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A VENDOR'S GUIDE TO BANKRUPTCY

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VENDOR'S RIGHTS

A VENDOR'S GUIDE TO BANKRUPTCY

With an Analysis of a Vendor's Reclamation, Stoppage and Withholding of Delivery Rights and the Impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)

By James M. Sullivan and Gary O. Ravert***

I. Introduction

The recent changes to the Bankruptcy Code and the recent wave of automotive bankruptcy filings have focused the public's attention on the impact that a large bankruptcy filing can have on the thousands of affected suppliers. Historically, suppliers of goods have scrambled to protect themselves after a large bankruptcy filing because, in most bankruptcy cases, unsecured creditors are able to obtain only a modest recovery on their prepetition claims. Most suppliers have tried to mitigate the impact of a bankruptcy by timely asserting their reclamation rights (the right to regain title and possession to goods sold), but such rights may provide little recourse where the debtor's inventory has been resold or pledged as collateral. Some have sought to lessen the impact by securing critical vendor payments (if they have no contract with the debtor) or assumption of the contracts (if they do have contracts with the debtor), either of which would result in full or partial payment of the prepetition debt, but only a small minority of suppliers are successful in securing such favorable treatment, especially at the beginning of a case. Finally, a

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small minority of suppliers has sought to condition delivery of future shipments on payment of prepetition amounts or improved payment terms, but such tactics are often met with swift and strong resistance by debtors on the ground that such actions are violative of the automatic stay imposed by section 362 of the Bankruptcy Code. The overwhelming majority of suppliers, therefore, have been left with little protection and, if the debtor was a major customer of the suppliers, a chain reaction of supplier bankruptcy filings sometimes ensued.

The Bankruptcy Abuse Protection and Consumer Protection Act of 2005 (BAPCPA), enacted in April 2005, changed the landscape in favor of suppliers of goods with respect to bankruptcies commenced on or after October 17, 2005. Favorable changes include: (i) more expansive reclamation rights; and (ii) the grant of an administrative expense claim[1] to suppliers for goods shipped within the twenty days prior to the bankruptcy filing.

What prompted the changes? It appears that Congress intended to remedy the perceived injustice caused by debtors that strung along their trade creditors just prior to filing for bankruptcy. With the new reclamation provisions, Congress has provided favored treatment for many suppliers, even though paying these claims may not be important to a debtor's reorganization. Many have wondered why suppliers of goods were favored over other creditor groups, such as service providers, unsecured lenders, and tort victims. In doing so, the new law diverges from the fundamental tenet of the Bankruptcy Code that equally situated unsecured creditors should receive equal treatment. This legislative change is curious because trade creditors are a diffuse group without a single strong lobby and the group whose powerful lobby was the force behind the law—major financial institutions—may end up hurt by these changes.

Section II of this article provides a "vendor's guide to bankruptcy," which includes useful steps vendors can take to protect their interests upon learning of a customer's bankruptcy filing. Section III will provide a brief executive summary of the recent changes to the Bankruptcy Code that have affected vendors' rights against a debtor, including the expanded reclamation rights and the new twenty-day administrative expense claim. Finally, Section IV will provide a detailed analysis of: (i) a vendor's reclamation, stoppage of delivery in transit, and withholding of delivery rights under state law; (ii) the extent to which such rights were recognized under the prior bankruptcy law; and (iii) the impact that BAPCPA has had, and will continue to have, on such rights in the future.

1. An administrative expense claim is a priority claim against the debtor that is entitled to be paid before claims of general unsecured creditors and is ordinarily paid in full.

II. Supplier's Guide to Bankruptcy

You have just received word that one of your major customers has filed for bankruptcy. What do you do? This section will provide suppliers with some useful guidance and tips for navigating the often confusing world of bankruptcy.

A. *Do Not Violate the Automatic Stay.*

Under the Bankruptcy Code, debtors are granted certain protections from creditors upon the filing of a bankruptcy case. The most significant of these protections is the "automatic stay" imposed by section 362 of the Bankruptcy Code.[2] The automatic stay is intended to provide a debtor with a breathing spell during its bankruptcy case and prohibits a very broad range of acts, including: (i) contacting the debtor to demand repayment of amounts owed as of the bankruptcy filing; (ii) taking actions against the debtor to collect money owed as of the bankruptcy filing; (iii) taking or exercising control of property owned or possessed by the debtor; (iv) starting or continuing collection actions, foreclosure actions, or repossessions against the debtor; (v) seeking to create, perfect, or enforce any lien against the debtor's property; (vi) terminating or modifying the debtor's rights under a contract; and (vi) exercising a setoff right against the debtor. If a creditor violates the automatic stay, a bankruptcy court may hold the creditor in contempt of court and award the debtor compensatory damages. In addition, where the violation is willful, the bankruptcy court may award punitive damages.

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2. *Grochocinski v. Allstate Ins. Co. (In re Lyckberg)*, 310 B.R. 881, 890 (Bankr. D. Ill. 2004) ("The automatic stay is a powerful tool of the bankruptcy courts[.]"); *In re Coleman*, 2003 Bankr. LEXIS 895 (Bankr. D. Vt. 2003) (same); *In re Halas*, 249 B.R. 182, 191 (Bankr. D. Ill. 2000) (same); 11 U.S.C. §362(a)(6) provides in relevant part that:

> Except as provided in subsection (b) of this section, a petition filed under . . . this title . . . operates as a stay, applicable to all entities, of—
>
> (1) the commencement or continuation . . . of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of a case under this title, or to recover a claim against the debtor that arose before the commencement of a case under this title;
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> (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
>
> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
>
> (4) any act to create, perfect, or enforce an lien against property of the estate;
>
> (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent such lien secures a claim that arose before the commencement of the case under this title;
>
> (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of a case under this title; [and]
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> (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor[.]

B. *Hire an Experienced Bankruptcy Lawyer.*

Managing the bankruptcy maze on one's own can be a daunting task. Hiring an experienced bankruptcy attorney can often provide a supplier with useful advice that is relevant to its particular situation. Although intended to provide suppliers with general guidance, this article cannot substitute for the valuable advice that can often be provided by an experienced bankruptcy attorney.

C. *Protect Your Rights.*

A supplier may have rights that will need to be preserved during the debtor's bankruptcy case and steps may need to be taken to protect those rights. Among other things, a supplier may have lien, reclamation, or claim rights that will need to be protected. Below are a few examples of actions that can be taken by a supplier to preserve its rights.

1. *Send a Written Reclamation Demand.* Do not delay. Although the new BAPCPA reclamation law does not state that a supplier's reclamation rights are subject to state law defenses, such as the rights of a subsequent purchaser of the goods in the ordinary course of the debtor's business, a supplier should assume that a bankruptcy court will continue to recognize such defenses. Therefore, it is important to send a reclamation demand to the debtor as soon as possible. A supplier should not wait until after it has obtained a full sales history if one is not readily available. Instead, a supplier should send out a reclamation demand without such detail (if it is not available) and then follow it up with an amended demand along with a detailed itemization of the goods being reclaimed as soon as it can. A supplier or its counsel should send the demand by fax or e-mail to the debtor and its counsel to ensure that the debtor receives the demand as quickly as possible. A supplier may also send a copy by certified mail, return receipt requested. Although it is not necessary to file a copy of the demand with the bankruptcy court, with electronic filing procedures in place in most jurisdictions, many suppliers, through counsel, file a notice of the reclamation demand with the bankruptcy court. Such a filing ensures that the debtor and other parties in interest are on notice of their reclamation demand. A typical demand might state something similar to the following:

> Pursuant to section 546(c) of the United States Bankruptcy Code, 11 U.S.C. § 546(c), we hereby demand immediate return of all goods sold by us and received by you within the 45 days prior to the commencement of your bankruptcy case [including but not limited to those identified on the attached schedule.] In addition, we hereby demand that you segregate and preserve all such goods for our benefit pending their return. Failure to abide by this demand may result in legal action being taken against you. This demand is being made without prejudice to any other rights we may have at law or in equity, including the right to an administrative expense claim under section

> 503(b)(9) of the United States Bankruptcy Code, 11 U.S.C. § 503(b)(9), for the value of any goods sold by us and received by you within the 20 days prior to the commencement of your bankruptcy case.

Absent a debtor's agreement to return goods subject to reclamation, a supplier may be required to commence an adversary proceeding against the debtor in the bankruptcy court to enforce its reclamation rights.[3]

2. *Object to Motions That Seek to Impair Supplier's Lien, Reclamation, or Claim Rights.* Many motions are filed in the beginning of, or during, a bankruptcy case that can have a significant impact upon the rights of a supplier. Common examples might include post-petition financing or cash collateral motions. Debtors typically give their postpetition and prepetition lenders priming or adequate protection liens and superpriority administrative claims that can affect the validity or priority of a supplier's lien, reclamation, or claim rights. Although such motions are usually granted, if suppliers are vigilant, certain protections can be incorporated into orders approving such motions that limit the negative impact of such motions on the suppliers' rights.

3. *File a Proof of Claim.* At a minimum, a supplier should file a proof of claim before the proof of claim deadline established by the bankruptcy court. Filing such a claim will ensure that the supplier will be entitled to vote on the debtor's chapter 11 plan and receive a distribution in connection with the case.

4. *File a Request for Payment of Twenty-day Administrative Claim.* A supplier should also file a claim for payment of its administrative claim pursuant to section 503(b)(9) of the Bankruptcy Code for the value of any goods received by the debtor within twenty days before the bankruptcy filing. Although section 503(b)(9) does not impose a time restriction on the filing of such a claim, the local rules of some bankruptcy courts may impose a deadline for filing such a claim. As of the date of this publication, the United States Bankruptcy Court for the District of Massachusetts has proposed a local rule[4] that would require such a claim to be filed within sixty days of the first date set for the meeting of creditors pursuant to section 341 of the Bankruptcy Code. Even if the bankruptcy court does not have a rule imposing a deadline to file the section 503(b)(9) claim, it may have a local rule imposing a deadline to file administrative claims in

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3. *See* Fed. R. Bankr. P. 7001(1)*; In re Realty S.W. Assocs.*, 140 B.R. 360 (Bankr. S.D.N.Y. 1992). It is not a violation of the automatic stay to commence an adversary proceeding against the debtor in the debtor's bankruptcy case. *See e.g., In re Washington Manufacturing Company*, 118 B.R. 555, 561 (Bankr. M.D. Tenn. 1990).

4. Proposed Local Bankruptcy Rule 3002-1 ("LR 3002-1") of the United States Bankruptcy Court for the District of Massachusetts requires that a claim pursuant to section 503(b)(9) of the Bankruptcy Code must be filed within sixty days after the first date set for the meeting of creditors pursuant to section 341 of the Bankruptcy Code. LR 3002-1 provides that failure to request allowance of the section 503(b)(9) claim within the specified time period will result in denial of the administrative expense treatment of such claim. Comments on LR 3002-1 are due by July 21, 2006.

general.[5] Accordingly, a supplier should ensure that it files its claim prior to any deadline imposed by the bankruptcy court.

D. *Consider Applying for Membership on Creditors' Committee.*

If a supplier is one of the largest unsecured creditors of a debtor, it may be invited to apply for membership on the creditors' committee. Although competition for membership is often strong, a creditor should consider both the benefits and the disadvantages of membership before agreeing to serve on a committee.

1. *Benefits of Committee Membership.* There are several potential benefits to service on a creditors' committee. Because members of a creditors' committee have obligations to investigate the debtor's business and affairs, and negotiate with the debtor concerning formulation of a plan of reorganization, members of a creditors' committee typically enjoy a higher degree of access to the debtor's executives and more detailed information about the causes of the debtor's bankruptcy filing and the results of the debtor's operations in chapter 11. Such increased access can often foster improved business relations between a committee member and the debtor both during a chapter 11 case and after a chapter 11 case is over. However, the committee members may have obligations to keep confidential certain information learned during the case. Members of a creditors' committee also have the opportunity to negotiate with the debtor concerning a plan of reorganization. Finally, because the committee will typically retain legal counsel and financial advisors, creditors who serve on the committee may be able to forego some of the expenses related to the retention of separate outside counsel or financial advisors.

2. *Disadvantages of Committee Membership.* There are also a few disadvantages to service on a creditors' committee. First, depending on the size and complexity of the case, service on a creditors' committee can take up a significant amount of time. During active parts of a chapter 11 case (such as in the beginning and during negotiation of a plan), creditors' committees will often meet at least once a week. However, except during direct negotiations with the debtor or other major creditor constituents, members are usually permitted to participate in creditor committee meetings by telephone. In addition, such negotiations are sometimes delegated to a negotiating subcommittee, which will report back to the full committee. Second, committee members are not paid for their time, although the expenses related to service on a creditors committee are typically reimbursable by a debtor's estate. Third, a member of a creditors' committee owes a fiduciary duty to all unsecured creditors.[6] In addition, a creditors' committee must take actions that will maximize the return to

5. For example, Local Bankruptcy Rule 1019-1(F)(1) of the United States Bankruptcy Court for the Southern District of Florida establishes a ninety-day deadline for filing an administrative claim after a case converts to chapter 7.

6. *In re Caldor, Inc.*, 193 B.R.165 (Bankr. S.D.N.Y. 1996); *In re ABC Automotive Products Corp.*, 210 B.R. 437 (Bankr. E.D. Pa. 1997).

all unsecured creditors generally, and members cannot look to prefer their individual interests over the interests of other unsecured creditors when acting on behalf of the committee.[7] A member can avoid such conflicts however by abstaining from discussing and/or voting on any matter that would be of particular benefit or detriment to that committee member. Finally, although members of a creditors' committee enjoy a qualified immunity from liability for their service on a creditors' committee,[8] that immunity is not absolute. A committee member who breaches his or its fiduciary obligations can be held liable for such breaches.[9]

E. *Negotiate An Agreement with the Debtor.*

There are two simple truisms when it comes to negotiating with a debtor. First, only the squeaky wheel gets the oil. In the early stages of a debtor's bankruptcy case, the debtor is performing financial triage. Only creditors who yell loudly and often will likely be heard because there are many other creditors seeking the debtor's attention. Sometimes counsel will have better luck getting the attention of the debtor's counsel. Other times, the client may have greater success speaking to the debtor directly. Generally, it is best to communicate with someone with the authority to grant the relief a supplier is seeking. Lower level employees of the debtor or junior associates with the debtor's law firm will not generally be able to assist a supplier in obtaining any type of meaningful relief. Therefore, a supplier should not be deterred if inquiries to lower level employees or junior lawyers are not fruitful.

Second, take everything a debtor says with a grain of salt. A debtor may exaggerate the truth to obtain bargaining leverage. For example, a debtor may suggest that a supplier is the only creditor requesting certain type of relief, or that the creditors' committee or the debtor's post-petition lender will not agree to such relief. A debtor may also suggest that a creditor does not qualify for such relief. A persistent and deserving supplier can sometimes obtain relief in spite of such alleged obstacles.

All things being equal, it is best to try to reach a consensual resolution with the debtor. The approach a supplier should take will often depend upon the importance of the supplier to the debtor and the importance of the debtor as a customer of the supplier. A supplier with significant bargaining leverage (for example, a sole-source supplier of a critical good) may be able to obtain more favorable treatment than a supplier without any significant bargaining leverage (for example, a supplier of non-critical goods with many alternate suppliers). Some of the types of relief that may be available to a supplier include a critical vendor payment (see Subsection II.E.1 below), assumption of existing contracts (see

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7. *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 717 (Bankr. S.D.N.Y. 1997).

8. *In re Envirodyne Indus., Inc.*, 174 B.R. 955 (Bankr. N.D. Ill. 1994).

9. *See Central Transport, Inc. v. Roberto (In re Tucker Freight Lines, Inc.)*, 62 B.R. 213 (Bankr. W.D. Mich. 1986).

subsection II.E.2 below), or immediate payment of its twenty-day administrative expense claim (see Subsection 4 below). If negotiations break down, a supplier may be able to increase its bargaining leverage through exercise of its stoppage of delivery rights (see Section II.F below) or through litigation (see Section II.F below). Generally, these latter remedies should be treated as last resorts.

1. *Seek to Obtain Critical Vendor Payments (If No Contract).* Debtors sometimes agree to pay all or a portion of a critical supplier's prepetition debt in exchange for concessions from the supplier. Such relief is generally not available if a supplier has a contract with the debtor, which requires the debtor to supply goods to the debtor. If a supplier has a contract with the debtor, a supplier may wish to negotiate an assumption of the contract instead (see Subsection II.E.2 below). Depending upon the degree of a supplier's leverage, a supplier may need to provide a debtor with incentives in order to obtain critical vendor status. Some possible incentives include: (1) an agreement to continue to supply goods to the debtor during the course of the bankruptcy case; (2) an agreement to maintain prices at a certain level during the course of the bankruptcy case; (3) an agreement to provide certain credit terms during the course of the bankruptcy case; (4) an agreement to reduce the amount of the supplier's claim in the case; and (5) an agreement to defer payment of the critical vendor payment for some specified period of time. Which, if any, of these incentives may be required will depend upon the facts of the case and the relative bargaining leverage of the parties. It is essential that a seller remember not to make payment demands or condition future business with the debtor on payment of prepetition arrears, which could be a violation of the automatic stay. The seller can stop doing business with the debtor and wait for the debtor to offer a critical vendor payment or, if there is a motion to pay critical vendors, it can ask if it is on the critical vendor list without conditioning the request on payment of the arrears.

2. *Request that Debtor Assume Prepetition Contracts.* Suppliers often seek to convince a debtor to assume their contracts at the beginning of a case. Two primary reasons why suppliers seek assumption: (1) a precondition to assumption of a contract is a cure of all defaults under the contract, including payment of all prepetition amounts,[10] and (2) assumption eliminates any preference liability[11] that may be associated with such con-

10. 11 U.S.C. § 365(b)(1).

11. Under section 547 of the Bankruptcy Code, a debtor may avoid and recover any payments made by a debtor on or within ninety days before the commencement of the bankruptcy case to a creditor for a pre-existing debt owed by the debtor while the debtor was insolvent if such payment resulted in the creditor receiving more than it would have received if the bankruptcy case were a chapter 7 case, the payment had not been made, and the creditor received payment of such debt to the extent provided by the Bankruptcy Code. Such payments are often called preferences because they allow a creditor to receive more than other similarly situated creditors who did not receive payments just prior to the bankruptcy filing.

tract.[12] Chapter 11 debtors are not generally required to make decisions on whether to assume or reject their executory contracts[13] with suppliers until confirmation of the debtor's chapter 11 plan. A debtor may agree to assume a contract sooner, however, if given sufficient incentives to do so. Some possible incentives include: (1) an agreement by the supplier to extend the term of the contract or to continue performing under the contract during the course of the debtor's bankruptcy case notwithstanding the supplier's possible right to terminate the contract or to withhold delivery of goods; (2) an agreement by the supplier to reduce prices below those called for under the contract; (3) an agreement to more favorable credit terms than called for under the contract; (4) an agreement to reduce the cure payment called for under the contract; and (5) an agreement to defer payment of the cure payment for some specified period of time. Many debtors are not likely to agree to an early assumption of a contract absent such incentives because, besides obligating the debtor to cure all prepetition defaults and releasing the supplier from any preference liability relating to the contract, assumption also may expose the debtor to a potentially large administrative expense claim if the debtor were to subsequently breach the contract.[14] To avoid such ramifications, some debtors have conditioned early assumption of contracts upon certain concessions from the suppliers. In *In re Delphi Corp.*,[15] for example, the debtors established a program, which was approved by the bankruptcy court, that authorized them to assume certain contracts without further approval of the creditors' committee, the debtors' lenders, or the bankruptcy court if certain concessions were agreed to by the supplier. Among other things, the supplier had to agree that Delphi could terminate the contract at its convenience and that such termination would not give rise to an administrative expense claim. Other conditions included payment of a reduced cure amount paid in quarterly installments with the uncured balance of the prepetition claim to be treated as a general unsecured claim. Suppliers who sold their contract claims were not eligible to participate in the debtor's program. This requirement is not surprising because the primary purpose of offering early assumption

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12. *See e.g., Kimmelman v. Port Authority of New York and New Jersey (In re Kiwi International Air Lines, Inc.),* 344 F.3d 311 (3d Cir. 2003).

13. An executory contract is generally defined as one in which the obligations of both the debtor and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other. *See, e.g., Sharon Steel Corp. v. Nat'l Fuel Gas Distr. Corp.,* 872 F.2d 36 (3d Cir. 1989).

14. If a debtor breaches a postpetition contract or a prepetition contract that has been assumed, then the counterparty will be entitled to assert an administrative expense claim for any damages caused by such breach, which claim must be paid before any priority or general unsecured claims. On the other hand, if a prepetition contract, which has not been assumed, is rejected by the debtor, such a rejection will be deemed to be a prepetition breach and will only entitle the supplier to assert a prepetition claim. *See* 11 U.S.C. § 365(g); 11 U.S.C. § 502(g)(1); 11 U.S.C. § 507(a); 11 U.S.C. § 1129(a)(9)(A).

15. *In re Delphi Corporation.*, Case No. 05-44481-rdd, pending in the United States Bankruptcy Court for the Southern District of New York.

of a supplier's agreement is to incentivize the supplier to cooperate in the debtor's reorganization. A claim trader who purchases creditors' claims is not generally interested in the debtor's reorganization, but instead is interested in maximizing its recovery on the purchased claim. For this reason, it may not be advisable for a supplier that has a contract with a debtor to sell its contract claim until it is confident that it will not be able to reach an agreement with the debtor regarding assumption of its contract.

3. *Request Settlement or Release of Preference and Other Claims.* Although elimination of preference liability is a significant benefit of a contract assumption, a supplier without a contract may have preference exposure unless it can negotiate a waiver of such claims. A debtor may be willing to agree to such a condition (as well as a release of other claims between the parties), subject to court approval, because such a waiver would not typically impact the debtor's short term liquidity needs. A creditors' committee or a bankruptcy judge may resist a waiver of such claims at the beginning of a bankruptcy case on the basis that such a request is aggressive and that the committee has not had an adequate opportunity to investigate the claims. Ultimately, whether a supplier is successful in obtaining such relief will depend upon the total package being offered to the debtor and how much bargaining leverage the supplier has with the debtor.

4. *Request Immediate Payment of Administrative Claim.* As set forth in Sections II.C.4 above and III.A.2 and IV.C.5 below, BAPCPA provides suppliers of goods with an administrative expense claim for the value of goods received by the debtor in the twenty days prior to the bankruptcy filing. BAPCPA does not state, however, when the administrative expense claim must be paid. Therefore, debtors may agree to pay suppliers in the ordinary course of business or it may seek to avoid paying them until plan confirmation, which can be years after the bankruptcy filing. Suppliers should seek to obtain an agreement with the debtor that the administrative claim will be paid at the earliest possible time. In *In re Dana Corp.*,[16] for example, the debtors obtained court authority to pay such administrative claims in the ordinary course of their business and some trade creditors have been successful in having such claims paid early in the case.

F. *Litigation As an Alternative to Failing Negotiations.*

If a supplier is unable to get the debtor's attention or negotiations with the debtor are not going well, a supplier may have no choice but demonstrate to the debtor that it is willing to litigate to get what it wants. Listed below are a few common examples.

1. *Moving for Relief From the Automatic Stay to Terminate a Contract.* Provisions in a contract that permit a party to terminate the contract upon

16. *In re Dana Corporation*, Case No. 06-10354-brl, pending in the United States Bankruptcy Court for the Southern District of New York.

the bankruptcy filing or financial condition of the other party are not generally enforceable.[17] However, a supplier may have the right under its contract with a debtor to terminate the contract for other reasons, or for no reason at all. In such a situation, a supplier can gain bargaining leverage with a debtor by threatening to terminate the agreement. A supplier is prohibited by the automatic stay imposed by section 362 of the Bankruptcy Code from carrying out such a threat, however, unless it first obtains relief from such stay. By filing a motion for relief from the automatic stay to terminate the contract, a supplier can sometimes get the debtor's attention, which can lead to a negotiated resolution. A supplier should not file such a motion, however, unless it is prepared to walk away from the contract because it is possible that the debtor's response will be to agree to the termination.

2. *Moving to Compel the Debtor to Assume or Reject the Contract.* In addition to, or in lieu of, moving for relief from the automatic stay to terminate the contract, a supplier can move to compel the debtor to assume or reject the contract. Under section 365(d)(2) of the Bankruptcy Code, a debtor may assume or reject an executory contract at any time before confirmation of a plan but the bankruptcy court, on the request of any party to such contract, may order the debtor to determine within a specified period of time whether to assume or reject the contract. Generally, bankruptcy judges are loathe to grant such motions at the beginning of a case and will rarely force the debtor to do so prior to plan confirmation;[18] however, a judge may force a debtor to make such a decision earlier in the unusual case where the equities warrant it. One example might be where the supplier was about to incur substantial costs that could not be recovered if the contract were soon rejected. Again, such a motion might serve to get the debtor's attention, allowing the parties to reach a consensual resolution.

3. *Asserting Right to Withhold Delivery of Orders Under a Contract.* A supplier's assertion of the right to withhold delivery of orders under a contract may cause the debtor to file an order to show cause seeking to compel the supplier to perform under the contract. As stated above, debtors are likely to take the position that a supplier is prohibited by the automatic stay from exercising such rights. As set forth in Section IV.B.2 herein, the case law is sparse on this issue but the little there is appears to support a supplier's position that the assertion of such rights does not violate the automatic stay. In *In re Dana Corp.*, Sypris Technologies found itself having to defend against an order to show cause brought against it by the debtor because Sypris asserted that it had the right under the Uniform Commercial Code (U.C.C.) to demand payment for goods in advance rather than on forty-five-day terms as called for under the contract. The bankruptcy judge issued a temporary restraining order requiring

17. 11 U.S.C. § 365(e).

18. *See, Nostas Assocs. v. Costich (In re Klein Sleep Prods.),* 78 F.3d 18, 35 (2d Cir. 1996).

Sypris to honor the payment terms in the contract pending a preliminary hearing. The parties were eventually able to settle their dispute on terms acceptable to both parties. The entry of a temporary restraining order against Sypris shows that asserting a supplier's right to withhold delivery is not without risk. The more conservative course would be to file a motion for a determination by the bankruptcy court that the supplier's assertion of such rights would not violate the automatic stay, or, alternatively, that relief from the automatic stay should be granted to permit the supplier to exercise its right to withhold delivery. The one thing that is clear, however, is that assertion of the supplier's rights to withhold delivery of orders may get the debtor's attention, allowing the parties to reach a consensual resolution.

4. *Move for Immediate Payment of Administrative Expense Claim.* It is too soon to know whether judges will be receptive to such motions, but such a motion might serve to get the debtor's attention, allowing the parties to reach a consensual resolution.

III. Executive Summary of Reclamation Changes to the Bankruptcy Code: BAPCPA

In April 2005, Congress enacted the most sweeping reforms to the Bankruptcy Code in almost thirty years. The reclamation changes altered the landscape in favor of suppliers of goods with respect to bankruptcies commenced on or after October 17, 2005. Favorable changes include: (i) more expansive reclamation rights, and (ii) the grant of an administrative expense claim to suppliers for goods shipped within the twenty days prior to the bankruptcy filing.

A. *Reclamation Rights*

Congress has created a new federal reclamation right under BAPCPA. Prior bankruptcy law merely recognized a vendor's state law reclamation rights, which were typically available under Article 2 of the U.C.C. The new law has expanded the time period for which a vendor can assert a reclamation claim and perhaps limited the defenses that may be available to debtors.

1. *Amount of Goods that Can Be Reclaimed.* Under prior bankruptcy law, a vendor could assert a reclamation claim (*i.e.*, a demand for a return of goods sold) for the goods received by the debtor during the ten days prior to the bankruptcy filing so long as the vendor asserted the claim within twenty days of the debtor's receipt of the goods.

Under the new law, a vendor may assert a reclamation claim for goods received by the debtor during the forty-five day period prior to the bankruptcy filing as long as the vendor asserts the claim within twenty days of the bankruptcy filing or within forty-five days of the debtor's receipt of the goods, whichever is later. Accordingly, under the new law, the

amount of goods that can be reclaimed is much higher and a vendor has more time to assert its reclamation rights.

2. *Debtor's Defenses to a Reclamation Claim.* The prior bankruptcy law recognized a number of state law defenses, which were not specifically set forth in the Bankruptcy Code. For example, a reclamation claim would likely be denied if the debtor had consumed or resold the goods before the vendor had asserted its reclamation claim or if the debtor had pledged the goods to a secured creditor.

The new law specifically provides that a vendor's reclamation claim is subject to the rights of a secured creditor with a lien on the goods but does not identify any of the other defenses available under state law. An argument could be made that Congress's failure to identify these other defenses suggests that no other defenses exist. It remains to be seen whether the bankruptcy courts will interpret the new law in this way.

B. *New Right to Administrative Expense Claim.*

The new law gives a vendor, whether or not it asserts a reclamation claim, the right to an administrative expense claim for the value of the goods received by the debtor in the ordinary course of the debtor's business within the twenty-day period before the bankruptcy filing. This new right is very favorable to a vendor because administrative expense claims are generally paid in full. In addition, it may be possible to receive payment on such a claim at the early stages of a bankruptcy case.

IV. Analysis of a Vendor's Reclamation and Stoppage and Withholding of Delivery Rights Under State and Federal Bankruptcy Law

This section addresses a seller's rights when it discovers that a buyer is insolvent. It will first briefly describe the right of a supplier of goods under state law, including a supplier's reclamation rights and the often forgotten right of a supplier to stop delivery in transit and to withhold delivery of new orders upon a customer's insolvency unless the seller receives payment of all past due amounts and cash in advance or cash on delivery for future shipments. Next, this section will describe the impact upon such rights caused by a pre-BAPCPA bankruptcy filing. Finally, this section will analyze the changes to such rights following enactment of BAPCPA.

A. *Sellers' Rights Under State Law Where Buyer Is Insolvent*

The U.C.C., which has been adopted in substantially the same form in forty-nine of the fifty states,[19] provides a seller of goods with certain

19. *See, e.g.,* Rochelle L. Wilcox, Ordinary Care Under the Code: A Look at the Evolving Standard of Bank Liability Under U.C.C. 4-406, 1997 Utah L. Rev. 933, 934 ("The Uniform Commercial Code was completed in 1950 and has since been adopted, at least in part, by every state, the District of Columbia, Guam, and the Virgin Islands."). U.C.C.

rights when the seller discovers the buyer is insolvent. U.C.C. § 2-702 provides:

> (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 (Section 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 section (2) is subject to the rights of a buyer in the 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 provides:

> The seller may stop delivery of goods in the possession of a carrier or other bailee when he discovers the buyer to be insolvent (Section 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 payment due before delivery or if for any other reason the seller has a right to withhold or reclaim the goods.

In sum, U.C.C. § 2-702 provides the seller with three rights, depending upon the location of the goods at the time the seller discovers the buyer's financial condition. The seller may: (1) reclaim goods already in the actual or constructive possession of the buyer, (2) stop deliveries of goods already in transit (regardless of who holds title to the goods), and/or (3) refuse delivery of pending or future orders (regardless of who holds title to the goods).

1. *Right to Reclaim Goods.* A seller's right to reclaim goods sold on credit or on cash terms where the check bounces arises under U.C.C. § 2-702(2). To reclaim goods, the seller must show: (i) the goods were sold to the buyer; (ii) the buyer received the goods while insolvent; and (iii) the seller demanded the goods within ten days of the buyer's receipt of the goods.[20] Where the buyer has misrepresented its solvency to the seller within three months before delivery of the goods, the ten-day rule does not apply.[21] If a seller is successful in reclaiming its goods, it may not pursue any other remedy with respect to the reclaimed goods against the

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Article 2 has not been adopted in Louisiana. U.C.C. Rep. Serv. State Code Variations, Louisiana, p. 1 (West 2001). Louisiana law provides suppliers of goods with a statutory vendor lien that is similar to a reclamation right. La. Civ. Code. Ann. arts. 3217(7), 3227.

20. U.C.C. § 2-702(2).

21. *Id.*

buyer, such as suing for damages.[22] Accordingly, a seller should carefully consider what its best remedy is before reclaiming. For example, where goods are specially made for the buyer, there may be no other market for them and a seller may achieve better results by suing for damages rather than reclaiming the goods.

The seller's right to reclaim goods is subject to certain defenses. First, the buyer must still have possession of the goods, *i.e.*, those goods must still be in the buyer's actual or constructive possession.[23] As described above, a seller's right to reclaim is subject to the rights of a subsequent buyer who purchased from the original buyer and took possession of those goods in the ordinary course of business or any other good faith purchaser.[24] Thus, if those goods have been resold or are pledged to a creditor, the seller's reclamation right is cut off.[25] For example, in most cases, the rights of a reclaiming seller are subject to the rights of a secured creditor with a lien on after-acquired inventory.[26] In those cases, the courts have held that a secured creditor with a lien on after-acquired inventory is a "good faith purchaser" as contemplated by U.C.C. § 2-702 and possesses rights superior to the reclaiming creditor. In such a case, a reclaiming creditor is required to show that the secured party's lien is less than the value of the collateral securing it. If it is, the reclaiming seller's reclamation right has value. If the secured party is undersecured, the reclamation right has no value and is effectively cut off. Moreover, a seller whose reclamation rights are subject to the rights of a secured creditor may not demand that the secured creditor look to other assets in which the seller does not possess an interest pursuant to the equitable doctrine of marshalling.[27] In a few older cases, courts have held that the reclaiming seller's rights are superior to the secured party with the floating lien.[28] Those cases do not appear to have been widely followed.[29]

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22. U.C.C. § 2-702(3).

23. *See, e.g., In re Adventist Living Ctrs., Inc.,* 52 F.3d 159, 162 (7th Cir. 1995); *Pester Refining Co. v. Ethyl Corp. (In re Pester Refining Co.),* 964 F.2d 842 (8th Cir. 1992).

24. U.C.C. § 2-702(3).

25. *See, e.g., In re Samuels & Co. Inc.,* 526 F.2d 1238 (5th Cir. 1976); *Galey & Lord Inc. v. Arley Corp. (In re Arlco, Inc.),* 239 B.R. 261 (Bankr. S.D.N.Y. 1999); *In re Victory Markets Inc.*, 212 B.R. 738, 742 (Bankr. N.D.N.Y. 1997).

26. *Galey & Lord Inc. v. Arley Corp. (In re Arlco, Inc.),* 239 B.R. 261, 267-268 (Bankr. S.D.N.Y. 1999) (citing *In re Victory Markets Inc.,* 212 B.R. 738, 742 (Bankr. N.D.N.Y. 1997) (citing cases).

27. *See, e.g., In re Arlco, Inc.,* 239 B.R. at 274-77.

28. *In re Mel Golde Shoes*, 403 F.2d 658 (6th Cir. 1968); *In re American Food Purveyors, Inc.*, 17 U.C.C.RS 436 (N.D.Ga.1974) (adopting reasoning in *In re Mel Golde*).

29. *Yenkin-Majestic Paint Corp. v. Wheeling-Pittsburgh Steel Corp. (In re Pittsburgh-Canfield Corp.),* 309 B.R. 277, 284 (B.A.P. 6th Cir. 2004) (holding that "[m]ost secured creditors are good faith purchasers under the Uniform Commercial Code, thus the rights of a reclaiming seller generally will be inferior to those of a secured creditor who has a security interests in the goods . . [.]"); *Mitsubishi Consumer Elecs. Am., Inc. v. Steinberg's, Inc. (In re Steinberg's, Inc.),* 226 B.R. 8, 10 (Bankr. D. Ohio 1998) ("*In re American Food Purveyors, Inc.*, . . . is quite old and has generally not been followed.").

Second, the goods must still be in identifiable form, *i.e.* the seller's goods must be capable of being reclaimed.[30] Where the goods have been mixed with other identical goods prior to a reclamation demand, the seller must be able to trace its goods into that specific bulk quantity of goods in the buyer's possession or its reclamation right may be lost.[31] Finally, where the goods have been consumed by the buyer prior to a reclamation demand, the seller's right to reclaim those goods is extinguished.[32]

2. *Right to Stop or Refuse Delivery.* A seller may also stop delivery in transit or refuse to make new shipments unless the buyer agrees to: (i) pay cash in advance or cash on delivery, and (ii) pay for all the goods previously delivered. As noted, the right to stop delivery or refuse to take and ship new orders is unaffected by the buyer's attempt to resell the goods to a good faith purchaser for value (as in a direct ship scenario).[33] U.C.C. § 2-403(1) provides that a buyer acquires only voidable title (*e.g.*, title that is voidable upon the exercise of a seller's stoppage, withholding, or reclamation rights under U.C.C. § 2-702) until the seller's deadline to exercise remedies under U.C.C. § 2-702 and 2-705 has expired. If the buyer fails to properly pay for the goods, the seller may void title by exercising its remedies under U.C.C. § 2-702 or 2-705. Section 2-403 further provides that a buyer with voidable title can nonetheless pass full title to a good-faith purchaser for value. Therefore, under U.C.C. § 2-403, a buyer with possession of the goods may cut off a seller's right of reclamation by transferring title and possession of the goods to a good-faith purchaser for value. Accordingly, the seller's right to stop delivery or to refuse to make new shipments is valid even though title to the goods may have already passed to the buyer or subsequent buyer[34] and extends to stopping delivery or refusing to make new shipments even if the goods are already in the hands of a bailee who had not yet turned the goods over to the buyer.

B. *Prior Bankruptcy Law (Cases Commenced Before October 17, 2005): Recognition of State Law Rights*

The Bankruptcy Code in effect prior to BAPCPA protected a seller's state law reclamation rights from attack by a debtor or bankruptcy trus-

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30. *In re Arlco, Inc.*, 239 B.R. 261, 266 ("to be subject to reclamation, goods must be identifiable and cannot have been processed into other products.").

31. *In re Charter Co.*, 54 B.R. 91, 92-93 (Bankr. M.D. Fla. 1985) (holding where crude oil can be traced into an identifiable mass that was subject to the buyer's control on the day of demand and that the respective mass contained only crude oil of like kind and grade, an otherwise proper reclamation will be valid).

32. *Union Packing Co. v. Chicago Food Processors,* No.83C1890, 1984 U.S. Dist. LEXIS 16032, at *13-14 (N.D. Ill. June 8, 1984) (reclamation right was extinguished where at the time of the reclamation demand the beef carcasses had been consumed by the debtor).

33. *See* U.C.C. § 2-403; *see also In re Nat'l Sugar Refining Co.*, 27 B.R. 565, 569 (S.D.N.Y. 1983).

34. *See* U.C.C. § 2-403; *see also In re Nat'l Sugar Refining Co.*, 27 B.R. at 569.

tee.[35] The bankruptcy trustee's right to attack or avoid certain creditor actions furthers one of the fundamental goals of bankruptcy. Under bankruptcy law, all similarly situated creditors are supposed to share proportionately in the assets of the debtor and individual creditors are not supposed to receive preferential treatment. To further that goal, a trustee (or debtor in possession) is granted the power to undo a transfer to a creditor that has the effect of giving that creditor preferential treatment. Prior to the enactment of section 546(c) of the Bankruptcy Code, efforts to reclaim goods were often challenged as preferential transfers in violation of the Bankruptcy Code.[36] Although such challenges to reclamation were occasionally successful,[37] the cases suggest that a seller's right to withhold delivery or stop delivery in transit was never successfully challenged in a preference action.[38] The legislative history of former section 546(c) indicates that enactment of that section was intended to recognize, in part, the reclamation rights provided by section U.C.C. § 2-702 and protect from challenge a seller's right to reclaim goods sold on credit to an insolvent buyer.[39]

1. *Reclamation Rights.* The language in former section 546(c) closely tracked the language of U.C.C. § 2-702. Section 546(c) provided:

> Except as provided in subsection (d)[40] of this section, the rights and power of a trustee under sections 544(a), 545, 547, and 549 of this title are subject to any statutory or common-law right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, but—

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35. Because a debtor generally has all of the rights and powers of a trustee where a trustee is not appointed, any reference herein to a trustee would likely be equally applicable to a debtor and the terms trustee and debtor may be used interchangeably herein. *See* 11 U.S.C. §§ 1107, 1203, 1304.

36. *In re Fabric Buys*, 34 B.R. 471, 474 (Bankr. S.D.N.Y. 1983) (citing cases).

37. *See, e.g., In re Peoples Marketing Corp.*, 347 F. 2d 398 (7th Cir. 1965) (holding seller waived reclamation right by accepting return of certain merchandise and seeking to reclaim the remainder of the shipment at a later time); *In re Good Deal Supermarkets, Inc.*, 384 F. Supp. 887 (D.N.J. 1974) (reclamation right under New Jersey law not permitted because allowance would have violated the priority scheme of the Bankruptcy Code).

38. *In re Fabric Buys*, 34 B.R. at 474.

39. *In re National Sugar Refining Co.,* 27 B.R. 565, 570-571 ("The legislative history of . . . section expresses its purpose: "[§ 546(c)] specifies that the trustee's rights and powers under the strong arm clause, the successor to creditors provision, the preference section, and the post-petition transaction section are all subject to any statutory or common-law right of a seller, in the ordinary course of business, of goods to the debtor to reclaim the goods if the debtor received the goods on credit while insolvent . . . . The purpose of the provision is to recognize, in part, the validity of section 2-702 of the Uniform Commercial Code, which has generated much litigation, confusion, and divergent decisions in different circuits.") (citing H.R. Rep. No. 595 at371-372 (1977); S. Rep. No. 989 at 86-87 (1978), U.S.C.C.A.N. 5787, 6327).

40. Section 546(d) addresses reclamation rights of grain producers and United States fishermen.

> (1) such seller may not reclaim any such goods unless such seller demands in writing reclamation of such goods
> (A) before ten days after receipt of such goods by the debtor; or
> (B) if such ten day period expires after the commencement of the case, before twenty days after receipt of such goods by the debtor; and
> (2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court
> (A) grants the claim of such a seller priority as a claim of a kind specified in section 503(b) of this title; or
> (B) secures such claim by a lien.

Upon passage of section 546(c), a seller of goods was no longer able to reclaim goods based upon a debtor's misrepresentation of its solvency within three months before delivery of the seller's goods. Court's interpreting section 546(c) have held that although section 546(c) was the exclusive reclamation remedy available to a seller of goods, the *reclamation* remedy provided therein was not an exclusive *seller* remedy.[41] In other words, section 546(c) did not preclude other remedies available to a seller of goods under state law, such as the right to withhold delivery of goods or to stop goods in transit.

a. *The Automatic Stay.* In addition to providing defenses to the trustee's avoiding powers, section 546(c) allowed a seller to take certain actions against the debtor's bankruptcy estate without running a foul of another fundamental element of bankruptcy: the automatic stay. As noted in Section II.A above, section 362 of the Bankruptcy Code provides for an automatic stay upon the commencement of a bankruptcy case, barring, among other things, all actions to demand payments or take control of property of the debtor. Pursuant to section 546(c), a seller of goods did not need to seek relief from the automatic stay to make a reclamation demand under the U.C.C. (but would still need relief from the automatic stay to retake possession of the goods from the debtor or to resell them[42]). Accordingly, under section 546(c), a seller could make a reclamation demand for goods without: (i) taking a risk such action would subject him to an avoidance action by the debtor or a bankruptcy trustee; or (ii) violating the automatic stay.

b. *Timing of Reclamation Demand.* Although section 546(c) recognized, in part, a seller's state law reclamation rights, it altered the form and timing of the demand. For example, under section 546(c), the demand had to be in writing. In addition, the seller had to make the demand for those goods within ten days of the buyer's receipt, *unless* the ten-day period expired after the commencement of the bankruptcy case. If the ten-day period expired after the case commenced, then the total period by which the written demand was required to be made was expanded to twenty days after receipt of such goods by the debtor. Accord-

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41. *In re Fabric Buys,* 34 B.R. at 474.
42. *In re Waccamaw's HomePlace*, 298 B.R. 233, 237 (Bankr. D. Del. 2003).

ingly, if the ten-day period under the U.C.C. expired one day after the commencement of the bankruptcy, the seller was given an additional ten days or eleven days after the bankruptcy filing to make written demand.

c. *Variations Regarding Proof.* There are two notable differences in the proof requirements between former bankruptcy law and UCC § 2-702. First, section 546(c) required that the goods to have been sold in the "ordinary course of [the] seller's business." U.C.C. § 2-702 has no such requirement. Second, under U.C.C. § 2-702, a seller could prove that a debtor was insolvent on either a balance sheet basis (*i.e.*, the sum of such debtor's debts exceeded the fair value of its assets) or by showing the debtor failed to pay its debts in the ordinary course of business. U.C.C. § 1-201(23). Under 546(c), however, a seller was only permitted to prove the debtor's insolvency on a balance sheet basis.[43] These two changes in the proof requirements have made it more difficult to reclaim goods against a bankrupt debtor.

d. *Reclamation Defenses.* Because section 546(c) did not expand a seller's state law reclamation rights, the seller's right to reclaim goods remained subject to state law defenses. Thus, a seller's reclamation right could be lost if: (i) the goods had been resold by the debtor in the ordinary course of business, (ii) the goods had been commingled with identical goods and could not be identified or traced,[44] or (iii) the goods had been consumed by the debtor.[45]

In addition, in most cases applying section 546(c), the rights of a reclaiming seller were also subject to the rights of a secured creditor with a lien on after-acquired inventory.[46] In those cases, the courts have held that a secured creditor with a lien on after-acquired inventory was a "good faith purchaser" as contemplated by U.C.C. § 2-702(3) and possessed superior rights to those goods than the reclaiming creditor.

Finally, section 546(c) gave the debtor an additional defense to a reclamation claim. Under former section 546(c), the debtor could seek to satisfy a reclamation claim by forcing the seller, with bankruptcy court authority, to accept an administrative claim or a lien on account of the goods sought to be reclaimed. Accordingly, even if the reclaiming creditor had an alternative buyer available to purchase the reclaimed goods, it could have been forced to accept a lien or an administrative claim against the debtor in lieu of reclamation.

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43. *See* 11 U.S.C. § 101(32); *see also, e.g., Oakland Gin Co. v. Marlow (In re Julien Co.),* 44 F.3d 426, 431-32 (6th Cir. 1995); *In re Video King of Ill., Inc.*, 100 B.R. 1008 (Bankr. N.D. Ill. 1989); *In re Diamond Lumber, Inc.,* 102 B.R. 77, 78 (Bankr. N.D. Tex. 1988); *In re Flagstaff Foodservice Corp.*, 56 B.R. 899, 905 (Bankr. S.D.N.Y. 1986). *But see Ambico, Inc. v. AIC Photo, Inc. (In re AIC Photo, Inc.),* 57 B.R. 56 (applying the U.C.C. definition of insolvent rather than the definition of insolvent under the Bankruptcy Code).

44. *In re Charter Co.,* 54 B.R. at 92-93.

45. *In re Arlco, Inc.,* 239 B.R. 261, 266 (citing *Party Packing Corporation v. Rosenberg (In re Landy Beef Co., Inc.),* 30 B.R. 19, 21 (Bankr. D. Mass. 1983); *Union Packing Co. v. Chicago Food Processors*, 1984 U.S. Dist. LEXIS 16032.

46. *See, e.g., In re Arlco, Inc.,* 239 B.R. at 267.

2. *Stopping Delivery in Transit and Withholding Delivery.* A party to a contract with a debtor is obligated to perform under that contract until the debtor rejects the contract.[47] Further, a postpetition attempt to terminate a contract is an effort to exercise control over property of the estate and violates the automatic stay.[48] However, cases suggest that a supplier's exercise of its stoppage and withholding of delivery rights under U.C.C. § 2-702 does not violate the automatic stay. Other cases, though not directly addressing a supplier's rights under U.C.C. § 2-702, suggest that a supplier's exercise of such rights will violate the automatic stay.

a. *Cases Recognizing Stoppage and Withholding of Delivery Rights.* The few courts to specifically address the issue have all found that former section 546(c) did not preclude the right of a seller of goods to stop delivery in transit or to withhold delivery of future orders under a contract (regardless of whether title to such goods had passed to the debtor) and that a seller's exercise of such rights under U.C.C. § 2-702 after a bankruptcy filing does not violate the automatic stay.[49] For example, in *In re National Sugar Refining Co.*, a seller commenced a shipment of goods to the debtor, then learned of the debtor's insolvency prior to the debtor's receipt of the goods.[50] The seller exercised its right under U.C.C. § 2-702 to stop delivery of the goods while in transit and, once the goods were recovered from the shipper, to withhold delivery of such goods from the debtor.[51] The United States District Court for the Southern District of New York held that it was irrelevant that title of the goods had already passed to the debtor under the contract because, under section 546(c) of the Bankruptcy Code, the seller had a claim to the goods that was superior to the debtor's.[52] In addition, the court held that the seller's actions in stopping delivery of the goods did not violate the automatic stay because the seller's exercise of its stoppage rights did not abrogate, but merely sus-

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47. *In re Gunter Hotel Associates,* 96 B.R. 696, 700 (Bankr. W.D. Tex. 1988) ("In the Court's view, an executory contract under Chapter 11 is not enforceable against the debtor party, but is enforceable against the nondebtor party prior to the debtor's assumption or rejection of the contract." (citing *In re Feyline Presents, Inc.,* 81 B.R. 623, 626 (Bankr. D. Colo. 1988)).

48. *See, e.g., In re Computer Commun., Inc.,* 824 F.2d 725 (9th Cir. 1987).

49. *See, e.g., Montello Oil Corp. v. Marin Motor Oil, Inc. (In re Marin Motor Oil, Inc.),* 740 F.2d 220, 225 (3d Cir. 1984) (holding right to stop goods in transit is a right that is distinct from reclamation); *Morrison Indus., L.P. v. Hiross, Inc. (In re Morrison Indus., L.P.),* 175 B.R. 5, 9 (Bankr. W.D.N.Y. 1994) (noting that the definition of reclaim following *In re National Sugar Refining Co.* and holding that "the clear parallelism of U.C.C. §§ 2—702 and 705, command a broad, non—literal interpretation of the word "reclaim" —— one which includes a refusal to deliver and stoppage in transit."); *Lansdale Family Rest., Inc.,* No. 91-8009, 1992 U.S. Dist. Lexis 3192 (E.D. Pa. March 12, 1992); *In re Nat'l Sugar Refining Co.*, 27 B.R. 565, 572; *In re Fabric Buys,* 34 B.R. 471. *But see Sportfame of Ohio v. Wilson Sporting Goods Co. (In re Sportfame of Ohio, Inc.),* 40 B.R. 47 (Bankr. N.D. Ohio 1984) (compelling seller of goods to continue to sell goods to debtor postpetition where contracting party conditioned future shipments on payment of the prepetition debt).

50. *In re National Sugar Refining Co.*, 27 B.R. at 567.

51. *Id.*

52. *Id.* at 569.

pended, the contract at issue.[53] The court further opined that the future course of the parties under the contract was governed by section 365 of the Bankruptcy Code, *i.e.,* the debtor could have compelled the seller to ship the goods in conformance with the contract by assuming the contract pursuant to section 365(b) of the Bankruptcy Code.[54] The court then remanded the case to the bankruptcy court so that the bankruptcy court could decide the unresolved issues relating to assumption or rejection of the contract.[55]

In sum, these cases suggest that a seller retains its right to stop delivery of goods in transit and to refuse delivery of goods under a contract after a bankruptcy filing and that exercise of such rights after a bankruptcy filing does not violate the automatic stay.

b. *Contrary Authority.* Some debtors have attempted to rely upon a few cases, which appear to suggest that even a supplier with no contractual obligation to do so can be compelled to sell goods to a debtor. It should be noted that none of the reported cases that have compelled a vendor to supply goods to a debtor addressed the vendor's stoppage and withholding of delivery rights under U.C.C. § 2-702. The cases where courts have ordered a seller of goods to continue to supply the debtors with goods all appear to have done so in response to: (i) a violation of the automatic stay because the refusal was deemed an act to collect on a prepetition debt,[56] or (ii) a complaint seeking a mandatory injunction.[57] A mandatory injunction is considered to be an extraordinary remedy for which the debtor would generally need to show: (a) immediate and irreparable harm to the reorganization, (b) a balancing of the equities favors the debtor, (c) a likelihood of success on the merits, and (d) that issuance of the injunction is in the public interest.[58]

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53. *Id.* at 572.

54. *Id.* at 573-574.

55. *Id.* at 575.

56. *In re Sportfame of Ohio, Inc.*, 40 B.R. 47; *In re Parkman*, 27 B.R. 460 (Bankr. N.D. Ill. 1983), and *In re Haffner*, 25 B.R. 882 (Bankr. N.D. Ind. 1982).

57. *In re Sportfame of Ohio, Inc.,* 40 B.R. 47; *Ike Kempner & Bros., Inc. v. U.S. Shoe Corp. (In re Ike Kempner & Bros., Inc.),* 4 B.R. 31 (Bankr. E.D. Ark. 1980); *Blackwelder v. Drexel-Heritage Furnishings, Inc. (In re Blackwelder),* 7 B.R. 328 (Bankr. W.D.N.C. 1980).

58. The standard for injunctive relief varies from circuit to circuit, but most of the tests require some form of these elements. *See, e.g., Cobell v. Norton*, 391 F.3d 251 (D.C. Cir. 2004); *Heideman v. S. Salt Lake City*, 348 F.3d 1182, 1188 (10th Cir. 2003) (quoting *Resolution Trust Corp. v. Cruce*, 972 F.2d 1195, 1198 (10th Cir. 1992)); *Reuters, Ltd. v. United Press Int'l, Inc.*, 903 F.2d 904, 907 (2d Cir. 1990)(*quoting Coca-Cola Co. v. Tropicana Prods., Inc.,* 690 F.2d 312, 314-15 (2d Cir. 1982)). The purpose of a preliminary injunction is "to merely preserve the positions of the parties until a trial on the merits can be held." *Univ. of Tex v. Camenisch*, 451 U.S. 390, 395 (1981). There are three types of disfavored preliminary injunctions: "(1) preliminary injunctions that alter the status quo; (2) mandatory preliminary injunctions; and (3) preliminary injunctions that afford the movants all the relief it could recover at the conclusion of a full trial on the merits." *O Centro Espirita Benficiente Uniao Do Vegetal v. Ashcroft*, 389 F.3d 973, 977 (10th Cir. 2004) (*en banc*) (citing *Acierno v. New Castle County*, 40 F.3d 645, 653 (3d Cir. 1994) ("A party seeking a mandatory preliminary injunction that will alter the status quo bears a particularly heavy burden in

The leading case cited for this proposition is *In re Sportfame of Ohio, Inc.*[59] In *Sportfame*, the United States Bankruptcy Court for the Northern District of Ohio was faced with a complaint by a debtor seeking an order directing a seller of goods to continue to do business with the debtor on a cash on delivery basis.[60] The seller, Wilson Sporting Goods Co. (Wilson), refused to ship its product to the debtor unless the debtor paid the prepetition arrears.[61] The debtor argued and the court agreed that, without Wilson's products, the debtor's reorganization efforts would be harmed.[62] The court held that Wilson's sole reason for refusing to ship goods to the debtor was its desire to coerce the debtor's repayment of its prepetition indebtedness and that its act, albeit passive, was an "act to collect, assess, or recover a claim against the debtor" in violation of section 362(a)(6) of the Bankruptcy Code. The court then relied on its equitable powers under section 105 of the Bankruptcy Code[63] to order Wilson to continue to ship to the debtor for the remainder of the bankruptcy case on cash in advance or cash on receipt payment terms.[64] Although it acknowledged the extraordinary nature of the injunctive remedy, the court found that such an injunction was required to remedy the seller's violation of the automatic stay and to promote the debtor's rehabilitation effort.[65]

Despite the ultimate conclusion of the *Sportfame* court, the court left open the possibility, and at least one subsequent court has agreed, that

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demonstrating its necessity."); *Wetzel v. Edwards*, 635 F.2d 283, 286 (4th Cir. 1980) ("Mandatory preliminary injunctions do not preserve the status quo and normally should be granted only in those circumstances when the exigencies of the situation demand such relief."); *Anderson v. United States*, 612 F.2d 1112, 1114-15 (9th Cir. 1980) ("Mandatory preliminary relief, which goes well beyond simply maintaining the status quo pendente lite, is particularly disfavored."). Accordingly, the standard for a mandatory injunction is even more exacting than the standard for a preliminary injunction that merely preserves the status quo.

59. *In re Sportfame of Ohio, Inc.,* 40 B.R. 47.

60. *Id.*

61. *Id.* at 49.

62. *Id.* at 52.

63. 11 U.S.C. § 105(a).

64. *In re Sportfame of Ohio, Inc.,* 40 B.R. at 52-53.

65. *Id.* at 51, 53. In support of its decision, the *Sportfame* court cited two other cases, *In re Parkman*, 27 B.R. 460 and *In re Haffner*, 25 B.R. 882. Unlike *Sportfame,* neither *Parkman* nor *Haffner* involved the sale of goods under article two of the U.C.C. . In addition, *Haffner* relied upon section 525 of the Bankruptcy Code in holding that a governmental unit was prohibited from refusing to extend certain benefits to a debtor based solely on the debtor's failure to pay a prepetition debt due the governmental unit. Section 525 of the Bankruptcy Code provides that:

> a governmental unit may not deny revoke, suspend, or refuse to grant a license, permit, charter franchise, or other similar grant . . . to a person that is or has been a debtor under this title . . ., solely because such bankrupt or debtor is or has been a debtor under this title . . .

Accordingly, *Parkman* and *Haffner* are simply not authoritative in the U.C.C. sale context.

Wilson could have simply stopped shipping goods with no explanation and not run afoul of the automatic stay.[66] The *Sportfame* court observed:

> While perhaps unremarkable otherwise, Wilson's actions take on an added significance upon the filing of a petition in bankruptcy. Wilson could have simply refused, for any reason, to sell goods to debtor or offered no explanation for its refusal to do business. Instead, its sole reason for refusing to sell goods to debtor was its desire to collect its prepetition debt. The act in this context had the effect of interfering with the reorganization effort, a result at odds with the purpose of the bankruptcy laws.[67]

In *Sportfame*, the court did not address the seller' stoppage and withholding of delivery rights under U.C.C. § 2-702. The *Sportfame* decision appears to be inconsistent with a seller's rights under U.C.C. § 2-702, which gives a seller the right to demand payment of its prepetition debt as a condition to its performance under the contract. Accordingly, it is unclear whether the *Sportfame* court would have decided the case in the same way had the seller in that case asserted its rights under U.C.C. § 2-702.

Accordingly, it appears under the prior bankruptcy law a seller probably had the right to stop or withhold delivery of goods under a contract following a debtor's bankruptcy filing. However, it is possible that a court would find that the exercise of such rights would violate the automatic stay and, thus, compel a supplier to continue selling to a debtor, whether or not it had a contract with the debtor, where its sole reason for refusing to sell to the debtor is the debtor's failure to pay its prepetition debt to the seller or where the seller's failure to sell the goods to the debtor would cause immediate and irreparable injury to the debtor's reorganization effort. In such a situation, a court would likely require the debtor to provide the seller with adequate assurance of payment, such as cash in advance or cash on delivery.

C. *BAPCPA (Cases Commenced On or After October 17, 2005): Creation of a New Federal Right of Reclamation*

Congress expanded the rights of sellers of goods when it passed BAPCPA. Although it is too soon to say the precise extent to which those rights were enlarged (because it will take time before the courts decide how the legislative changes should be interpreted), BAPCPA clearly has: (i) created a new federal reclamation right; (ii) expanded the reclamation period and the time within which a seller may assert its reclamation rights; and (iii) given a seller an absolute right to an administrative expense claim for certain goods shipped to the debtor.

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66. *Divane v. A & C Elec. Co.*, 193 B.R. 856, 862 (N.D. Ill. 1996) (citing *In re Sportfame*, 40, B.R. 47, 50).

67. *In re Sportfame*, 40 B.R. at 50.

1. *New Federal Reclamation Right.* Congress has created a new federal reclamation right under BAPCPA. Former section 546(c) specifically made a trustee's avoidance rights subject to "any statutory or common law right of a seller" that sold goods to the debtor in the ordinary course of business while the debtor was insolvent. Under BAPCPA, Congress has removed the reference to statutory or common law rights. Section 546(c) now provides:

> (1) Except as provided in subsection (d)[68] of this section and in section 507(c), and subject to the rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under sections 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 forty-five days before the date of the commencement of a case under this title, but such a seller may not reclaim such goods unless such seller demands in writing reclamation of such goods—
>
> (A) not later than forty-five days after the date of receipt of such goods by the debtor; or (B) not later than twenty days after the date of commencement of the case, if the forty-five-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 may still assert the rights contained in section 503(b)(9).

By striking the reference to statutory or common law rights and expressly including a right to reclaim, Congress created a new federal reclamation right that preempts state law reclamation rights with respect to debtors in bankruptcy.

2. *Exercising Reclamation Rights Under BAPCPA.* As under prior law, a seller is still required under BAPCPA to show that the goods were sold to the debtor in the ordinary course of the seller's business and that the debtor received such goods while insolvent. However, the time period for which a seller may reclaim goods is significantly expanded. Under BAPCPA, a seller now has to make the reclamation demand within forty-five days of the date on which the debtor receives the goods. If the forty-five-day period expires after the commencement of the bankruptcy proceeding, the demand can be made within twenty days of the commencement date. Accordingly, if the forty-five-day period expires one day after the bankruptcy filing of the bankruptcy case, the seller will have an additional twenty days after the bankruptcy filing or nineteen days after expiration of the forty-five-day period to assert its reclamation rights. Under the prior version of the Bankruptcy Code, the seller was afforded a mere ten-day extension after the bankruptcy filing to assert its reclamation

68. As noted above, section 546(d) of BAPCPA specifically addresses reclamation rights of grain producers and United States fishermen. This provision was unchanged by BAPCPA.

rights. Such an extended period enables a seller to reclaim far more goods in its reclamation demand.

3. *Debtor's Defenses Under BAPCPA.* As under the prior law, a seller's rights under BAPCPA are subject to possible defenses. Unlike the old law, BAPCPA provides that reclamation rights are subject to (i) section 507(c); and (ii) the rights of a holder of a security interest in such goods or the proceeds thereof. The reference to section 507(c) was apparently intended to refer to section 507(b). Section 507(c) addresses a governmental unit's priority rights in connection with the giving of an erroneous tax refund or credit. Section 507(b) gives a secured creditor a superpriority administrative claim to the extent that an adequate protection lien provided to such creditor under section 362, 363, or 364 is inadequate. No cases have yet addressed this apparent drafting error. If the courts interpret the provision as probably intended, then a seller's reclamation rights will probably be subject to the rights of a secured creditor that is granted an adequate protection lien on the goods supplied by the seller. As discussed in Section II.C.2 above, a seller may need to guard against a debtor's efforts to grant such an adequate protection lien on assets being reclaimed by the seller.

Unlike the former Bankruptcy Code, new section 546(c) specifically addresses the priority of a prior lien on the goods or the proceeds of those goods. Under BAPCPA, Congress eliminated any controversy regarding the priority of a party with a security interests in the debtor's inventory. A seller's rights to reclaim goods are now clearly subject to the prior rights of a holder of a security interest.

Further, it is not clear if a debtor's ability to assert its state law defenses has been extinguished. As noted above, by striking the reference to statutory or common law rights, BAPCPA does not explicitly incorporate a seller's state or common law defenses. Under the U.C.C., the seller's reclamation right was subject to the rights of a subsequent buyer of goods in the ordinary course of business or other good faith purchaser. Because Congress did not include an explicit recognition of state law rights or defenses, one might argue that such defenses are not recognized under BAPCPA. Until the courts have concluded otherwise, however, seller's should assume that such defenses have been preserved.

4. *Stopping Delivery in Transit and Withholding Delivery of Future Orders Under BAPCPA.* As noted in Section IV.B.1 above, the courts generally did not treat section 546(c) as a seller's exclusive remedy with respect to prior bankruptcy law, but rather its exclusive reclamation remedy. The absence of clear language to the contrary in BAPCPA suggests that the new reclamation law has not changed a seller's other remedies, such as its right under the U.C.C. to stop delivery in transit and withhold delivery of future orders following a bankruptcy filing. Instead, it is likely that the changes merely altered a seller's exclusive reclamation remedy under section 546(c) of the Bankruptcy Code. Further, because *Sportfame* has not been widely followed, it is unlikely that a seller of goods would be com-

pelled to continue selling goods to a debtor when there is no contract existing between the parties. It appears that there is a significant risk to the seller, though, if such refusal to continue to do business is conditioned on the payment of the prepetition arrears (even though U.C.C. § 2-702 appears to give a seller such a right). In those circumstances, section 362 of Bankruptcy Code and the bankruptcy court's inherent equitable powers under section 105(a) of the Bankruptcy Code, may provide authority to the court to compel the seller to continue to ship goods to the debtor.

5. *New Right to Administrative Expense Claim.* Section 546(c)(2) of BAPCPA gives a seller, whether or not it serves a reclamation demand, the right to an administrative expense claim under section 503(b)(9) for goods sold to a debtor within the twenty-day period before the commencement of the bankruptcy case. Section 503(b)(9) provides:

> After notice and a hearing, there shall be allowed administrative expenses, . . . including—the value of any goods received by the debtor within twenty 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.

Section 503(b)(9) grants a clear and automatic right to an administrative expense claim for the goods received by the debtor in the ordinary course of the debtor's business within twenty days before the bankruptcy filing, whether or not a reclamation demand is made. Note that the administrative expense claim test differs from the reclamation test in that for an administrative expense claim the seller must show the goods were received in the ordinary course of the *debtor's* business. For reclamation, a seller must show the goods were sold in the ordinary course of the *seller's* business. Thus, even if a seller is not entitled to reclaim goods, it may still be entitled to an administrative expense claim or vice versa.

It is also worth noting that section 503(b)(9) grants the administrative expense claim for the "value" of goods received by the debtor. The statute does not specify whether the term "value" is meant to be the fair market value of the goods at the time the debtor receives them or the value as stated on the seller's invoice. This distinction will likely be a source of litigation.

V. Conclusion

The recent changes to the Bankruptcy Code have greatly expanded the remedies available to a supplier who sells goods to a debtor. Suppliers now enjoy significantly broader reclamation rights and a new right to an administrative expense claim for goods shipped shortly before the bankruptcy filing. If a seller is diligent, however, it can maximize these remedies and take advantage of others that are often forgotten, such as a seller's right to stop delivery in transit and its right to withhold delivery of goods under a contract pursuant to Article 2 of the U.C.C. We hope that this article provides a useful reference tool to suppliers and their advisors alike in navigating the sometimes confusing maze of bankruptcy.

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