

# THE CREDIT MEMO

Volume I, No. I

January 2005

## Does The Bankruptcy Code Really Protect Reclamation Rights Under the Uniform Commercial Code?

Section 2-207 of the Uniform Commercial Code affords a seller of goods certain rights to recover or “reclaim” goods delivered to an insolvent buyer. Following closely on the heels of this provision, Section 546(c) of the Bankruptcy Code recognizes and, under the circumstances discussed below, respects a seller’s right to reclaim goods from a bankrupt buyer. This edition of *The Credit Memo* discusses how the bankruptcy laws influence a seller’s right to reclaim goods from an insolvent buyer, as well as the different approaches bankruptcy courts have adopted when evaluating reclamation rights.

### Establishing The Right To Reclaim Goods

Section 546(c) of the Bankruptcy Code specifically recognizes that the right to reclaim goods is not lost upon the buyer’s bankruptcy. To invoke this provision, a seller must show that:

- ♦ it has a statutory or common law right to reclaim the goods;
- ♦ the goods were sold in the ordinary course of business;
- ♦ the debtor was insolvent when it received the goods;
- ♦ a written reclamation demand was delivered to the debtor within 10 days after the goods were delivered or, if that 10-day period happens to straddle the bankruptcy filing, within 20 days after the debtor received the goods; and
- ♦ the debtor had the goods in its possession at the time the written reclamation demand was received.

Meeting the first requirement noted above — the statutory or common law right to reclaim goods — generally is not hard. Section 2-702 of the Uniform Commercial Code expressly provides the right and it also has the force and effect of state law.

Satisfying the second and third requirement for invoking the reclamation right under Section 546(c) of the Bankruptcy Code also is not difficult, especially when the buyer-debtor files for bankruptcy relief and its insolvency is apparent. Assuming an ordinary credit transaction, there also would seem to be little basis for disputing that the goods were delivered in the ordinary course of business.

Meeting the fourth condition for reclamation under Section 546(c) requires the seller to send a written notice to the buyer advising that the right has been exercised. The notice is important and reclamation demands that do not satisfy the notice requirement may be ineffective. The notice should, among other things, specifically identify the goods that are being reclaimed and, in fact, ideally should attach a copy of the invoices or other documents specifically identifying the goods. The notice also should be delivered in a manner ensuring it is received as soon as possible and providing some confirmation of delivery. Bankruptcy courts have recognized that the automatic stay does not prohibit a party from sending a reclamation notice.

Additionally, the notice to the debtor must be delivered “before 10 days after receipt of such goods by the debtor” or, if the 10-day period straddles the filing of the bankruptcy case, “before 20 days after receipt of such goods by the debtor.” As a practical matter, the notice of reclamation should be provided as soon as possible because, as discussed below, the right is lost if the notice is received after the debtor-buyer no longer has possession of the goods.

Finally, Section 546(c) of the Bankruptcy Code requires some proof that the buyer had the goods in its possession at the time it received the written reclamation demand. The right of reclamation often fails because the seller is unable to establish the buyer had the goods when it received the demand. Furthermore, a buyer may defeat a reclamation demand if it continues to sell goods after receiving a reclamation demand for those goods. The surest protection, then, is to file a suit to block the buyer from selling any further goods that are subject to the reclamation demand. Suit can be filed in the bankruptcy court when the buyer has filed a bankruptcy case or in an appropriate state or federal court in the absence of a bankruptcy case.

### Secured Creditors Have Priority Over Reclaiming Sellers

Unfortunately, once a seller has met all of the above requirements, it still might not realize the expected benefit, principally because the right to reclaim goods is subject to the rights of a secured creditor. This issue arises where the buyer has previously granted a lien on inventory to its lender. Section 2-702(c) of the Uniform Commercial

SEYFARTH  
ATTORNEYS SHAW LLP

This newsletter is one of a number of publications produced by the firm. For a wide selection of other such publications, please visit us online at [www.seyfarth.com](http://www.seyfarth.com).

Copyright © 2005 Seyfarth Shaw LLP

All rights reserved

Code provides that a seller's right to reclaim is "subject to" the rights of a buyer in the ordinary course or a good faith purchaser. In most instances, a secured creditor will qualify as a good faith purchaser for purposes of Section 2-702(c) of the Uniform Commercial Code.

Thus, in most cases a secured lender's floating lien upon inventory will block or impair a reclaiming seller's right to recover inventory in the buyer's possession. This is a significant limitation on the right of reclamation, particularly within the bankruptcy context where a lender generally will have a floating lien upon inventory.

## Bankruptcy Courts Disagree On The Protections Available To Reclaiming Sellers

Bankruptcy courts have struggled with the amount of protection that a reclaiming seller can expect. This is largely because of the Uniform Commercial Code provision which makes a lender's lien on inventory superior to a reclaiming seller's right to recover goods. A synthesis of reported decisions and other sources suggests three primary schools of thought have emerged.

Some courts hold that a reclaiming seller is entitled to a priority claim or junior lien against the buyer-debtor for the value of the goods, so long as the seller properly asserts its reclamation demand by following the steps outlined above. This view offers reclaiming sellers the most protection because priority claims are paid before general unsecured claims under the Bankruptcy Code. It is based upon language in Section 546(c) of the Bankruptcy Code stating that "the court may deny reclamation to a seller with such a right of reclamation that had made such a demand only if the court — (1) grants the claim of such a seller priority as a claim of a kind specified in Section 503(b) of the title, or (2) secures such claim with a lien."

Other courts reason that a reclaiming seller's reclamation right is essentially of no practical value unless the seller establishes that the specific collateral it shipped remains in the debtor's possession and the secured creditor no longer holds a lien upon the subject collateral. Under this view, a reclaiming seller generally will not obtain much protection in bankruptcy because of the strong possibility that the identified property will either have been sold, or, if not sold, still subject to the lien of a secured creditor while in the buyer's possession.

Finally, a third view, which offers reclamation claimants more protection than the second view, but not as much as the first, recognizes that a reclaiming seller is entitled to a priority claim, or a junior lien, even if the collateral has been sold and the proceeds used to pay the secured creditor, so long as the value of all of the collateral subject to the secured creditor's lien exceeds the amount owed to the secured creditor (*i.e.*, the secured creditor is oversecured).

## Conclusion

Credit and finance professionals should be mindful of the limitations on the right to reclaim goods and not get lulled into a false sense that they are protected so long as they have sent a proper reclamation demand. In many cases, sending the demand is just the first step in what can become a long, arduous and sometimes expensive recovery process. The limitations on reclamation rights, however, should not dissuade a seller from trying to perfect them. Despite the variability in the law, one thing is certain: a seller that fails to send a proper reclamation demand will not, under any circumstances, have a priority claim for the subject goods.

### ATLANTA

One Peachtree Pointe  
1545 Peachtree Street, N.E., Suite 700  
Atlanta, Georgia 30309-2401  
404-885-1500  
404-892-7056 fax

### BOSTON

World Trade Center East  
Two Seaport Lane, Suite 300  
Boston, Massachusetts 02210-2028  
617-946-4800  
617-946-4801 fax

### CHICAGO

55 East Monroe Street, Suite 4200  
Chicago, Illinois 60603-5803  
312-346-8000  
312-269-8869 fax

### HOUSTON

700 Louisiana Street, Suite 3700  
Houston, Texas 77002-2731  
713-225-2300  
713-225-2340 fax

### LOS ANGELES

One Century Plaza  
2029 Century Park East, Suite 3300  
Los Angeles, California 90067-3063  
310-277-7200  
310-201-5219 fax

### NEW YORK

1270 Avenue of the Americas, Suite 2500  
New York, New York 10020-1801  
212-218-5500  
212-218-5526 fax

### SACRAMENTO

400 Capitol Mall, Suite 2350  
Sacramento, California 95814-4428  
916-448-0159  
916-558-4839 fax

### SAN FRANCISCO

560 Mission Street, 31st Floor  
San Francisco, California 94111-5858  
415-397-2823  
415-397-8549 fax

### WASHINGTON, D.C.

815 Connecticut Avenue, N.W., Suite 500  
Washington, D.C. 20006-4004  
202-463-2400  
202-828-5393 fax

### BRUSSELS

Boulevard du Souverain 280  
1160 Brussels, Belgium  
+32 (0)2 647 60 25  
+32 (0)2 640 70 71 fax

---

This newsletter is a periodical publication of Seyfarth Shaw LLP and should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have. For further information about these contents please contact a member of the Firm's Bankruptcy, Workouts and Reorganizations Practice Group.