Mor borrowed the money, repaid the pre-petition secured creditors (extinguishing their security interests), and gave the DIP Lenders super-priority security interests that same day.

194. *Phar-Mor, Inc. v. McKesson Corp.*, 534 F.3d 502, 503-04 (6th Cir. Ohio 2008).

fees, and money allotted to reclamation claims, it was left with \$30 million towards the payment of \$185.5 million of general unsecured claims.<sup>195</sup>

In February 2003, Phar-Mor motioned the bankruptcy court to reclassify its outstanding reclamation claims as general unsecured claims. In the support of its motion, Phar-Mor argued that supplier's administrative-expense priority claims were extinguished when the goods subject to reclamation were sold with the proceeds used to pay the DIP lenders. Conversely, the suppliers claimed that they were automatically entitled to either an administrative expense priority claim or a lien for a full amount of their reclamation rights allowed by section 546(c).<sup>196</sup> The bankruptcy court denied Phar-Mor's motion and held that even though the reclamation claims were rendered subject to DIP lender's super-priority, the suppliers had properly filed their reclamation claims and had administrative-expense priority over the general claims.<sup>197</sup>

After having its motion for reconsideration denied twice by the bankruptcy court, and having the district court uphold the bankruptcy court, Phar-Mor appealed to the Sixth Circuit Court of Appeals. On appeal, the main issue in Phar-Mor was whether the supplier's administrative expense priority of its reclamation claim was barred when the goods subject to reclamation were sold and those proceeds were used to satisfy a secured creditor's superior claim.<sup>198</sup> The Sixth Circuit affirmed the lower courts' decisions and held that McKesson was properly granted its administrative expense priority in lieu of its reclamation claim.<sup>199</sup> In its ruling, the court noted that the state law granted supplier a right to reclaim its goods and that a secured creditor's claim did not defeat that right.<sup>200</sup> The court further found that pre-BAPCA section 546(c)(2) granted the bankruptcy court the power to deny a properly reclaiming supplier its right to reclaim goods, but only if the denied supplier is either given an administrative priority in the amount of the goods or a lien on the proceedings resulting from the use of those goods by the debtor.<sup>201</sup>

The Phar-Mor decision is neither an anomaly nor a new trend, but rather a pro-supplier decision based on pre-BAPCPA laws. As during the

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195. *Phar-Mor, Inc.*, 301 B.R. at 504.

196. *Id.* at 496 (Bankr. N.D. Ohio, 2003). See also Bruce S. Nathan, *Are Reclamation Rights Preserved Where Debtor's Secured Dip Lender Pays Off Pre-Petition Secured Inventory Lender? Yes and No!*, BUS. CREDIT, Mar. 2004, at 16–20.

197. *Phar-Mor, Inc.*, 301 B.R. at 504.

198. *Id.* at 503.

199. *Phar-Mor, Inc.*, 301 B.R. at 504, 508.

200. *Id.* at 508.

201. *Id.* See *In re Dairy Mart Convenience Stores Inc.*, 302 B.R. 128, 134 (Bankr. S.D.N.Y. 2003) (rendering creditor's reclamation demands valueless and reclassified them as unsecured claims).

pre-BAPCPA period, the reclamation remains an ineffective remedy for suppliers, as illustrated by the post-BAPCPA decisions in *AMS*, *Dana*, and *Incredible Auto Sales*.<sup>202</sup> In light of post-BAPCPA court holdings, debtors and secured creditors are likely to interpret the *Phar-Mor* decision as irrelevant to subsequent practice because *Phar-Mor* was confined to UCC's narrower reclamation period and was based on the pre-BAPCPA version of section 546(c).<sup>203</sup> Conversely, the suppliers may assert that the *Phar-Mor* holding is an attempt by the Sixth Circuit court to send a message that it is time to stop robbing suppliers of their remedies under UCC and the Bankruptcy Code.<sup>204</sup> Further, although *Phar-Mor* never mentions section 503(b)(9), suppliers are likely to argue that the holding is relevant to their claims because it stands for the proposition that section 503(b)(9) administrative remedy claims that were created post-BAPCPA should not be eviscerated like reclamation remedies.<sup>205</sup>

#### IV. REMEDIES UNDER STATE LAW

In addition to BAPCPA, suppliers that sold goods to an insolvent buyer or a buyer who becomes insolvent may seek remedies available under the applicable state law provisions of Uniform Commercial Code ("UCC").<sup>206</sup> For the purposes of UCC, "goods" are defined as all things, including specially manufactured goods, which are movable at the time of identification to the contract for sale.<sup>207</sup> Under the UCC, the buyer is considered insolvent if: (1) the buyer generally ceased to pay debts in the ordinary course of business other than as a result of a bona fide dispute pertaining to those debts; (2) the buyer is unable to pay debts as they become due; or (3) if the buyer is insolvent within the meaning of the federal bankruptcy law.<sup>208</sup>

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202. Gretchko, *supra* note 192, at 55. Although cases such as *In re Lawrence Paperboard Corp.*, 52 B.R. 907 (Bankr. D. Mass. 1985), *In re Shattuc Cable Corp.*, 138 B.R. 557 (Bankr. N.D. Ill. 1992), *In re Pester Refining Co.*, 964 F.2d 842 (8th Cir. 1992), and *In re Arlco*, 239 B.R. 261 (Bankr. S.D.N.Y. 1999) did not kill reclamation altogether, they rendered it a useless remedy. By the late 1990s, case law had evolved to eviscerate completely the reclamation remedy.

203. Gretchko, *supra* note 192, at 54-55.

204. *Id.*

205. *Id.*

206. Harrington & Morrisey, *supra* note 127, at 301. ("Outside of bankruptcy, § 2-702 of the Uniform Commercial Code ("UCC") governs reclamation.")

207. U.C.C. § 2-105 (2004). Money in which the price is to be paid, investment securities and things in action by definition are not goods. The term "goods" also includes the unborn young of animals and growing crops and other identified things attached to realty as described in the section on goods to be severed from realty (§ 2-107). *Id.*

208. U.C.C. § 1-201(23) (2004). *See* Nathan, *supra* note 130, at 22. Insolvency is based on either

### A. RESCISSION OF SALE

The UCC provides the supplier of goods on credit with remedies to rescind the sale and reclaim the goods delivered to the insolvent buyer.<sup>209</sup> This remedy is available when the buyer fails to perform in the accordance with the contract,<sup>210</sup> such as tender a payment for the purchased goods when due.<sup>211</sup>

### B. GOODS IN TRANSIT

If the supplier discovers that the buyer is insolvent, the supplier may refuse to deliver or stop the delivery to the buyer in accordance to its contractual obligations.<sup>212</sup> The supplier may stop the delivery even if the contract calls for an extension of credit terms, such as a payment due within thirty days of the receipt of the invoice, unless the supplier is immediately paid in cash.<sup>213</sup>

Upon learning of buyer's insolvency, the supplier may also stop delivery of goods in transit or in the possession of a carrier or a bailee.<sup>214</sup> The supplier has the right to stop delivery until the insolvent buyer receives the goods.<sup>215</sup> The supplier may stop delivery of goods whether they are in

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the balance sheet test where liabilities exceed assets, or the equity test where the debtor has ceased paying its debts in the ordinary course of business or is unable to pay its debts as they become due. *See* 11 U.S.C. § 101(32) (2004) for federal bankruptcy code definition of insolvency.

209. U.C.C. § 2-702(1) (2004). 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 (§ 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 (§ 2-403). Successful reclamation of goods excludes all other remedies with respect to them. U.C.C. § 2-705 (2004).

210. U.C.C. § 2-703(1) (2004).

211. *Id.*, § 2-703(2)(f).

212. U.C.C. § 2-703(1), § 2-703(2)(a), § 2-703(2)(b).

213. *Atwood-Kellogg, Inc. v. Nickerson Farms*, 602 N.W. 2d 749, 752 (1999) (stating that the burden is on the seller to show that the seller demand the cash payment from the buyer).

214. U.C.C. § 2-705(1) (2003). The seller may stop delivery of goods in the possession of a carrier or other bailee when he discovers the buyer to be insolvent (§ 2-702) and may stop delivery of carload, truckload, planeload or larger shipments of express or freight when the buyer repudiates or fails to make a payment due before delivery or if for any other reason the seller has a right to withhold or reclaim the goods. *Id.*

215. U.C.C. § 2-705(2)(a) (2003).

possession of the carrier or a bailee.<sup>216</sup> To prevent the delivery of the goods, the supplier must notify the carrier or bailee.<sup>217</sup> This notice must be received by the carrier or bailee in sufficient time to halt the delivery.<sup>218</sup> After such notification, the carrier or bailee must hold and deliver the goods according to the supplier's directions.<sup>219</sup> As a result, the supplier is liable to the bailee for any ensuing charges or damages.<sup>220</sup>

Once the buyer receives or has constructive possession of the goods, the supplier's right to stop the delivery is extinguished.<sup>221</sup> Thereafter, the supplier may only get the goods back through reclamation process under the state law.<sup>222</sup>

### C. CASH ON DELIVERY

The supplier may refuse delivery unless cash payment is made for all the goods to be delivered under the contract.<sup>223</sup> When the supplier discovers that the buyer is insolvent, the supplier may unilaterally change the contract terms and require buyer to pay immediately for prior deliveries in cash.<sup>224</sup> In addition to withholding the delivery of goods, the seller may require additional assurances of payment only in cash for deliveries. This rule applies even if prior deliveries were made and even if the contract's credit terms had not expired as to the due date of payments relating to prior deliveries.<sup>225</sup>

The term "cash" has a specific application under the U.C.C. The term suggests that the supplier is not required to accept a check or any other financial instrument except for physical cash from the buyer. Although a solvent buyer's check is commercially normal and proper, it is unreasonable to make supplier accept insolvent buyer's check because of

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216. U.C.C. § 2-705(2)(b) (2003).

217. U.C.C. § 2-705(3)(a) (2003).

218. *Id.*

219. U.C.C. § 2-705(3)(b) (2003). There is an exception to this rule. If a negotiable document of title has been issued for goods, the bailee is not obliged to obey a notification to stop until surrender of the document. *See* U.C.C. § 2-705(3)(c) (2003). In addition, a carrier who has issued a nonnegotiable bill of lading is not obliged to obey a notification to stop received from a person other than the consignor. *See* U.C.C. § 2-705(3)(d) (2003).

220. *Id.*

221. U.C.C. § 2-705(2)(a)–(d) (2003). *See Donegal Steel Foundry Co. v. Accurate Products Co.*, 516 F.2d 583, 584 n. 21 (3d Cir. N.J. 1975) (noting that "[u]nder a bailment contract a bailee may be directed to return the identical thing bailed or its product to the bailor").

222. *In re Kellstrom Indus.*, 282 B.R. 787, 790 n. 3 (Bankr. D. Del. 2002) (noting the state law differences).

223. U.C.C. § 2-702(1) (2003).

224. *In re Layton Fabrics, Ltd.*, 1969 WL 11021, at \*1 (N.Y. Sup. Ct. Feb. 14, 1969).

225. *Id.*

the great likelihood that check will be dishonored when presented for payment.<sup>226</sup>

#### D. RECLAMATION UNDER STATE LAW

In general, under the U.C.C. state law provides for the reclamation of goods delivered to the insolvent buyer if the supplier can satisfy all of the following conditions: (1) goods were sold to the debtor on credit terms, (2) debtor was insolvent at the time it received the goods, and (3) the supplier demanded return of the goods within ten days of the debtor's receipt of the goods.<sup>227</sup> If the buyer makes misrepresentations to the supplier pertaining to its solvency, the time for reclamation is extended.<sup>228</sup> To successfully reclaim the goods sold, some states require that the goods sold must still be in the possession of the insolvent buyer and identifiable when the demand is received.<sup>229</sup>

The supplier's reclamation rights are subject to the rights of a good faith purchaser.<sup>230</sup> The U.C.C. defines "purchaser" as a person that takes by a purchase<sup>231</sup>, and "purchase" as taking by sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, gift, or any other voluntary transaction creating an interest in property.<sup>232</sup> A purchaser of supplier's goods from the insolvent transferor, the initial

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226. 3 RICHARD W. DUESENBERG, LAWRENCE P. KING, HENRY DEEB GABRIEL, & WILLIAM H. HENNING, SALES & BULK TRANSFERS UNDER THE U.C.C. § 13.03 2 (Matthew Bender ed., 2011).

227. U.C.C. § 2-702 (2003). Under U.C.C. section 2-705(2) a "seller may reclaim the goods upon demand made within a reasonable time after the buyer's receipt of the goods" where reasonable time is defined by "nature, purpose, and circumstances of the action" under U.C.C. § 1-205(a). However, states that adopted the UCC provide for a more definite term defining time. For example, see Chapter 106, section 2-702(1) of the Massachusetts General Laws, "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)" and section 2-702(2) "[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 days after the receipt . . . ." See also Nathan, *supra* note 130, at 23.

228. U.C.C. § 2-702(2) (2003). Under a state law, a supplier may have unlimited time to reclaim its goods if the buyer made a written misrepresentation of solvency within three months of supplier's delivery of goods. For example, chapter 106, section 2-207(2) of the Massachusetts General Laws states: "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."

229. *Flav-O-Rich, Inc. v. Rawson Food Serv., Inc.*, 846 F.2d 1343, 1347 (11th Cir. 1988); *Galey & Lord, Inc. v. Arley Corp. (In re Arlco, Inc.)*, 239 B.R. 261, 266-67. See *Harrington & Morrisey, supra* note 127, at 301-02; *Monfort, Inc. v. Kunkel (In re Morken)*, 182 B. R. 1007, 1017 (Bankr. D. Minn. 1995) (slaughtered cows, not identifiable at the time reclamation demand, are not subject to reclamation).

230. U.C.C. § 2-702(3) (2003).

231. U.C.C. § 1-201(30) (2003).

232. U.C.C. § 1-201(29) (2003).



buyer, acquires all title that the insolvent transferor had or had power to transfer.<sup>233</sup> An insolvent buyer-transferor with voidable title has power to transfer a good title to a good faith purchaser for value.<sup>234</sup>

This means that a secured creditor with a floating inventory lien has a priority over the rights of the reclaiming supplier.<sup>235</sup> The courts have held that secured creditors with liens on insolvent buyer's inventory are good faith purchasers and thus have superior rights to a reclaiming supplier.<sup>236</sup>

## V. CONDITIONS THAT IMPROVE THE LEVERAGE OF A SUPPLIER

Leverage in the context of a supplier's negotiations for payment of accounts receivable due the supplier refers to the bargaining power that the supplier has in negotiating favorable terms from a bankrupt or financially troubled customer. While legislation and case law clearly disadvantage a supplier who is owed money by a bankrupt customer, a supplier can improve its negotiating position if it displays foresight in its contract negotiation. Three important issues impact a supplier's leverage: (1) the true contract partner, (2) the nature of the contract's duration, and (3) the time remaining on the contract.

The courts make an important distinction between a contract involving a supplier and a bankrupt corporation and a contract between a supplier and one of a bankrupt corporation's subsidiaries.<sup>237</sup> The bankruptcy of a corporation may not be automatically synonymous with the bankruptcy of its subsidiaries and affiliates. Thus, a supplier who contracts with an insolvent subsidiary of a bankrupt parent corporation can move

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233. U.C.C. § 2-403(1) (2003). A purchaser of a limited interest acquires rights only to the extent of the interest purchased. *Id.*

234. U.C.C. § 2-403(1) (2003). Under UCC, the term "good faith," except as otherwise provided in Article 5, means honesty in fact and the observance of reasonable commercial standards of fair dealing. *See* U.C.C. § 1-201(20). As per U.C.C. § 2-403(1), when goods have been delivered to the good faith buyer under a transaction of purchase, the good faith buyer has such power even though (a) the transferor was deceived as to the identity of the purchaser, (b) the delivery was in exchange for a check which is later dishonored, (c) it was agreed that the transaction was to be a "cash sale," or (d) the delivery was procured through fraud punishable as larcenous under the criminal law. *Id.*

235. Nathan, *supra* note 130, at 22. *See* Harrington & Morrisey, *supra* note 127, at 302.

236. *Alliance Healthcare Corp. v. Primary Health Svs. (In re Primary Health Sys.)*, 258 B.R. 111, 117 (Bankr. D. Del. 2001) ("[a] creditor with a prior perfected security interest in inventory which contains an after-acquired property clause is a good faith purchaser under the UCC").

237. *See* *Rondout Valley Cent. Sch. Dist. v. Coneco Corp.*, 339 F. Supp. 2d 425 (2004) (where in denying the petitioner's motion for summary judgment and refusing to employ piercing of the corporate veil doctrine, the court has held that the parent company was not liable for the breach of contract of its insolvent subsidiary). *See also*, Brad B. Erens, Scott J. Friedman, & Kelly M. Mayerfeld, *Bankrupt Subsidiaries: The Challenges to the Parent of Legal Separation*, 25 EMORY BANKR. DEV. J. 66 (2008) available at [http://www.law.emory.edu/fileadmin/journals/bdj/25/25.1/ErensFriedman\\_Mayerfeld.pdf](http://www.law.emory.edu/fileadmin/journals/bdj/25/25.1/ErensFriedman_Mayerfeld.pdf).

expeditiously to improve the likelihood of full payment of its accounts receivable.

The courts distinguish between the parties' obligations under long verses short-term contracts.<sup>238</sup> If the contract is short-term or order-by-order, the supplier is often not required by the court to comply with the terms of the contract on an extended basis.<sup>239</sup> However, if the contract is long-term, the supplier is likely to be obligated to comply with the existing contract's terms even when payment is delayed indefinitely or bankruptcy of the customer is approved.<sup>240</sup>

In essence, the shorter the time remaining on a contract, the greater the leverage a supplier has over a financially troubled or bankrupt customer. It is unlikely that the debtor would be able to negotiate better terms with a new supplier than it can with the current supplier, who probably has vested interests in the debtor's financial recovery, not the least of which is the full payment of accounts receivable. Consequently, a supplier with little time remaining on a contract with an insolvent or nearly insolvent debtor may be able to renegotiate especially favorable terms for a new or extended contract. Such terms might include requirements for accelerated or immediate payment of outstanding receivables, cash in advance or cash on delivery in lieu of credit terms, and an order-by-order rather than long-term arrangement.

## VI. EARLY ACTION SUPPLIER TACTICS

Upon the discovery of the customer's insolvency, the supplier can utilize the U.C.C. to force a renegotiation with the debtor prior to the debtor's bankruptcy hearing. In addition to the options described in prior sections,<sup>241</sup> a supplier with an ongoing contract or outstanding accounts receivable from a bankrupt customer can consider other tactics to improve its outcome, specifically quick positioning for contract assumption,

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238. See 11 U.S.C. § 365 (noting that subject to a court's approval, a trustee may assume or reject any executor contract of the debtor).

239. *Id.*

240. *Id.* See also 11 U.S.C. § 363. This section of the bankruptcy code permits the debtor in possession or a trustee to sell property obtained from the suppliers in the regular course of business. See also *In re HLC Properties, Inc.*, 55 B.R. 685 (Bankr. N.D. Tex. 1985) (discussing application of 11 U.S.C. 363).

241. This is relevant to U.C.C. § 2-702, which provides that a seller may refuse delivery except for cash when it discovers the buyer to be insolvent, and to U.C.C. § 2-703, which provides that where a buyer refuses to make payment due on or before delivery then, with respect to any goods directly affected, the aggrieved seller (supplier) may withhold or stop delivery of goods, even if they are in transit under U.C.C. § 2-705.

obtaining critical supplier status, and securing adequate assurance of the debtor's future performance.

#### A. QUICK CONTRACT ASSUMPTION

A financially distressed debtor must assume or reject an executory contract for the sale of goods before confirmation of its plan of reorganization.<sup>242</sup> A supplier that is a party to an executory contract is obligated to perform during the period between the bankruptcy filing and assumption or rejection of the contract.<sup>243</sup> If the supplier decides to suspend or not honor the agreement, the debtor may assert legal claims against the supplier for breach of contract and violations of the automatic stay.<sup>244</sup>

For a supplier, contract assumption can be advantageous because the debtor must resolve outstanding receivables and all other monetary defaults that arose prior to the bankruptcy.<sup>245</sup> In addition, the debtor must give adequate assurance of its future performance under the contract. Another benefit is that claims under assumed contracts are assigned administrative priority, requiring that they be paid in full on confirmation of the bankruptcy plan. Additionally, the bankruptcy code allows compelling the debtor to make an early assumption or rejection decision.<sup>246</sup> Finally,

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242. 11 U.S.C. § 365 (2003). A contract is executory if obligations are owed by both parties to the contract. See *In re Dynamic Tooling Sys., Inc.*, 349 B.R. 847, 852-53 (Bankr. D. Kan. 2006). Under section 541, executory contracts are part of the estate's property. Section 1123(b)(2) states that a bankruptcy plan may, subject to the provisions of section 365, provide for the assumption or rejection of executory contracts. Further, section 1123(b)(3) states that a plan may not only provide for the adjustment and settlement of any claims or interests of the debtor or the estate, but also that the trustee, the debtor, or a special representative of the estate may retain and enforce such claims or interests.

243. Bruce S. Nathan, *A Trade Creditor's Post-Petition Obligations Under An Unexpired Executory Contract Prior To Assumption Or Rejection: The Muddled State Of The Law*, BUS. CREDIT, Sep. 2006, at 1 (noting that "[i]f a debtor wishes to assume an executory contract or lease, the debtor must, among other things, cure all payment and other defaults under the contract, or provide adequate assurance of such cure, and provide adequate assurance of the debtor's ability to perform all of its future obligations under the contract. If the debtor rejects the contract, the debtor is deemed to have breached the contract as of the bankruptcy filing date and the creditor has an unsecured claim for its damages arising from such breach. Rejection also relieves the creditor of any further obligations under the contract").

244. *Id.* at 2 (noting that meanwhile the debtor may compel "the creditor to continue selling goods or providing services prior to any decision to assume or reject the contract, while the debtor is free to seek rejection of contract (and thereby terminate any further obligation to perform) any time during the bankruptcy case").

245. *In re United Am., Inc.*, 327 B.R. 776, 786 (Bankr. E.D. Va. 2005) (noting that "[i]n order to assume an executory contract, the debtor must cure or provide adequate assurance that it will promptly cure its default. Its default is the failure to pay the pre-petition claim in accordance with the contract. The debtor must also give assurances of future performance").

246. 11 U.S.C. § 365(d)(2). Under chapter 9, 11, 12, or 13 of the Bankruptcy Code, the trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal

assumption of the contract gives the supplier an incumbent's advantages in extending the contract on favorable terms. For these reasons, a supplier may find it advantageous to position for early contract assumption.

## B. CRITICAL SUPPLIER STATUS

The principle of bankruptcy law that similarly situated creditors receive equal treatment is not universally held.<sup>247</sup> A supplier in search of a viable post-petition strategy for collecting payment of pre-petition receivables should consider the benefits of being designated as a "critical supplier." The critical supplier doctrine is an exception created by the courts in some states, including Delaware, Michigan, and New York, that allows an insolvent customer to argue for special status from a particular supplier.<sup>248</sup> A motion to pay critical vendors is a request for the court to authorize an exception to the general principle favoring equal treatment of

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property of the debtor at any time before the confirmation of a plan but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease. *Id.*

247. See *Sumy v. Schlossberg*, 777 F.2d 921, 932 (4th Cir. Md. 1985) (noting that "[the] longstanding principle of equal treatment of similarly situated creditors may be violated"). See also *In re Piper Aircraft Corp.* 168 B.R. 434, 440 (S.D. Fla. 1994) (suggesting that the benefits of fresh start in bankruptcy law may supersede the principal of creditor's equal treatment).

248. The judicially created exception of "critical supplier" has its roots in the doctrine of necessity. For example:

The policy of equal treatment of creditors does not trump freedom of contract. Absent a contractual agreement, there is no obligation to deal with another party, whether a party in bankruptcy or not. Without a contract, suppliers can refrain from dealing with a debtor. Frequently, the decision to do so is based more on the uncertainty of payment for post-petition goods and services. A problem arises when the theory of equal treatment meets the reality that, from time to time, certain suppliers are essential to the continued viability of a business and a debtor's ability to reorganize. If the suppliers legitimately decline to have further dealings with the debtor, the reorganization effort will come to an end before it has had an opportunity to begin. In this instance, it is impossible to reconcile the objectives of encouraging reorganizations and assuring the equal treatment of creditors. To insist upon the latter necessarily precludes the former. The Doctrine of Necessity is an attempt to reconcile these principles in these narrow circumstances. The remedy, payment of select pre-petition unsecured claims, flies in the face of all of the notions of equal treatment of creditors. It is, however, a necessary deviation because otherwise there will be no reorganization and no creditor will have an opportunity to recoup any part of its pre-petition claim . . . Three tests for the application of the Doctrine of Necessity have developed which, if applied, retain the narrowness and the exceptional quality of the Doctrine: (1) the vendor must be necessary for the successful reorganization of the debtor; (2) the transaction must be in the sound business judgment of the debtor; and (3) the favorable treatment of the critical vendor must not prejudice other unsecured creditors.

See *United Am., Inc.*, 327 B.R. at 781-82.

similar claims, and pay one prepetition creditor ahead of others.<sup>249</sup> Consequently, such a request is carefully scrutinized and is only granted when the circumstances establish that the selected payments are necessary to the reorganization case and will ultimately benefit all creditors of the estate.<sup>250</sup> According to the Doctrine of Necessity,<sup>251</sup> a supplier is critical if:

- (1) it is the only supplier of “essential goods and services,”<sup>252</sup>
- (2) it supplies “essential goods and services at a significantly reduced price,”<sup>253</sup> and
- (3) it would not “survive non-payment of pre-petition claims,” and would therefore stop supplying the debtor.<sup>254</sup>

The Bankruptcy Court for the Northern District of Texas held that section 105(a) of the U.C.C. authorizes bankruptcy courts to authorize payment of prepetition claim to creditors that are critical to the debtor’s continued operation.<sup>255</sup> The court created the following three-element test of the debtor for determining when payment of prepetition claim to suppliers is critical and allowed:<sup>256</sup> (1) evidence that dealing with the claimant is indispensable to profitable operations or preservation of the estate,<sup>257</sup> (2) evidence that failing to deal with the claimant will likely cause harm or eliminate an economic advantage that is greater than the amount claimed,<sup>258</sup> and (3) evidence that no practical or legal alternative exists by which the debtor can deal with the claimant and that payment is the only

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249. *In re Coserv, LLC*, 273 B.R. 487, 494 (Bankr. N.D. Tex. 2002). See *Osborne v. Howell Electric Motors (In re Fultonville Metal Prods. Co.)*, 330 B.R. 305, 313 (Bankr. M.D. Fla. 2005) (stating that “[t]he request to pay selected prepetition vendors is a clear departure from basic bankruptcy precepts”).

250. *Fultonville Metal Prods. Co.*, 330 B.R. at 313. See *In re Tropical Sportswear Int’l Corp.*, 320 B.R. 15, 17 (Bankr. M.D. Fla. 2005) (where the court found that the payment of critical vendors should be approved only upon an evidentiary showing that “(1) the payments were necessary to the debtor’s reorganization; (2) that a sound business reason justified the payments, in that the vendors would refuse to do business with the debtor absent the payments; and (3) that the disfavored creditors would not be harmed by the payments”).

251. Andrew J. Currie & Sean McCann, *Hold on to Those Payments, Critical Vendors: Capital Factors v. Kmart*, AM. BANKR. INST. J., Jun. 2003, at 34.

252. *Id.*

253. *Id.*

254. *Id.*

255. *In re CoServ, L.L.C.*, 273 B.R. 487, 493, 497 (Bankr. N.D. Tex. 2002).

256. *Id.* at 498–99.

257. *Id.* at 498. (noting that “[t]o meet this requirement debtor must show that, for one reason or another, dealing with the claimant is virtually indispensable to profitable operations or preservation of the estate”).

258. *Id.* at 498–99 (“[A] . . . debtor must show that meaningful economic gain to the estate or to the going-concern value of the business will result or that serious economic harm will be avoided through payment of the prepetition claim, which itself is materially less than the potential loss to the estate or business”).

alternative.<sup>259</sup>

If critical supplier status is granted, (a) the supplier is paid in advance of and at a higher percentage than other general unsecured creditors and (b) its pre-bankruptcy claims converted into administrative claims that must be paid in full prior to confirmation of a plan of reorganization.<sup>260</sup> However, there is a major downside for a critical supplier, namely that the supplier is often required by negotiations with the debtor to waive their section 2-503 (b)(9) claims and associated rights.

### C. ADEQUATE ASSURANCE OF FUTURE PERFORMANCE

Under U.C.C. section 2-609, if reasonable insecurity exists concerning a debtor's ability or willingness to satisfy its future financial obligations, such as late payments, the supplier can issue a demand for adequate assurance of performance.<sup>261</sup> The debtor must then provide written assurances to the supplier of the debtor's ability to satisfy future obligations, including evidence of financial viability such as a letter of credit.<sup>262</sup> If a debtor fails to provide the demanded adequate assurance, the supplier has the right to modify or suspend its performance under the contract.<sup>263</sup>

Such situations arose frequently in 2008-2009 when secondary suppliers (tier-2) that provide products to direct suppliers (tier-1) of a bankrupt corporation employed a tactic involving provisions of Article 2 of the U.C.C. in an effort to receive payment for delivered goods or services.

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259. *CoServ, L.L.C.*, 273 B.R. at 499 (stating that "[i]f payment is intended to assuage the [creditor's] concern about future dealings, a deposit, collect on delivery terms, payment of shipment and countless other devices are available that will not offend the general principle that prepetition claims should not be paid").

260. 11 U.S.C. § 105.

261. U.C.C. section 2-609 provides: (1) A contract for sale imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either party, the other may in writing demand adequate assurance of due performance and until he receives such assurance may, if commercially reasonable, suspend any performance for which he has not already received the agreed return. (2) Between merchants, the reasonableness of grounds for insecurity and the adequacy of any assurance offered shall be determined according to commercial standards. (3) Acceptance of any improper delivery or payment does not prejudice the aggrieved party's right to demand adequate assurance of future performance. (4) After receipt of a justified demand failure to provide within a reasonable time, not exceeding 30 days, such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract. *Id.*

262. Several court rulings clarify the requirements for written notice. *See Nat'l Ropes, Inc. v. Nat'l Diving Serv., Inc.*, 513 F.2d 53 (5th Cir. 1975); *contra*, *ARB, Inc. v. E-Systems, Inc.*, 663 F.2d 189 (D.C. Cir. 1980); *Automated Energy Systems, Inc. v. Fibers and Fabrics of Georgia, Inc.*, 298 S.E. 2d 328 (1982); *Scott v. Crown*, 765 P.2d 1043 (Colo. App. 1988).

263. U.C.C. § 2-609, official cmt. 2 (2004).

For example, tier-1 suppliers in the automobile industry filed motions under U.C.C. section 2-609 asserting that they had reasonable grounds for insecurity concerning the debtor's ability to perform under the terms of the supply contracts.<sup>264</sup> The suppliers consequently claimed that they were entitled to adequate assurance of future performance of the debtor as a precondition to satisfying their own contractual obligations.<sup>265</sup>

Reasonable grounds for insecurity are determined in fact by commercial standards, and require that the supplier provide an objective factual basis for its insecurity, such as the debtor's failure to satisfy past due accounts. In instances where the supplier has reason to believe that the customer is in financial distress but not yet declared bankrupt, the supplier can unilaterally impose terms of cash-in-advance or cash-on-delivery as explicitly authorized under U.C.C. §2-702(1).

Timing is critical in attempting to benefit from an adequate assurance claim. Once a debtor is granted a Chapter 11 bankruptcy, the debtor typically demands that a supplier continue to perform on an underlying contract. The debtor will file a motion to enforce the automatic stay and the terms and conditions of the existing contract even though it offers no post-petition payment to suppliers or modifications to the contract that are objectionable to the supplier.<sup>266</sup>

## VII. THE CURRENT REALITY AND UNSETTLED ISSUES

The recession of 2007-2009 and the lingering post-recessionary effects have tested the corporate bankruptcy process. In particular, there was scrutiny of the safeguards designed to prevent suppliers from bearing an unfair financial burden from their contractual agreements with financially distressed corporate customers. The BAPCPA of 2005 was intended to enhance traditional protections and remedies for suppliers. However, after several years of litigation, the conclusion may be drawn that

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264. See Daniel N. Sharkey, *The "Car Wars" in Court: Steel, Plastics, Terms, and Other Fronts in Automotive Supply Litigation*, Mich. B. J., Dec. 2008, <http://www.michbar.org/journal/pdf/pdf4article1450.pdf> (discussing litigation of automotive suppliers).

265. Patrick Mears, *Long Term Supply Contracts In Auto Supplier Bankruptcies*, AUTOMOBILE BANKR. RESOURCES, Oct. 20, 2009, <http://www.lexisnexis.com/community/bankruptcylaw/blogs/bankruptcycommentary/archive/2009/09/15/long-term-supply-contracts-in-auto-supplier-bankruptcies.aspx>.

266. In many bankruptcy cases, the debtor will reject the demands of suppliers for cash on delivery or cash in advance. In *In re Visteon Corp.*, 2010 WL 1416796 (Bankr. D. Del.), Visteon sent a letter notifying its suppliers that an automatic stay had been imposed to prevent third parties from taking actions against its assets without prior approval of the Bankruptcy Court, under § 362 of the Bankruptcy Code. Therefore, Visteon reasoned that the supplier's demands, which in the debtor's view represented noncourt approved, unilaterally demands, would violate the automatic stay.

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the provisions have failed to deliver on their promise. The general provisions of section 503(b)(9) and section 546(c) are now swallowed by exceptions, which complicates suppliers' understanding of their rights when a debtor files for bankruptcy and provide significant obstacles to recovery of either payment or goods sold.

Even with the enactment of section 546(c), which substantially extended the time for reclamation claims, suppliers continue to encounter the same pre-BAPCPA obstacles to relief<sup>267</sup> as evidenced by court holdings in the *AMS*, *Dana*, and *Incredible Auto Sales*. By the time the reclamation demand is made, most of the debtor's asset-based financing has a prioritized lien on the goods the supplier is attempting to reclaim. Thus, if the value of a reclaiming a supplier's goods does not exceed the amount of debt secured by the prior lien, the supplier's reclamation claim is valueless.<sup>268</sup> Further, by the time of reclamation demand, the goods sold by the supplier may become commingled with debtors finished product or resold, which again makes reclamation moot. As a result, the suppliers' efforts to reclaim goods under section 546(c) rarely produce any beneficial results.<sup>269</sup>

Although section 503(b)(9) attempts to improve the supplier's position pertaining to goods sold to the debtor within the twenty days pre-bankruptcy, the actual benefit to be derived by the supplier is at best illusory.<sup>270</sup> In reality, if the supplier is unable to obtain an immediate payment of a section 503(b)(9) claim and the case is thereafter rendered administratively insolvent, the supplier is unlikely to ever receive money on its claim.<sup>271</sup> A section 503(b)(9) claim does not give an immediate right to payment and the scheduling remains in the discretion of the bankruptcy court. If the value of the bankruptcy estate is less than the value of the filed administrative claims, the supplier and other creditors must agree how their respective individual claims will be paid. Notwithstanding providing new remedies for suppliers that deliver goods to the debtor within a twenty-day prepetition period, the BAPCPA fails to provide adequate remedies for businesses that provide services.

Despite the new BAPCPA provisions, the questions of how a supplier may reclaim the goods sold or receive full payment on its goods sold to a

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267. Nathan, *supra* note 130, at 22–25.

268. *In re Dana Corp.*, 367 B.R. at 409, 419 (Bankr. S.D.N.Y. 2007).

269. Jack F. Williams, *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?* JUDICIARYHOUSE.GOV (Mar. 11, 2009), <http://judiciary.house.gov/hearings/pdf/Williams090311.pdf>.

270. Miller & Welford, *supra* note 139, at 494.

271. *Id.*



customer who thereafter filed for bankruptcy remain unanswered. Additional uncertainty in the law still exists<sup>272</sup> as supplier advocates believe that the Phar-Mor decision reopened the possibility of viable reclamation claims<sup>273</sup> and the language of section 503(b)(9) administrative claims continues to be interpreted differently by the courts.<sup>274</sup> It is unlikely that the drafters of BAPCPA envisioned the various ancillary issues that would arise from their new legislation and its ineffectiveness to address previously existing issues pertaining to suppliers. Thus, unless the BAPCPA's provisions are amended or uncertainty is greatly reduced in supplier bankruptcy practices, the goal of providing greater protection for suppliers will remain unaccomplished.

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272. Muazzin Mehrban, *Proposals to Repeal Certain Provisions of BAPCPA*, FINANCIERWORLDWIDE.COM. (Feb. 2010), <http://www.financierworldwide.com/article.php?id=5921&page=2> (stating that "BAPCPA is the most complicated overhaul of the bankruptcy code for several decades, and despite it being four years since its implementation, certain areas of the law remain hazy").

273. Wanda Borges, *Hot Issues in Bankruptcy in Today's Economic Climate*, NAT'L. ASS'N. OF CREDIT MGMT., 2009 (noting that "[i]nterestingly, despite the ruling in the Dana case, a subsequent ruling may have reopened the possibility of viable reclamation claims. Long dormant, the 6th Circuit Court of Appeals rendered its decision in the Phar-Mor, Inc. v. McKesson Corp. case in 2008. The Sixth Circuit found that properly reclaimed goods remain the seller's property and never become the debtor's property, thus, in this way a secured creditor's claim cannot attach to the properly reclaimed goods.").

274. William J. Burnett & Colleen A. Garrity, *Two New Judges, Two New Opinions: Too Bad for 503(b)(9) Suppliers*, ABIWORLD.NET, (Mar. 2007), <http://abiworld.net/newsletter/utc/vol5num1/TwoNewOpinions.html>.