

# **2005 BANKRUPTCY REFORM LEGISLATION CHANGES OF INTEREST TO TRADE VENDORS<sup>1</sup>**

## **PRE-PETITION GOODS AND RECLAMATION**

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 makes significant changes to how trade vendors are treated. The new law may provide a trade vendor (1) an administrative expense claim and (2) an expanded right to reclaim goods. The revised provisions are now effective.

### **I. PRE-“REFORM” LAW**

Under prior law, a trade vendor who shipped goods to a soon-to-be debtor could reclaim those goods *under applicable non-bankruptcy law* if it gave written notice of reclamation within 10 days of the receipt of the goods by the other party (extended to 20 days if the 10 days had not run when the bankruptcy was filed). The bankruptcy court could deny the vendor the right to reclaim, but only if it gave the vendor an administrative claim or a lien.

However, because the Bankruptcy Code referred to the vendor’s rights under statute or common law, the state Uniform Commercial Code provisions governing reclamation applied. This meant that the right to reclaim was subject to (inferior to) the rights of a “good faith purchaser.” This almost always includes the buyer’s secured lender. So reclaiming vendors were often found not to have “valid reclamation claims” and were cut out by the secured lender. This is referred to as the “valueless” defense to the reclamation claim.

But where there was equity above the lender’s lien, or where they could negotiate with the lender, reclaiming vendors would receive a junior lien or an administrative expense priority position if not allowed to reclaim their goods.

The new law gives trade vendors two possible types of claim--

### **II. THE NEW LAW--ADMINISTRATIVE CLAIM.**

#### **A. The Statutory Language.**

The first significant change for trade vendors is not really “reclamation.” It applies to all sellers of “goods,” whether they file a reclamation notice or not. 11 U.S.C. § 503(b) of the Bankruptcy Code, which determines what claims have administrative priority, has been amended

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to grant a trade vendor (seller of goods) an administrative expense claim for the value of any goods **received** by a debtor within **20 days** prior to the debtor's bankruptcy filing, provided the goods were sold to the debtor in the **ordinary course** of the **debtor's** business.

Section 503(b)(9) provides:

(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including –

(9) the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.

The consequence of having an administrative expense priority for a pre-petition claim is that the vendor receives payment *after* secured claims, but *before* other pre-petition unsecured claims. So 20 days' worth of costs for goods are "moved" from pre-bankruptcy into the post-bankruptcy period, to be paid with post-petition vendors, the debtor's attorneys, accountants, and other professionals, and other priority costs.

## **B. Application Of The Plain Language.**

The U.S. Supreme Court frequently reminds judges and lawyers to comply with the "plain language" of a statute. Unfortunately, in the case of the bankruptcy reform legislation, the drafters were often not clear, as will be seen below.

To be entitled to an administrative expense claim under section 503(b)(9), a trade vendor must demonstrate:

- (1) the value of goods sold,
- (2) the goods were received by the debtor within 20 days before the filing, and
- (3) the goods were sold in the ordinary course of the "debtor's business."

By its plain language, a section 503(b)(9) administrative claim appears to be unrelated to any lender's security interest in the goods or their proceeds. Therefore, the administrative expense claim appears to exist independent of any defense to the validity of a reclamation claim, including the "valueless" defense. It also appears to be independent of various other state law defenses to a reclamation claim including consumption and commingling, which were difficult issues on which the reclaiming creditor previously had the burden of proof. Finally, there is no requirement to demonstrate that the debtor was insolvent when the goods were received. Thus, section 503(b)(9) appears to grant a trade vendor an important new right, which is more than an expansion of traditional reclamation rights.

### C. Questions To Be Answered.

Significant questions remain concerning the interpretation of section 503(b)(9), the resolution of which will affect the scope of the trade vendor's right to an administrative expense claim. These include:

- How will "value" be interpreted in determining the amount of the allowed administrative expense claim?
- Will "value" of the goods be the contract price?
- Will the contract price be a presumption that can be rebutted or otherwise subject to reductions or discounts?
- How will the ordinary course of the debtor's business be determined? And how is it different from the seller's ordinary course of business?
- If the vendor is entitled to an administrative expense claim, when will it be paid: (1) at the outset of the case, (2) at confirmation of a plan, or (3) at some other time?
- If not paid at the outset of the case, how will courts address an administrative expense claimant's right to adequate assurance of payment while the case goes on?
- Is the administrative expense priority claim retained if a vendor reclaims the goods?
- What is a "good"?
- Does this section include mixed goods and services?
- Will trade vendors with part priority claims be eligible to serve on the Committee? If not, will this shift the balance on committees in large cases even more toward the interests of bondholders, to the detriment of trade debt?

It has been suggested that giving priority to 20 days' worth of pre-petition unpaid claims will make it much harder for a debtor to reorganize successfully. For the rare debtor who is paying vendors on a current basis, this will move most of its unsecured debt into priority position. From the creditor's perspective, too, this change may work to the detriment of the trade vendor who was previously sophisticated enough to file a reclamation notice. Now all sellers of goods have an enhanced position, not just those who made the effort to exercise their rights; and if the weight of administrative claims causes the case to fail, all vendors lose a customer.

### III. THE NEW LAW--THE RIGHT TO RECLAIM.

#### A. The Statutory Language.

The right to reclaim goods is separate and distinct from the administrative claim provision discussed above. The new law increases the time to make a reclamation demand from 10 (or 20) days to 45 days before the bankruptcy filing (but not later than 20 days after the filing date, if the 45 day period had not expired).

This right to reclamation is found in 11 U.S.C. § 546(c), which now provides:

(c)(1) Except as provided in subsection (d) of this section and in section 507(c),<sup>2</sup> and subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under 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 *45 days* before the date of the commencement of a case under this title, but such seller may not reclaim such goods unless such seller demands in writing reclamation of such goods –

(A) not later than *45 days* after the date of receipt of such goods by the debtor; or

(B) not later than 20 days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.

(2) If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9). (my italics above.)

#### B. Application Of The Plain Language.

To reclaim goods, a vendor must demonstrate that:

- (1) the goods were sold in the ordinary course of the “*seller's business*,”
- (2) the debtor received the goods while insolvent,
- (3) the debtor received the goods within 45 days of the filing of the case, and
- (4) the vendor gave written demand to reclaim the goods
  - (i) not later than 45 days after receipt, or
  - (ii) not later than 20 days after the filing of the case if the 45 days expired after the filing.

The failure to send a reclamation notice **does not affect** the vendor's right to the administrative claim discussed above. The benefit to sending the reclamation notice is that under revised section 546(c), the right of reclamation applies for a significantly longer timeframe than

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<sup>2</sup> The reference to section 507(c) appears to be a “technical” error. The proper reference should likely be section 507(b).

under its predecessor – 45 days as opposed to 10 days. The notice period is similarly expanded. **But**, there is now an express recognition that the vendor’s right to reclaim is “subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof.” Under prior law, this was not always the case—as in states where the law was not clear on that issue, or where the secured lender was not a “good faith purchaser” within the meaning of the UCC. The new law makes clear that the “valueless” defense now applies in all cases where there is a senior secured lender.

Finally, revised section 546(c) is also significant—and confusing--for what it **eliminates**. It deletes the former language giving the court authority to grant vendors an administrative claim or trade lien. The revised section also eliminates any reference to state or other non-bankruptcy law such as the UCC. Thus, while the mechanics of asserting reclamation remain the same and the time to reclaim is expanded under section 546(c), other revisions may have unintended consequences that will make reclamation a less attractive alternative:

### C. Questions To Be Answered.

- Does the elimination of the court’s authority to grant vendors an administrative claim or trade lien prohibit a court from granting that relief? Are trade vendors stuck with reclaiming the goods?
- Does the vendor have an absolute right to reclaim or only the right to request reclamation? Can a debtor or the court stop reclamation?
- Is the “junior trade lien” now impossible?
- Will the automatic stay bar the recovery of the goods because it is an “act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate” under 11 U.S.C. § 362(a)(3)?
- Can a reclamation creditor obtain relief from the stay under 11 U.S.C. § 362(d) for cause? This requires a motion. Does it have to be done before the goods are used up?
- Will a reclamation creditor be barred from reclaiming the goods even if the secured lender is over-secured (ie, the debtor has equity in the goods beyond the amount of the security interest) because the goods are still subject to a lien?
- Are the “prior rights” of a secured creditor still subject to dispute under non-bankruptcy law?
- Does the elimination of reference to state law and the UCC create an “federal” right to reclaim under the Bankruptcy Code?

- Does the elimination of the reference to state law and the UCC mean that the principles underlying the UCC and the decades of case law interpreting that section do not apply when construing section 546(c) of the Bankruptcy Code?
- If state law (UCC) defenses to reclamation such as consumption or commingling are still available, does the new law shift the burden of proof from the vendor to the debtor?
- Will the right to reclaim (as well as the administrative expense claim) simply foster more litigation between the debtor and trade vendors at the outset of the case? Uncertainty = spending money.

#### **IV. PRACTICAL CONSIDERATIONS**

All of the questions identified above (and the others you will come up with from a particular situation) demonstrate that this area is now very uncertain. They suggest a number of practical responses:

A. Consider whether you want to reclaim the goods—and get them back. This may now be the only remedy for a “reclaiming” creditor.

B. If you decide on the reclamation option, determine what goods the debtor had on hand as of the filing date, and what goods the debtor currently has on hand. It remains unclear whether, having received a reclamation notice, the debtor may continue to consume the goods. With the new uncertainty about how the law will work, you may want to take action in bankruptcy court to protect the reclamation right.

C. As soon as the case files, calculate the value of good shipped in the preceding 20 days. This will be your administrative claim. If the debtor does not promptly give you notice of what it intends to do as to that claim—pay, adequately assure that it will be able to pay—and the amount warrants it, seek legal advice on how to proceed. Again, with so much uncertainty, you may need to take action in the court early in the case.

### **DEFENDING PREFERENCE CLAIMS**

#### **I. ORDINARY COURSE DEFENSE**

Generally, the October 17, 2005 effective date refers to the date the petition commencing the case was filed, and not the date the adversary proceeding was commenced. As a result, it will likely be a year or more before the avoidance action amendments take effect. Avoidance actions are often not commenced until near the running of the two-year statute of limitation.

Under current law, a creditor may shield a transfer in the “ordinary course” from avoidance if the transfer was made:

- (A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;
- (B) in the ordinary course of business or financial affairs of the debtor and transferee; **and**
- (C) according to ordinary business terms.

11 U.S.C. § 547(c)(2). The final requirement’s “ordinary business terms” refers to terms in the seller’s industry as a whole. Thus, the defendant had to prove that the payments were both ordinary between it and the debtor, and were ordinary in its industry. The latter often required an outside expert who could testify about the industry in general.

The Reform Act only requires a creditor to show that the transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee and was made:

- (A) in the ordinary course of business or financial affairs of the debtor and the transferee; **or**
- (B) according to ordinary business terms.

The disjoining of the final two elements should make it easier (and cheaper) to protect transfers under the ordinary course defense. Some commentators, however, speculate that trustees and debtors will more aggressively pursue preference actions. Thus, it is conceivable that the intended effect of the amendment may be muted.

## **II. DOLLAR LIMITS**

Under prior law, a bankruptcy debtor or trustee could sue a preference defendant for any amount of money in the court where the bankruptcy was pending. This allowed the plaintiff to “extort” settlements from defendants over relatively small amounts, because the cost of defending in a distant court was not worth the effort.

The new law makes changes to the venue provisions of 28 U.S.C. § 1409(b) to provide that an action to recover a non-consumer debt against a non-insider of the debtor for **less than \$10,000** must be filed in the district in which the defendant is located. This should deter suits for small amounts.

## **MISCELLANEOUS PROVISIONS**

### **I. SMALL BUSINESS DEBTORS**

The new law has special expedited provisions for “small business” debtors. A small business is defined as a business with debts not exceeding \$2,000,000 (not counting debt to affiliates), where the United States Trustee is unable to appoint a Creditors Committee, or the court determines that the Committee is not sufficiently active.

If a debtor is a small business, the time to confirm a plan is accelerated, but the debtor may not need to file a separate disclosure statement. There is also more detailed reporting required. The idea is to move these cases along quickly, and not allow them to languish in Chapter 11, as they often have in the past.

## II. EXCLUSIVITY

Under current law, only the debtor may file a plan in the first 120 days of the case (then has another 60 days to get a plan confirmed), and courts frequently extend this “exclusivity” period for years, especially in large/complex cases.

Under the new law, courts no longer have the authority to grant extensions of exclusivity beyond **18 months to file a plan and 20 months to get it confirmed.**

Exclusivity is really only relevant if there is a risk of some group filing a competing plan, which is very rare. But the threat of such a plan is useful in bargaining with a debtor, so this change will shift more power to the creditors in Chapter 11 cases. The unintended consequence will probably be that debtors will file plans on time, but that the plans are less likely to be successful, because the debtor in a large/complex case really has not had enough time to work out its problems.

## III. OTHER NEW PRIORITY CLAIMS

There are other new administrative expense priority claims that will compete with the trade vendors’ 20-days-of-goods claims, and that in the aggregate will make it harder for a debtor to get out of bankruptcy—

A. Employee **wages and benefit priority** amount is increased from \$4,925 per employee to **\$10,000 per employee.**

B. Under the new law, a debtor must decide whether to assume or reject its commercial real estate leases within 210 days of filing. For many companies—especially retail—this is a very short time. The new law provides that where a debtor assumes such a lease, but later decides (or is forced) to reject it, the landlord will have an administrative expense priority of **two years lease payments**, without any rights of setoff for security deposits, damages, etc. This can be a very significant amount.

C. All **taxes** incurred by the bankruptcy estate, including property taxes, now have administrative priority. Under prior law, property taxes were only paid when the property was sold because they were a lien on the property. Other taxes that were secured by a lien could be paid out over time; now they must be paid in full before the debtor can emerge from Chapter 11.