



Legal Alert

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QUESTION: DID CONGRESS IMPROVE MY RIGHTS TO RECLAIM GOODS FROM INSOLVENT CUSTOMERS?

ANSWER: EFFECTIVE IN OCTOBER 2005, CREDITORS' RECLAMATION RIGHTS WILL BE EXPANDED BY THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005.

Both the Uniform Commercial Code and the Bankruptcy Code allow you to reclaim goods that have been sold to an insolvent buyer on credit in certain situations. One note of caution is that Congress did not change the terms of Uniform Commercial Code § 2-702. So if the insolvent customer does not file bankruptcy, you still will be required to comply with the shorter notice provisions under state law.

If you sell goods to someone, and then discover that the buyer is insolvent, you can refuse delivery of the goods unless the buyer pays you in cash. You can also insist that the insolvent buyer pay you cash for all of the goods you previously delivered under the contract before you deliver anything else. Moreover, if you discover that the buyer is insolvent after the goods have been shipped, you may stop delivery of the goods while they are still in transit. UCC § 2-702.A.

If the insolvent buyer has already received your goods on credit, you may reclaim the goods by making demand within ten (10) days after they were received by the buyer. UCC § 2-702.B. In order to be able to prove that you made demand to reclaim the goods, you should make the demand in writing and deliver it to the buyer as quickly as possible.

You do not need to worry about the ten-day deadline for your reclamation notice if the buyer misrepresents its solvency to you in writing within 3 months before delivery of the goods. You cannot base your right to reclaim goods on the customer's fraudulent or innocent misrepresentation of solvency or intent to pay, unless the customer misrepresented its solvency in writing within 3 months before delivery. UCC § 2-702.B.

Your right to reclaim the goods will be subject to the rights of any buyers in the ordinary course or other good-faith purchasers or lien creditors. Therefore, you need to act immediately upon learning of the buyer's insolvency in order to avoid problems with third parties obtaining superior rights to the goods.

In addition, you need to make sure that you really want to have your goods returned before you exercise the remedy of reclamation. The Uniform Commercial Code states that: "Successful reclamation of goods excludes all other remedies with respect to them."

None of the foregoing has changed, so what is the commotion about? Well, if your buyer is insolvent and you are reclaiming goods, can a bankruptcy be far away? Fortunately, the right to reclaim goods under UCC § 2-702 is also recognized in the Bankruptcy Code in 11 USC § 546 (c). In the bankruptcy setting, reclamation rights have definitely been expanded.

The bankruptcy trustee or the debtor-in-possession can't avoid the rights of sellers of goods to reclaim goods sold to debtors in the ordinary course of sellers' businesses if debtors receive the goods while insolvent, and within 45 days of the commencement of the bankruptcy case. A seller may only reclaim goods under the bankruptcy code if the demand for reclamation of goods is in writing. Unlike the UCC time limit and the existing bankruptcy time limit of 10 days, the amended bankruptcy code will allow the demand for reclamation to be made within 45 days from the debtor's receipt of the goods.

But what happens if the bankruptcy is filed during the 45-day period allowed for making the written demand to reclaim the goods? The amended bankruptcy code says that the written reclamation demand must be made no later than 20 days after the commencement of the bankruptcy case if the 45-day demand period expires after the bankruptcy case begins.

The changes to § 546 (c) make it clear that the right to reclaim goods is subject to the prior rights of a holder of a security interest in those goods or the proceeds of those goods. Since most companies have a secured line of credit with the bank that covers all goods, inventory, etc., what practical use is the right to reclaim goods?

The very good news about the changes to § 546 (c) and § 503 (b)(9) is that there will be a new category of administrative expense claims, providing a safety net to unsecured creditors. Even if a creditor fails to make an effective and timely written reclamation demand, the creditor will still be entitled to an administrative expense claim for the value of any goods received by the debtor in the ordinary course of the debtor's business within 20 days of the beginning of the bankruptcy case.

So, unsecured creditors who take the risk of continuing to do business in the ordinary course with shaky buyers, will be allowed administrative priority claims for those goods sold on credit and received by the debtor within 20 days of the filing of the bankruptcy case. Having your unsecured claim go from the bottom of the list, up to the top of the list alongside trustees' fees, attorneys' fees, and such other priority claims will be a great advantage to those creditors who have been burned by continuing to sell to debtors within 20 days before bankruptcy filings.

There will be many other changes brought about by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. If you or your colleagues have questions regarding these changes, please feel free to call me.