



FIFTY WAYS TO LEAVE YOUR DEBTOR: LESSER-KNOWN REMEDIES FOR JILTED CREDITORS

SETOFF AND RECOUPMENT

**Presentation For:
American Bankruptcy Institute/ Annual Spring Meeting
Unsecured Trade Creditors Committee
April 13, 2007**

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I. SETOFF

- A. Generally, state law requires the following four elements in order to effectuate a setoff:
1. The obligation to be setoff must be property of the debtor;
 2. The existing indebtedness is due and owing;
 3. There is a mutuality of the obligation between the debtor and the creditor; and
 4. The claim and the debt are valid and enforceable.

Setoff is based on the notion that if one or both parties is owed money, he or she should be able to avoid having to pay his or her debt prior to collecting his or her claim. The right of setoff is an efficient method for settling debts where the parties can reduce their obligations to each other by setting off one claim against another.

- B. The Bankruptcy Code does not grant setoff rights per se, state law governs the creditor's right of setoff. *see Citizens Bank v. Strumpf*, 516 U.S. 16 (1995). Section 553 of the Bankruptcy Code acknowledges that a creditor has the right of setoff under state law and merely preserves setoff rights. Section 553 of the Bankruptcy Code also establishes limits on a creditor's ability to exercise its setoff rights. Section 506(a) treats valid setoff rights as a secured claim.
- C. The right of setoff under state law is generally viewed as a self-help measure that may be used by a creditor at his or her election. Once a debtor has filed for bankruptcy, a setoff of a pre-petition claim against pre-petition obligations cannot be taken without permission from the bankruptcy court. The automatic stay arising under Section 362 of the Bankruptcy Code acts to prevent a creditor from unilaterally exercising setoff rights. The creditor must obtain a bankruptcy court order granting relief from the automatic stay to permit setoff. *see Stephenson v. Salisbury (In re Corland Corp.)*, 967 F.2d 1069, 1076 (5th Cir. 1992).
- D. Section 553's limitations on the right to exercise setoff are as follows:
1. "Mutuality": The debts must have been between the same parties acting in the same right or capacity. *see Cohen v. Savings Bldg. & Loan Co. (In re Bevill, Bresler & Schulman Asset Management Corp.)*, 896 F.2d 54, 57, 22 C.B.C.2d 551, 556 (3d Cir. 1990); *Olsen-Frankman Livestock Marketing Serv., Inc. v. Citizens Nat'l Bank of Madelia*, 605 F.2d 1082 (8th Cir. 1979) This means that each party is both a creditor and a debtor of the other party in the same capacity. For example: A owes B on a personal loan that

occurred prepetition. B owes A for services A rendered for B prepetition. In this scenario, the debts could be setoff. An example of where the debts would lack mutuality is as follows: A is indebted to B for a personal loan. B is indebted to A in A's capacity as a trustee for a trust. Mutuality only means that each party owes something to the other in the same right and capacity. It does not require that the obligations be from the same contract or transaction.¹

- a. Risks of "Triangular Setoff" where a creditor is dealing with multiple affiliated debtors. A's obligations to Company B cannot be setoff against affiliated Company C's indebtedness to A, unless otherwise permitted by agreement between A, B, and C. *Sherman v. First City Bank of Dallas (In re United Sciences of Am., Inc.)*, 893 F.2d 720, 723, 22 C.B.C.2d 638, 642 (5th Cir. 1990); *Elcona Homes Corp. v. Green Tree Acceptance, Inc. (In re Elcona Homes Corp.)*, 863 F.2d 483, 486 (7th Cir. 1988) (citing 4 Collier on Bankruptcy ¶ 553.04[1]); *In re Garden Ridge Corp.*, 338 B.R. 627 (Bankr. D. Del. 2006). See the following sample language:

"XYZ Papers Inc., and its direct and indirect affiliates, divisions and subsidiaries including, but not limited to, XYZ Papers Holdings Inc., XYZ Canada Inc., XYZ Limited and XYZ NH LLC (hereinafter collectively "XYZ") and ABC Inc. and its direct or indirect affiliates, divisions or subsidiaries including, but not limited to, ABC Inc. (collectively "ABC") agree that notwithstanding anything to the contrary contained herein or contained in any other contract, agreement or document, XYZ may offset any debt owing by XYZ to ABC against any debt owing by ABC to XYZ."

¹ Recoupment, however, requires that the claims must have occurred from the same contract or transaction.

Note: The agreement, at least as to the paragraph above, must be signed by all ABC and XYZ entities that do business with each other.

2. “Prepetition”: Both the debt and the claim owed must have arisen prior to the debtor’s bankruptcy filing. For purposes of the setoff under Section 553 of the Bankruptcy Code, a debt arises when all transactions required to create a liability occur, regardless of whether the claim is contingent, unliquidated or unmatured when the petition is filed. *See* 11 U.S.C. 553(a); *In re Delta Airlines*, 341 B.R. 439 (Bankr. S.D.N.Y. 2006)(rejection damage claim is not a prepetition claim that could be setoff against a prepetition obligation to a debtor).
3. “Disallowed”: Certain claims which have been disallowed under Section 502 of the Bankruptcy Code cannot be used as the basis for a setoff. Examples of claims that have been disallowed under Section 502 are exempted property claims, claims that are unenforceable against the debtor because of usury, unconscionability, or failure of consideration. *See* 11 U.S.C. § 553(a)(1).
4. “Transferred”: Claims against a debtor cannot be offset if (a) the claims were transferred, by an entity other than the debtor, to such creditor within 90 days before the filing of the debtor’s bankruptcy; and (b) the debtor was insolvent when the claim was acquired.² *See* 11 U.S.C. 553(a)(2).
5. “Build-up”: A creditor cannot incur obligations to the debtor within 90 days of the filing of a bankruptcy petition where the purpose of the incurrence of such obligations was to create or increase the right of setoff and the debtor was insolvent at the time of setoff. *See* 11 U.S.C. §553(a)(3); *In re U.S. Aeroteam, Inc.*, 327 B.R. 852 (Bankr. S.D. Ohio 2005)
6. “Improvement in Position”: Under the Bankruptcy Code, the trustee or debtor-in-possession has the power to recover from any amounts set off during the 90 days preceding the filing of a petition for bankruptcy that sum representing an improvement in the creditor’s position. *See Lee v. Schweiker*, 739 F.2d 870, 877, 11 C.B.C.2d 834, 842 (3rd Cir. 1984).

² Section 553(c) creates a rebuttable presumption that the debtor was insolvent 90 days prior to the filing of a bankruptcy petition.

- a. The initial benchmark used in calculating any improvement in the creditor's position under Section 553(b) is the point in time that is 90 days before the commencement of the debtor's bankruptcy case. The relevant calculation of any avoidable improvement proceeds in four stages:
 - i. Section 553(b) requires the calculation of the creditor's setoff position 90 days before the commencement of the debtor's case. This is done by comparing the creditor's claim with the creditor's debt, and determining the extent to which the creditor's claim exceeds the amount of the debt. The amount by which the creditor's claim exceeds the amount of the creditor's debt is called the "insufficiency".
 - ii. if there were no insufficiency on the 90th day, Section 553(b) requires the court to determine whether there was an "insufficiency" on any day after the 90th day (but before the commencement of the debtor's case). This determination is also accomplished by comparing the creditor's claim with the creditor's debt.
 - iii. in order to calculate any improvement in the creditor's setoff position, Section 553(b) sets the initial reference date as (a) 90th day prior to the petition date if an "insufficiency" existed on the 90th day and (b) any "insufficiency" existing on the first day during the 90 days preceding the petition date on which there was an "insufficiency" if there was no "insufficiency" on the 90th day. Thus, if there was an "insufficiency" on the 90th day, and an "insufficiency" on any other day during the 90 day period, the point of reference would be set on the 90th day.³
 - iv. Section 553(b) requires a comparison between the creditor's setoff position at the initial reference point (as calculated in (iii)) and the day on which

³ In the hypothetical discussed above, there was no insufficiency on the 90th day. The first day on which there was an insufficiency was the 75th day. Thus, in the hypothetical, the initial reference point for determining any improvement in setoff position under Section 553(b) would be the creditor's insufficiency on the 75th day.

any setoff was actually taken. Section 553(b) permits the trustee to recover any improvement in the creditor's position measured by any decrease in the creditor's insufficiency on the date of setoff.⁴

If the creditor's position improved during the 90 days prior to bankruptcy, but the creditor did not exercise its setoff rights during this period, the creditor has no exposure under Section 553(b).

Below are three examples to help clarify the "Improvement in Position Test" which can be tricky to understand.

Example 1:

Suppose A had a claim against a debtor for \$15,000. At 90 days before the commencement of the debtor's bankruptcy case, A owed the debtor \$10,000. The "insufficiency" at 90 days was thus \$5,000. At 30 days before the commencement of the debtor's bankruptcy case, A owed the debtor \$14,000, thus reducing the insufficiency to \$1,000. A took a setoff of the amount the debtor owed to it against the amount it owed to the debtor on the 30th day. Because the insufficiency at the time of setoff (\$1,000) was less than the insufficiency at 90 days prior to filing (\$5,000), A improved its position (by \$4,000). The trustee may recover the improvement (\$4,000), but A may keep \$10,000 from its setoff (\$14,000 less the \$4,000 recovered by the trustee).

Example 2:

Suppose A had a claim against a debtor for \$15,000. At 90 days before the commencement of the debtor's bankruptcy case, A owed the debtor \$10,000. The insufficiency at 90 days was thus \$5,000. At 89 days before the petition date, the A owed the debtor \$8,000, thus leaving an insufficiency to \$7,000. At 30 days before the petition date, A owed the debtor \$14,000, thus leaving an insufficiency of \$1,000. A took a setoff of the amount the debtor owed to it against the amount it owed to the debtor on the 30th day. In calculating any recoverable improvement, Section 553(b) requires use of the *later of* the insufficiency at 90 days before the

⁴ Continuing the hypothetical discussed in the preceding note, suppose the creditor incurred additional indebtedness of \$30,000 to the debtor on the 50th day prior to filing for bankruptcy relief, resulting in a balance due of \$80,000. Suppose further that the creditor offset the \$80,000 balance due against its \$100,000 claim on that same day. By taking the setoff on the 50th day before bankruptcy, the creditor took advantage of a \$30,000 improvement in its position from the 75th day. Because of this improvement, § 553(b) would permit the trustee to recover \$30,000 from the creditor.

petition date and the *first* date during the 90 days in which there was *any* insufficiency. Thus, in this example, Section 553(b) requires use of the insufficiency at 90 days (\$5,000). It does not matter that the amount of the insufficiency increased the next day. Compare the insufficiency at 90 days (\$5,000) to the insufficiency on the actual date of setoff (\$1,000). The difference (\$4,000) is the improvement in position. Therefore, the trustee can recover \$4,000 and A may keep \$10,000 (\$14,000 on the date of the setoff less the \$4,000 recoverable by the trustee).

Example 3:

Suppose that, at 90 days before a bankruptcy filing, the debtor owed A \$10,000 and A owed the debtor \$10,000. At all times during the 90 day period, the amount A owed to the debtor fluctuated between \$10,000 and \$15,000. At all times during the 90 day period, the amount the debtor owed to A remained at \$10,000. Since there never was any insufficiency during the 90 day period, A was entitled to offset \$10,000 to cover the entire amount owed to it, with no portion subject to recovery.

II. SETOFF DISTINGUISHED FROM RECOUPMENT

- A. The rights of setoff and recoupment have similarities that often overlap. Each right can be used in a debtor's bankruptcy case. Both work to reduce a claim from a debtor's estate by the creditor asserting it. Both are state law claims.
- B. Recoupment is essentially a defense to a debtor's claim against a creditor. It allows a creditor to reduce its claim when setoff might be unavailable. All that is required to invoke recoupment is that it arises from what is defined as a single or unified transaction or claim. Further, a creditor entitled to assert the right of recoupment need not seek stay relief or obtain the permission of the Bankruptcy Court in order to effectuate the recoupment.
- C. Recoupment is the setting up of a demand arising from the same transaction as the plaintiff's claim or cause of action, strictly for the purpose of abatement or reduction of such claim. The justification for the recoupment doctrine is that where the creditor's claim against the debtor arises from the same transaction as the debtor's claim, it is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation, and application of the limitations on setoff in bankruptcy would be inequitable. In the bankruptcy context, recoupment has often been applied where the claims arise out of a single contract that provides

for advance payments based on estimates of what ultimately would be owed, subject to later correction. However, an express contractual right is not necessary to effect a recoupment. Nor does the fact that a contract exists between the debtor and creditor automatically enable the creditor to effect a recoupment. Both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without meeting its obligations. *See* 4 Collier on Bankruptcy ¶ 553.10[1].

- D. Recoupment is not mentioned in the Bankruptcy Code and exists independent of it. *Holford v. Powers (In re Holford)*, 896 F.2d 176, 179, 22 C.B.C.2d 1097, 1099-1100 (5th Cir. 1990) This fact can be a very powerful tool for a creditor to protect and reduce their claim(s) against a debtor in bankruptcy. A party that fulfills the requirements of recoupment can use it to reduce its claims against prepetition debts, postpetition debts, or some combination. There are none of the limiting factors that Section 553 employs in the setoff context.

III. **CAN SETOFF AND RECOUPMENT RIGHTS BE LIMITED OR ELIMINATED IN A CHAPTER 11 FINANCING ORDER OR CONFIRMED CHAPTER 11 PLAN?**

- A. Financing Orders: beware of provisions that subordinate setoff rights to the rights of the Chapter 11 secured lender.
- B. A majority of courts hold that confirmation and discharge does not eliminate the subsequent exercise of a right of setoff. *IRS v. Luongo (In re Luongo)*, 259 F.3d 323 (5th Cir. 2001); *Carolco Television Inc. v. National Broadcasting Co. (In re De Laurentis Entertainment Group, Inc.)*, 963 F.2d 1269 (9th Cir. 1992) (holding that it would be unfair and inconsistent with Congressional intent to preclude setoff), *cert. denied*, 506 U.S. 918 (1992); *Davidovich v. Welton (In re Davidovich)*, 901 F.2d 1533 (10th Cir. 1990); *but see United States v. Continental Airlines (In re Continental Airlines)*, 134 F.3d 536, 542 (3d Cir. 1998) (confirmation of a chapter 11 plan precluded the exercise of a setoff right by the government).

IV. **PRIORITY DISPUTE SETOFF RIGHTS VS. ACCOUNTS RECEIVABLE SECURED LENDER**

- A. Former Article 9: Prior to the 2001 revision of Article 9 of the UCC, courts varied in their application and use of Article 9 to resolve priority disputes between secured creditors and creditors exercising rights of setoff. *see* 4 Collier on Bankruptcy ¶ 553.12.

- B. Revised Article 9: Revised Article 9⁵ uniformly resolved the issue of priority disputes among holders of setoff rights and secured creditors. Under UCC §§ 9-404(a)(1),(2) a secured party's security interest in collateral is subject to any setoff or recoupment defense. *See In re U.S. Aeroteam, Inc.*, 327 B.R. 852 (Bankr. S.D. Ohio 2005).

V. **POST-PETITION SETOFF RIGHTS**

- A. Although the code does not explicitly allow for setoff of postpetition claims, case law has established such a right. *See In re Mohawk Industries, Inc.*, 82 B.R. 174, 179 (Bankr. Mass. 1987).
- B. *Mohawk Industries* held that postpetition setoff can be effectuated only if the requisite mutuality exists between the two obligations. 82 B.R. 174, 180. Mutuality exists between obligations that both arise postpetition. *See In re Service Decorating Co.*, 105 B.R. 859, 865 (N.D. Ill. 1989). Generally, prepetition obligations can not be setoff against obligations that arise postpetition.

⁵ As of January 1, 2007, all fifty states as well as the District of Columbia and the U.S. Virgin Islands have adopted revised Article 9.

**FIFTY WAYS TO LEAVE YOUR DEBTOR: LESSER
KNOWN REMEDIES FOR JILTED CREDITORS.**

(Statutory and Common Law Liens and Joint Check Agreements)

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I. Treatment of Statutory and Common Law Liens under UCC Article 9

A. Non-Article 9 state law generally governs statutory and common law liens

B. One noteworthy exception:

1. Section 333 of revised Article 9 (previously 9-310) confers priority on a person who furnishes services or materials with respect to goods subject to a security interest if:

a) Local statute or rule of law gives a lien;

b) The lien is possessory; and

c) The local statute does not expressly provide otherwise.

2. Retention of possession to preserve perfection of possessory lien does not violate automatic stay

3. Non-Article 9 state law governs priority between non-possessory statutory liens and security interests; first-in-time, first-in-right rule (Illinois)

II. Statutory liens

A. Bankruptcy Code Definition: liens of distress for rent, whether or not statutory, and liens arising solely by force of statute under specified circumstances or conditions (11 U.S.C. § 101(53)), but excluding security interests and judicial liens

B. Examples of statutory liens:

1. Mechanic's, contractor's, materialman's or supplier's liens

2. Artisan's, repairman's or processor's liens

3. Producer's or commodity depositor's liens

4. Warehouseman's lien

5. Attorney's (charging) or professional services liens

6. Oil and gas product liens

7. Agister's lien

8. Commercial real estate broker lien

9. Healthcare services lien

C. Trustee or DIP can avoid three classes of liens:

1. Liens for rent or liens of distress for rent;
2. Liens triggered by debtor's financial distress and would alter the Bankruptcy Code's priority distribution scheme; and
3. Liens that are not perfected or enforceable at commencement of bankruptcy case against a bona fide purchaser

D. Perfection of various statutory liens

1. Mechanic's, contractor's, materialman's or supplier's liens

a) Description: lien on personal property for labor or materials provided to debtor

b) In most states, perfection requires recording and/or notice to debtor (e.g. Illinois, New York, Vermont, Idaho, Colorado, Alabama, Kentucky, Florida, Texas, Mississippi, North Dakota)

(1) File lien statement/affidavit/notice identifying party with whom lienor contracted with county or town clerk as prescribed by applicable state law or commence enforcement suit

(2) Some states may require filing before work commences; some states allow filing of notice of intent to furnish labor or materials and lien perfection date relates back

(3) Filing or commencement of suit within prescribed time (e.g. Kentucky: within 1 month after work was last performed; Illinois, New York and Colorado: within 4 months after work was last performed; North Dakota: within 6 months after work was last performed)

(4) Most states require notice to be served on debtor

- c) Some states require timely commencement of enforcement suit (e.g. Oregon) or entry of final order in enforcement action (e.g. Maryland) to perfect lien
- 2. Artisan's, repairman's or processor's liens:
 - a) Description: lien on tools, molds, dies, patterns, forms, etc. that are in possession of artisan, repairman, processor or molder and belong to the customer for work performed therewith
 - b) Most states only require possession (e.g. Ohio, Iowa, Florida, Massachusetts, Illinois, Arkansas)
 - c) Perfection may also be accomplished by filing notice within prescribed time period (e.g. Arkansas: 120 days)
- 3. Producer's or commodity depositor's liens
 - a) Description: lien in favor of producer or handler on agricultural products
 - b) Perfection may depend on type of agricultural products, but some states require filing of notice/affidavit within prescribed period of time (e.g. Ohio: 60 days)
 - c) In other states, there are no formal perfection requirements (e.g. California) and lien extinguishes only upon relinquishment of possession
- 4. Warehouseman's lien
 - a) Description: lien for unpaid charges on goods covered by a warehouse receipt
 - b) Perfection requires issuance and mailing of receipt by person engaged in storing goods for hire (e.g. Massachusetts, Kansas)
- 5. Attorney's (charging) or professional services liens
 - a) Description: lien against client property, including judgment amounts and settlement proceeds
 - b) Perfection requires notice of lien to be filed in same manner as financing statement (e.g. Minnesota), statutory lien (e.g. Georgia) or with clerk of court where action is pending (e.g. Colorado)
 - c) Additional requirements in many states (e.g. Illinois):

(1) Agreed upon fee between attorney and client or reasonable fee related to services rendered;

(2) Money or property recovered from suit; and

(3) Sufficient notice to debtor and opposing party

d) Common law attorney's (charging) lien (e.g. Florida, Michigan) require:

(1) Attorney-client contract;

(2) Express or implied understanding that payment is contingent upon recovery or will be paid from recovery;

(3) Attempt by client to avoid paying or dispute as to payment; and

(4) Timely notice of request for lien

6. Oil and gas product liens

a) Description: affords royalty owners, producers and other interest owners in oil and gas production to secure payment price; akin to mechanic's lien

b) Two categories / methods of perfection:

(1) Non-uniform UCC provisions (Texas, Wyoming, Kansas)

(a) Statutes simulate Article 9 due to superior treatment accorded consensual security interests over statutory liens by the Bankruptcy Code

(b) Parties entitled to security interest --"interest owners": a person owning an entire or fractional interest of any kind in oil and gas production at the time of severance, or a person who has an express, implied, or constructive right to receive a monetary payment determined by the value of the oil or gas production or the amount of production (e.g. owners of unleased mineral interests, royalty interests, and production payments)

(c) Obligations secured: (i) obligation of the first purchaser of oil and gas production to pay the purchase price; and (ii) the payment of all taxes that

are or should be withheld or paid by the first purchaser

(d) Property subject to security interest: production and proceeds

(e) Creation of security interest: signed writing giving interest owners a right under real estate law operates as “security agreement” (must contain sufficient legal description of land, but need not be filed; first purchaser need not be party to writing)

(f) Perfection: automatic without filing a financing statement (though a financing statement may be accorded higher priority in bankruptcy)

(2) Purely statutory lien (New Mexico, Oklahoma)

(a) Parties entitled to security interest and obligations secured: same as above

(b) Creation: automatic upon the sale of production

(c) Perfection: requires party to file Notice of Lien much like statutory mechanics lien; (NM: between 15 and 45 days after payment is due; OK: within 90 days of payment being due)

(d) Expiration: timely filed lien expires one year after date of filing

7. Agister's lien

- a) Description: lien on livestock and their offspring, products, etc for goods or services provided to owner
- b) Perfection generally accomplished through possession

8. Commercial real estate broker's lien

- a) Description: lien upon commercial real estate in the amount the broker is due under contract
- b) Perfection requires recording with local recording office prior to conveyance of property and notice to owner of record
- c) Lien extinguishes unless suit is commenced within 6 months of transfer or conveyance of property

9. Health care services lien

- a) Description: lien in favor of health care professionals and health care providers that render services in the treatment, care, or maintenance of an injured person
- b) Lien upon all claims and causes of action of the injured person, but may be limited to certain percentage of recovery amount and apportioned between lienors (e.g. Illinois: 20-40% of recovery depending on amount of liens)
- c) Perfection requires service of written notice by registered or certified mail on both the injured person and the party against whom the claim or right of action exists

I. Joint Check Agreements

- a. Definition: a check made out jointly to two parties that constitutes a contract between three parties and contains all the information concerning what is expected of all the parties and the consequences and remedies should the Agreement not be fulfilled
- b. Application: widely used in the construction industry, but useful in many situations involving payment chains (e.g. supplier-vendor-end user; supplier-subcontractor-contractor)
- c. Process: contractor / end user issues a check made payable to both the subcontractor / vendor and the supplier in an amount equal to what the subcontractor / vendor is owed for an order; the check is then signed by the subcontractor / vendor and given to the supplier for deposit; supplier then issues a check back to the vendor for the difference of what was paid by the contractor / end user and what the vendor owed the supplier for the product, thus reducing the risk of providing their marginal customer a large order and at the same time not lost a sale
- d. Benefits:
 - i. Generally: protects against situation where vendor or subcontractor uses proceeds from sale to pay other obligations not related to the transaction
 - ii. Bankruptcy
 1. May protect subcontractors or suppliers from losses and preference liability when the entity immediately above them in the payment chain files bankruptcy
 2. Basis: joint checks in the hands of a debtor are not “property of the estate” under express or constructive trust theories
 3. Express trust arises when parties contractually create a "trust fund" to ensure that the supplier receives monies for goods sold in the event the subcontractor to whom the supplies were delivered fails to pay its debt to the supplier
 - a. Express trusts require the following:
 - i. Explicit declaration of trust
 - ii. Clearly defined trust *res*

- iii. Intent to create a trust
 - iv. Most states require written instrument or technical trust instrument
- b. Constructive trust might be good enough; imposed in the following circumstances:
- i. To avoid unjust enrichment of one party at the expense of another; and
 - ii. To compel restitution of property that in equity and good conscience does not belong to a party

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**UCC ARTICLE 2 REMEDIES AND
PERISHABLE AGRICULTURAL
COMMODITIES ACT**

Presentation For:
American Bankruptcy Institute / Annual Spring Meeting
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April 13, 2007

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I. IDENTIFICATION AND ANALYSIS OF CONTRACT WITH TROUBLED SUPPLIER

A. Article 2 of the Uniform Commercial Code (“UCC”) Governs All Transactions Involving the Domestic Sale of Goods

1. **Identification and Analysis of Typical Contract Documents.** Collect and analyze all documents evidencing the contract or contracts for the purchase and sale of the subject goods. Documents include requests for quotations, purchase orders, invoices, and any amendments of those pieces of paper. Correspondence exchanged between the parties may have the effect of modifying the contract terms. Preprinted forms contain detailed terms and conditions printed on the reverse side of the form or on a separate sheet. Certain basic terms in the parties’ documents may conflict in which case the conflict must be resolved with reference to section 2-207 of the UCC or other applicable law.

2. General Rules of Contract Formation and Construction

(a) Article 2 Of The Uniform Commercial Code. Article 2 of the UCC establishes uniform provisions governing the sale of goods. Article 2 also covers contract formation, contract terms, contract enforcement, and warranties. Any analysis should begin with applicable state statutory and case law to ensure accuracy.

(b) The Sale Goods. At its most basic level, Article 2 applies to the sale of goods. UCC § 2-102. Goods are defined as “all things that are movable at the time of identification to a contract for sale” including future goods and specially manufactured goods. UCC § 2-103(1)(k). Article 2 further provides that “[g]oods must be both existing and identified before any interest in them may pass.” UCC § 2-105(1). Goods that are neither existing nor identifiable are considered “future goods” and any “purported present sale of future goods or of any interest therein operates as a contract to sell.” *Id.*

Specially manufactured goods purchased from a supplier for future delivery fall within the purview of Article 2. Accordingly, interest in specially manufactured goods will not pass to the buyer until the goods are identifiable. This time frame is important for a purchaser to know when its rights attach to the goods. Such goods may be sold in bulk, lots or commercial units. UCC § 2-105(3)-(5).

(c) Know Your Contract Rights. When negotiating with a seller, it is important to know your contract rights to ensure that you are obtaining the benefit of your bargain and retaining the protections afforded under Article 2. The following points will assist purchasers in dealing with suppliers.

- Purchasers should add terms and conditions at the time of contract formation that may be useful if the contract is challenged or breached at a later date - such as a reasonable liquidated damages provision and arbitration clause
- Purchasers should inspect documents received from a seller and be able to identify whether or not the seller added additional terms/deleted terms that may change the original offer or exclude certain warranties.
- Troubled sellers may alter form contracts by adding or deleting terms. Therefore, purchasers should never rely on common practice or previous contracts because the terms may not be the same. All contracts should be carefully reviewed to ensure that the terms of the same as previously agreed upon.

These changes or exclusions are not welcome surprises at a later date when the relationship between the parties is not very cordial. Documents are regularly exchanged between parties contracting for the sale of goods; however, these documents rarely contain all of the terms and conditions the parties think are applicable to the transaction. Further, documents such as purchase agreements, purchase orders, letters, and other correspondence may be exchanged between the parties and affect the terms and conditions of the initial offer or previous contract. Since supply agreements, purchase agreements, and purchase orders regularly cover extended periods of time, it is important to carefully review subsequent purchase orders and other correspondence to ensure that the seller is not attempting to change the original agreement. It is much easier to control the terms of the deal during formation rather than attempting to “clarify” the deal terms later through litigation.

(d) Contract Formation. At its most basic level, a contract is an agreement. UCC § 2-204(1). The analysis, however, is not that simple. There first must be an offer, usually in the form of a supply agreement, purchase agreement, or purchase order, that invites a reasonable acceptance by the seller. UCC § 2-206. For example, a purchase order requesting the “prompt or current shipment” of parts from a seller is an offer that invites acceptance by the seller. The seller can either promise to ship the parts or promptly ship the parts. In most instances, the seller will promise to ship by a date certain. If acceptance is not made in a reasonable time, the offeror may treat the offer as having lapsed. In the age of electronic communication, it is important to note that an offer and/or an acceptance may be by electronic means. UCC § 2-204.

(i) Important Definitions. Certain definitions are important when entering into any contract for the sale of goods:

- **“Contract’ for sale** includes both a present sale of goods and a contract to sell goods at a future time.” UCC § 2-106(1).

- “‘**Contract for sale**’ includes both a present sale of goods and a contract to sell goods at a future time.” *Id.*
- “A ‘**sale**’ consists in the passing of title from the seller to the buyer for a price[.]” *Id.*
- “A ‘**present sale**’ means a sale which is accomplished by the making of the contract.” *Id.*
- “Goods or conduct including any part of a performance are ‘**conforming**’ or conform to the contract when they are in accordance with the obligations under the contract.” UCC § 2-106(2).
- “‘**Termination**’ occurs when either party pursuant to a power created by agreement or law puts an end to the contract otherwise than for its breach. On ‘termination’ all obligations which are still executory on both sides are discharged but any right based on prior breach or performance survives.” UCC § 2-106(3).
- “‘**Cancellation**’ occurs when either party puts an end to the contract for breach by the other and its effect is the same as that of ‘termination’ except that the canceling party also retains any remedy for breach of the whole contract or any unperformed balance.” UCC § 2-106(4).

(ii) Nonconforming Goods. If the seller does not have or cannot produce goods that conform to the offer, a seller may ship nonconforming goods. UCC § 2-206. The shipment of nonconforming goods is not an acceptance by the seller if the seller “seasonably notifies the buyer that the shipment is offered only as an accommodation to the buyer.” *Id.* The buyer does not have to accept the nonconforming goods; however, the buyer’s remedies may be limited.

On the other hand a buyer may accept nonconforming goods with an expectation that the nonconforming goods will be “reasonably covered” by the manufacturer. *Atchole v. Silver Spring Imports, Inc.*, 379 F.Supp 2d 797, 803 (D. Md. 2005) (“whether a ‘general right to cure, applicable where a buyer accepts without knowledge of a nonconformity and thus without expectation that it will be cured, is also to be inferred, has been the subject of considerable dispute and the decisions are in conflict”); *Monarch Nutritional Laboratories, Inc. v. Maximum Human Performance, Inc.*, 205 WL 1683734 at *9 n.13 (D. Utah July 18, 2005) (“The UCC expressly allows a seller to limit a buyer’s remedy to ‘return of the goods and replacement of nonconforming goods or parts.’”).

A buyer should be aware that it can refuse nonconforming goods, which may happen more often than not when the supplier is facing troubled times and trying to raise capital by jettisoning its inventory.

(iii) Additional Terms Added to the Contract. A written acceptance can add additional terms that are different from the original offer. UCC § 2-207. The additional terms may not materially alter the contract, unless expressly consented to by the parties. In other words, an acceptance does not have to be the mirror image of the offer. For example, an supplier may respond to a purchase order by sending the buyer a writing that changes the original shipment terms, warranties, and/or credit terms.

- Purchasers must be alert to changes and their potential impact, especially with the long-term nature of many contracts with sellers and the numerous documents being exchanged.
- Purchasers must also be alert as to their conduct because conduct can alter the agreements. *Gage Products Co.*, 393 F.3d at 641-42 (notwithstanding a writing to the contrary, conduct between the parties can establish a contract).

The affect of competing contract terms is addressed in UCC § 2-207, which provides:

Subject to Section 2-202, if

1. conduct by both parties recognizes the existence of a contract although their records do not otherwise establish a contract,
2. a contract is formed by an offer and acceptance, or
3. a contract formed in any manner is confirmed by a record that contains terms additional to or different from those in the contract being confirmed, the terms of the contract are:
 - i. terms that appear in the records of both parties;
 - ii. terms, whether in a record or not, to which both parties agree; and
 - iii. terms supplied or incorporated under any provision of this Act.

(e) The Statute of Frauds. All contracts for the sale of goods in the amount of \$500 or more must be in writing, contain all material terms and be signed by the party upon which enforcement is sought. UCC § 2-201

(i) Required Terms. The writing may omit or incorrectly state the terms of the contract, except for the quantity term. UCC § 2-201. The quantity term, however, may be satisfied by a requirements contract. A contract governed by the Statute of Frauds is not enforceable in an amount of goods greater than listed in the writing.

On the other hand, contracts made between merchants are allowed to deviate from the strict requirements of the Statute of Frauds by confirming an oral agreement by a writing, unless the recipient of the confirming memorandum objects.

(ii) Certain Terms May Remain Open. The general contract formation requirements are forgiving because (i) the exact time of contract formation can be undetermined and (ii) certain nonmaterial contract terms may be left open. UCC § 2-204(2)-(3) (“Even if one or more terms are left open, a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.”).

(iii) Specially Manufactured Goods. The Statute of Frauds is also relaxed with respect to specially manufactured goods. *See GMAC Business Credit, L.L.C. v. Ford Motor Company et al.*, 100 Fed.Appx. 404, 410 n.1 (6th Cir. 2004) (“the statute of frauds does not apply to contracts for specially manufactured goods”) (citation omitted); *Arsape S.A. v. JDS Uniphase Corp.*, 2005 WL 2989296 at *5 (D. N.D. Nov. 3, 2005). As previously noted most, if not all, contracts with suppliers will involve specially manufactured goods. Contracts for specially manufactured goods that do not comport with the written requirements of the statute of frauds are enforceable against the buyer if the goods can not be used by others in the ordinary course of the suppliers’ business and the supplier begins production or causes production to begin.

(iv) Requirements Contracts. Article 2 of the UCC also addresses output, requirement and exclusive dealing contracts. UCC § 2-306. Contracts with suppliers for the amount of goods required to satisfy output requirements are limited to good faith and reasonableness. In other words, a requirements contract for 100 pieces a month can not be unilaterally changed to 1,000 pieces a month. Contracts with respect to the manufacturing of special goods require the supplier to use its best efforts to produce the goods and a concomitant requirement by the buyer to sell the goods.

(f) Contract Modification. An additional protection provided by Article 2 is the Parol Evidence Rule. UCC § 2-202. Under the Parol Evidence Rule, written contracts intended by the parties to be their entire and final agreement cannot be changed by prior written agreements or oral agreements made during contract formation - otherwise known as a merger clause. Therefore, contracts with suppliers should provide that the contract is intended to be the entire agreement between the parties and may only be modified by a writing signed by both parties. One exception is that prior written agreements “may be supplemented by evidence of: (a) course of performance, course of dealing, or usage of trade (section 1-303); and (b) consistent additional terms unless the court finds the record to have been intended also as a complete and exclusive statement of the terms of the agreement.” UCC § 2-202.

The Parol Evidence Rule does not prohibit contract modification. Parties to a contract may enter into a subsequent agreement to modify a previous contract, without consideration, subject to certain limitations. UCC § 2-209 identifies these limitations and provides:

(i) An agreement modifying a contract within this Article needs no consideration to be binding.

(ii) An agreement in a signed record which excludes modification or rescission except by a signed record may not be otherwise modified or rescinded, but except as between merchants such a requirement in a form supplied by the merchant must be separately signed by the other party.

(iii) The requirements of Section 2-201 [(Statute of Frauds)] must be satisfied if the contract as modified is within its provisions.

(iv) Although an attempt at modification or rescission does not satisfy the requirements of subsection (2) or (3), it may operate as a waiver.

(v) A party that has made a waiver affecting an executory portion of a contract may retract the waiver by reasonable notification received by the other party that strict performance will be required of any term waived, unless the retraction would be unjust in view of a material change of position in reliance on the waiver.

(g) Warranties. Article 2 of the UCC also provides protections to persons contracting with suppliers in the form of warranties. The warranties in Article 2 are as follows:

- § 2-312 - *Warranty of Title and Against Infringement; Buyer's Obligation Against Infringement*. This warranty provides that the goods purchased from

a supplier are conveyed with good title and protect the purchaser from future litigation challenging title. This warranty also provides that the goods purchased are not subject to an unknown security interest, lien or other encumbrance. On the other hand, in the case of specially manufactured goods with specifications provided by a purchaser, the purchaser must protect the supplier from claims arising from the design characteristics of the specially manufactured goods. This warranty may be disclaimed.

- § 2-313 - *Express Warranties by Affirmation, Promise, Description, Sample; Remedial Promise*. Promises made by suppliers with respect to the goods are enforceable. For example, a supplier warrants that a good will conform to a previous description, model or sample. The creation of this warranty is fluid and the terms “warrant” or “guarantee” are not required - an affirmation is sufficient.
- § 2-313A - *Obligation to Remote Purchaser Created by Record Packaged With Accompanying Goods* and § 2-313B - *Obligation to Remote Purchaser Created by Communication to the Public*. Suppliers are required to honor promises (i) made in writings included in packaging and/or (ii) communicated to the public with respect to new goods that are sold or leased not only to the original purchaser or lessee but to a third-party that purchases or leases the new good from the original purchaser or lessee. The words “warrant” or “guarantee” are not necessary - an affirmation is sufficient. The supplier may; however, limit the remedies in the case of breach.
- § 2-314 - *Implied Warranty: Merchantability; Usage of Trade*. Merchants warrant that the goods that they normally sell are merchantable and can be used for their intended purpose, are appropriately packaged, and conform to representations made on the label. This warranty may be excluded or modified.
- § 2-315 - *Implied Warranty: Fitness for a Particular Purpose*. The supplier warrants that the goods are fit to be used in the manner relied upon by the purchaser.
- § 2-316 - *Exclusion or Modification of Warranties*. As previously noted, certain warranties may be waived. For example, a modification of the implied warranty of merchantability in any contract, but a consumer contract, “must mention merchantability and in case of a record must be conspicuous.” All implied warranties may also be excluded by language such as “as is”, “with all faults” or other language that indicates that the warranty is excluded.
- § 2-317 - *Cumulation and Conflict of Warranties Express or Implied*. Warranties should be interpreted to be consistent with each other. When the parties’ intention is not clear “(a) [e]xact or technical specifications displace an inconsistent sample or model or general language of description[;] (b) [a] sample from an existing bulk displaces inconsistent general language of

description[;] (c) [e]xpress warranties displace inconsistent implied warranties other than an implied warranty of fitness for a particular purpose.”

B. United Nations Convention on Contracts for the International Sale of Goods

There may be instances in which a contract for the sale and purchase of goods across national borders between different-tiered suppliers or between a supplier and an OEM is not governed by Article 2 of the Uniform Commercial Code but by the United Nations Convention on Contracts for the International Sale of Goods (“CISG”). The CISG was adopted in 1980 at a diplomatic convention in Vienna, Austria and represented 50 years of efforts by international legal experts to adopt uniform rules for the international sale of goods. For the history of these efforts, see Peter Winship, *The Scope of the Vienna Convention on International Sales Contracts*, published in Galston & Smit, ed., *International Sales: The United Nations Convention on Contracts for the International Sale of Goods*, Matthew Bender Company (1984). To date, the CISG has been ratified by 66 nations including the United States, Canada, Mexico, France, South Korea and The Peoples’ Republic of China. The text of the CISG is reprinted at 15 U.S.C.A. Appendix (West 2005).

If applicable to a contract for the sale of commercial goods, the CISG will provide “gap filler” rules that govern contract formation and establish the rights and obligations of the buyer and seller. The 101 Articles of the CISG are divided into four parts. Part I sets forth the general provisions on the CISG’s sphere of application and rules of interpretation. Part II codifies the rules on formation of international sales contracts. The five chapters of Part III define the rights, obligations and remedies of the buyer and seller. Part IV defines the relation of the CISG to other international agreements, describes the reservations that nations are permitted to make to the convention, and provides rules for implementing the CISG.

The CISG applies only to international commercial sales of goods, *viz.*, sales between merchants of goods. Specifically excluded are sales of consumer items, auction or execution sales, and sales of ships, vessels or aircraft. CISG, Article 2. In order to be “international” in character, the sale must involve “parties whose places of business are in different states.” CISG, Article 1(1). The United States, when ratifying the CISG, stipulated that, absent express agreement by the parties to an international sales contract, the CISG would not apply to contracts between a U.S. party and a party whose place of business is in a nation that has not adopted the CISG. The provisions of the CISG do not apply to contracts for the delivery of services only. When a contract includes both goods and services, the CISG will apply when the sale of goods constitutes the “preponderant part” of the seller’s obligations. CISG, Article 3(2).

A primary benefit of the CISG to American exporters of goods is that it modulates disagreements concerning choice of law provisions in contracts for the international sale of goods. The contracting parties can elect to have the CISG provide the rules concerning the formation, performance and breach of contracts that can be easily discerned by reference to the CISG’s provisions and to court decisions interpreting them. An annotated version of the CISG and texts of court decisions from subscribing countries interpreting the CISG can be found on the following website maintained by Pace University: <http://joe.law.pace.edu>.

Finally, the CISG's rules closely parallel the provisions of UCC Article 2 and American courts will often refer for guidance to case law decided under a provision of Article 2 when its language closely tracks a corresponding provision in a CISG Article. *See, e.g., Delchi Carrier S.p.A. v. Roforex Corp.*, 71 F.3d 1024, 1028 (2d Cir. 1995); *Raw Materials Inc. v. Manfred Forberich GmbH & Co., KG*, 2004 WL 1535839 (N.D. Ill. 2004). Nevertheless, there are important differences between the CISG and Article 2 of the UCC, which must be kept in mind when an American buyer or seller of commercial goods negotiates an international sales transaction. These primary differences are as follows:

1. *Price Specification.* Under the CISG, a contract for the sale of goods will not exist unless a price term or a provision for determining price is provided in the agreement. CISG Article 14(1). Section 2-305 of the UCC, in contrast, permits the formation of an enforceable sales contract when there is no specified price.
2. *Offer Revocability.* Article 16(2)(b) of the CISG provides that a written or oral offer will become irrevocable when the offeree reasonably relies on it. Under section 2-305, an offer to be irrevocable must be stated in writing.
3. *Terms of Acceptance.* Under CISG Article 18(2), an acceptance of an offer occurs at the instant the acceptance reaches the offeror in a timely manner. In the majority of jurisdictions that have adopted UCC Article 2, acceptance occurs when it is mailed or transmitted by the offeree to the offeror.
4. *Battle of the Forms.* The CISG adopts the "mirror image" rule of offer and acceptance. If the acceptance materially alters the terms of the offer, the offer is deemed rejected and the acceptance becomes a counteroffer. CISG Article 19. Section 2-207 rejects this "mirror image" rule, permitting a contract to result from the "battle of the forms."
5. *Statute of Frauds.* The CISG does not require that, in order to be enforceable, a contract must be reduced to writing. In contrast, UCC Section 2-201 requires most commercial contracts to be evidenced by a writing "sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought." UCC § 2-201(1).

Finally, when international sales contracts involve the rights of third parties, an American buyer or seller of goods must be aware that the CISG does not contain any provisions concerning third party beneficiaries. If the CISG applies to a contract, third party rights are determined by applicable local law. *See, e.g., Caterpillar, Inc. v. Usinor Industeel*, 305 F.Supp.2d 659 (N.D. Ill. 2005).

II. REMEDIES AVAILABLE TO NONDEFAULTING PARTY

A. **Request for Adequate Assurance Under UCC § 2-609**

Often, certain factors will lead a seller to believe that a buyer is experiencing financial difficulties which may result in the buyer's inability to provide payment for goods, or otherwise render it unable to perform its obligations under an agreement. Perhaps the relationship in the

industry most susceptible to such concerns is that between the supplier and customer, where the supplier believes the customer is in financial crisis and it is industry knowledge that the customer is considering a major restructuring or even filing for bankruptcy. In such a situation, the supplier is likely to experience subjective, although not necessarily objective and reasonable, insecurity with respect to the customer's ability to perform under the existing purchase orders and requirements contracts that it has with the customer.

The UCC authorizes a party, upon reasonable grounds for insecurity, to demand adequate assurances of due performance and until it receives such performance, . . . if commercially reasonable, to suspend any performance for which he has not already received the agreed return. UCC § 2-609(1). However, the UCC does not require a party to request assurances as a condition precedent to recovery. The purpose of a demand under section 2-609 is to permit a party likely to be injured by the other party's nonperformance to take steps to protect itself without worrying that its own nonperformance will later be construed as a repudiation

Whether a supplier has reasonable grounds for insecurity is generally a question of fact. *Puget Sound Energy*, 271 B.R. at 640. Because the reasonableness of a supplier's insecurity is determined by commercial standards, an objective factual basis must exist for the supplier's insecurity, as opposed to a purely subjective fear that the customer will not perform. The UCC provides a broad definition of the circumstances that could cause a supplier's insecurity, including the solvency of a customer. UCC § 2-609 cmt. 4. However, the supplier's dissatisfaction with the customer's financial standing cannot be false or arbitrary.

Along those lines, a supplier will not have a reasonable ground for insecurity based solely on the fact that its customer filed for bankruptcy. However, reasonable security may arise solely from the customer falling behind on its account with supplier. So long as the customer continues to satisfy its contractual obligations and does not indicate that it does not intend to honor future obligations, the supplier has no reasonable grounds for insecurity.

The UCC requires a clear demand so that all parties are aware that, absent assurances, the demanding party will withhold performance. Any demand for adequate assurance typically needs to be answered within thirty (30) days, unless the express terms of the agreement reduce or extend such period.

Where a customer fails to timely respond to a supplier's demand, the supplier should take immediate action to terminate the agreement or the supplier will risk waiving the right to terminate. As an alternative, a supplier who wishes to continue performance after expiration of the thirty (30) day period may do so without waiving any of its rights to seek remedies by expressly and explicitly reserving its rights.

Whether a customer will be deemed to have offered adequate assurance is determined by factual conditions, including an exercise of good faith and observance of commercial standards. An absolute definition of adequate assurance does not exist, though. In some cases, the assurance offered by the customer may be less than a supplier demands and still be considered adequate. Prior to demanding adequate assurance, the supplier should assess whether the requested assurances are reasonable. If the assurances demanded are more than adequate and the customer refuses to accede to the excessive demands, a court may find that the demanding

supplier is in breach or has itself repudiated. As such, a supplier's request for adequate assurance must be reasonable under the circumstances and not be tantamount to overreaching.

B. Anticipatory Repudiation Under UCC § 2-610

The UCC provides that when a party “repudiates the contract with respect to performance not yet due, the loss of which will substantially impair the value of contract, the aggrieved party may . . . resort to any remedy for breach . . . even though he has notified the repudiating party that he would await the latter's performance and has urged retraction. . .” UCC § 2-610.

As discussed above, in a typical relationship between supplier and customer, certain factors, including statements or actions, may lead the supplier to believe that the customer will be unable to continue to perform its obligations pursuant to applicable agreements. In such a situation, a supplier may be tempted to infer that such statements or actions constitute a repudiation of the applicable agreement by the customer. However, a supplier must cautiously proceed with respect to anticipatory repudiation, which is deemed to have occurred where the statements or actions are unequivocal, definite and final or where an action reasonably indicates a rejection of the customer's continuing obligations.

If a supplier regards an apparent repudiation as an anticipatory repudiation, terminates its own performance and sues for breach, the supplier is placed in jeopardy of being found to have itself breached if the court determines that the apparent repudiation was not sufficiently clear and unequivocal to constitute an anticipatory repudiation justifying nonperformance. Conversely, if a supplier continues to perform after an apparent repudiation that, unbeknownst to the supplier, is actually an anticipatory repudiation, the supplier may be denied recovery for post-repudiation expenditures because of its failure to avoid those expenses as part of an effort to mitigate damages after the repudiation. Thus, where the supplier is unclear as to whether an anticipatory repudiation has occurred, it is advisable for the supplier to utilize section 2-609 of the UCC by demanding adequate assurance of future performance.

On its face, section 2-610 of the UCC appears to allow suit for breach upon a demand by the other party for more than the contract requires. The UCC cautions though, that a demand for more than what the contract requires in the way of counter-performance is not a repudiation. Rather, only when such demand amounts to an intention not to perform except on conditions which go beyond the contract does the demand constitute a repudiation. Similarly, a request for modification of a contract does not amount to a repudiation.

In order to qualify as an anticipatory repudiation, the performance repudiated must substantially impair the value of the contract to the other party. UCC § 2-610. While such a requirement is seemingly easily satisfied in cases of non-payment under non-requirements contracts, it becomes somewhat more complicated under requirements contracts. Where a supplier and customer enter into requirements contracts over several years, and the contract contains a minimum overall requirement, the customer may not be considered to have repudiated due to its failure to order its yearly requirements. Instead, because the overall requirements would be satisfied, the reduction in orders for the contract's final year would not amount to a substantial impairment of the contract's value.

Generally, the material breach of one contract does not justify an aggrieved party in refusing to perform another separate and distinct contract. Therefore, the aggrieved supplier should refrain from attempting to exercise its rights under section 2-610 with respect to agreements that the customer has not breached. Instead, it is advisable for the supplier to rely on the provisions of section 2-609 and demand adequate assurance of performance based, in part, on the customer's inability to perform the repudiated contract.

With respect to a supplier's actions for anticipatory repudiation, section 2-610(b) provides that an aggrieved party may "resort to any remedy for breach" of the contract "even though he has notified the repudiating party that he would await the latter's performance." UCC § 2-610(b). Therefore, despite a supplier's representations to the contrary, the supplier could exercise its rights under sections 2-701 *et seq.* of the UCC.

C. **Sellers' Remedies under UCC Article 2**

1. **In General.** Part 7 of Article 2 of the Uniform Commercial Code creates remedies for breach of contract for the benefit of nondefaulting sellers and buyers of goods on credit terms. These remedies are summarized in section 2-703 of the UCC and are discussed below.

2. **Termination of Credit Terms.** In the circumstance where a seller determines that its buyer that is purchasing goods on credit terms, is "insolvent" may refuse to ship goods on credit terms to the buyer. UCC § 2-702(1). The term, "insolvent," is defined in UCC § 1-201(23) as a person "who either has ceased to pay his debts in the ordinary course of his business or cannot pay his debts, as they come due or is insolvent within the meaning of the federal bankruptcy law." In these circumstances, a seller may insist upon cash payment for further shipments of goods on a cash in advance or cash on delivery basis.

3. **Reclamation.** Reclamation is a remedy provided to unpaid sellers of goods under section 2-702 of the UCC. It allows sellers of goods on credit to an "insolvent" buyer to reclaim those goods from the seller's possession. To exercise this right of reclamation, the seller must carefully follow the procedures set forth in §2-702(2) of the Uniform Commercial Code. Specifically, the seller must make demand within ten (10) days after the goods are received by the buyer.¹ Although the UCC does not require the demand to be made in writing, the prudent seller is well advised to make such a demand and to transmit it on an expedited basis by overnight courier, email and facsimile to the buyer. This demand should contain a list of the specific goods shipped by invoice number and description. The seller should retain records concerning proof of delivery, the invoices for the reclaimed goods, and the actual written notice of reclamation for judicial enforcement of the demand.

¹ If during the three months prior to delivery the buyer has made a misrepresentation of solvency in writing, the ten day limitation described above does not apply UCC §2-702(2). *See, e.g., In re Bel Air Carpets, Inc.*, 452 F.2d 1210 (9th Cir. 1971).

A seller's reclamation rights are subject to the rights of a buyer in the ordinary course or other good faith purchaser. Consequently, reclamation of the goods may not be possible if a creditor of the buyer holds a security interest in inventory that attaches to the goods sold on credit. Such a creditor is deemed to qualify as a good faith purchaser under the overwhelming weight of reported case law.

If the reclamation demand is proper and the goods are not subject to the lien of a senior lender and have not been consumed or sold, the seller has the right to a return of the subject goods. Under the UCC, the seller may use "self-help" to obtain possession of the goods, but may not breach the peace to do so. Thus, if the buyer refuses to turn over the goods, the seller may be required to file a replevin action in state or federal court to obtain possession.

4. **Stoppage of Goods in Transit.** If the seller has placed goods sold on credit terms with a carrier or other bailee for delivery to the buyer and, prior to their effective delivery, the seller learns of the buyer's insolvency, the seller may exercise its right to stop delivery of those goods in transit under §2-705 of the UCC. The seller may also stop delivery of a "carload, truckload, planeload or larger shipments of expenses or freight" where the buyer repudiates the contract, fails to make a payment due before delivery or "if for any other reason the seller has a right to withhold or reclaim the goods." UCC § 2-705(1). To exercise this remedy, the seller must notify the bailee by reasonable diligence to prevent delivery of the goods. UCC § 2-705(3)(a). After the bailee receives notice of stoppage in transit, the bailee must hold the goods and deliver them according to the instructions given by the seller. UCC § 2-705(3)(b). The seller is nevertheless responsible to the bailee for the payment of any costs or damages arising from stopping delivery.

5. **Identification and Salvage of Goods.** Upon the breach by the troubled supplier of its contract obligations to buy parts or systems from a vendor in the midst of the vendor's manufacture of those goods, the disappointed seller may proceed to identify² all conforming goods in its possession upon learning of the breach. UCC § 2-704(1)(a). The seller may also treat the finished and unfinished goods as the subject for resale to third parties. UCC § 2-704(1)(b). With respect to unfinished goods, the seller may "in the exercise of reasonable commercial judgment for the purpose of avoiding loss and of effective realization" either (i) complete manufacture of the goods and identify all of them to the contract; (ii) halt manufacture and resell the unfinished goods for scrap value; or (iii) act in "any other reasonable manner." UCC § 2-704(2). When a seller has work in process and raw materials that it is fabricating for the troubled supplier at the time that the seller learns of the supplier's breach of contract, Professors White and Summers recommend that the seller should proceed as follows:

² "Identification" of manufactured goods subject to a contract for their sale occurs, in the absence of the parties' agreement to the contrary, (i) when the contract is made if it is for the sale of goods "already existing and identified"; or (ii) if the contract provides for the sale of future goods, when those goods are "shipped, marked or otherwise designated by the seller as goods to which the contract refers." UCC § 2-501(1). Official Comment 4 to this section states that "there is no requirement . . . that the goods be in deliverable state or that all of the seller's duties with respect to the processing of the goods be completed in order that identification occur."

“In summary, the general standard, though not the exclusive one, is to compare two quantities: ‘What are my damages if I stop now?’ against ‘What are my damages if I complete and resell?’ If the former is greater than the latter, completion is commercially reasonable. Recall that the burden is on the buyer to show absence of commercial reasonableness and that the test is to be applied at the time of repudiation, not by hindsight at the time of trial.”

1 James J. White and Robert S. Summers, *Uniform Commercial Code* § 7-15 at pp. 408-09 (4th ed. 1995).

6. **Resale of Goods.** Section 2-703 of the UCC permits a seller of goods to a defaulting troubled supplier to resell the goods subject to the contract by public or private sale. Such a sale must be conducted by the seller in good faith and in a commercially reasonable manner to permit the seller to recover from the defaulting buyer, as damages, the difference between (i) the resale price for the goods; and (ii) the contract price plus any incidental damages to which the seller is entitled³ but minus any expenses saved by the seller caused by the breach. UCC § 2-706(1). If the seller determines to resell the goods by “private sale,” the seller must transmit to the buyer “reasonable notification” of the seller’s intent to resell the goods and identify the resale contract to the breached contract. UCC §§ 2-706(2), (3). The statutory requirements of a public sale, *viz.*, an auction, are more detailed:

- (a) the seller must identify the auction contract to the breached contract;
- (b) the seller may resell only identified goods except where there is a recognized market for the subject goods;
- (c) the seller must conduct the public sale at the “usual place” for such a sale (if one exists);
- (d) give the buyer reasonable notice of the time and place of the public auction unless the goods are perishable or threaten to decline speedily in value; and
- (e) display the goods at the public sale or provide for their reasonable inspection by bidders where the goods are located.

UCC §§ 2-706(2), (4).

³ UCC § 2-710 defines a seller’s incidental damages as including “any commercially reasonable charges, expenses or commissions incurred in stopping delivery, in the transportation care and custody of goods after the buyer’s breach, in connection with the return or resale of the goods or otherwise resulting from the breach.” Incidental damages, however, do not include consequential damages which a seller may not recover from a defaulting buyer under Article 2.

At a public sale, the seller is permitted to purchase the goods. UCC § 2-706(4)(d). A good faith purchaser at a private or public sale under this Code section will take free and clear of the defaulting purchaser's rights even though the seller fails to comply with all of the provisions of this section. UCC § 2-706(5).

In the event that the seller fails to comply with the provisions of UCC § 2-706 in conducting a public or private sale of the subject goods, the seller's damages will be measured in accordance with the standards set forth in UCC § 2-708, discussed below.

7. Damages for Nonacceptance of Goods or Repudiation of Contract.

Section 2-708 of the UCC provides two separate measures for contract damages when a buyer of goods refuses to accept goods subject to the contract or repudiates that contract. The first measure, set forth in UCC § 2-708(1) and commonly referred to as the "contract-market differential," permits the seller to recover the difference between (i) the market price determined at the time and place for tender of the goods; and (ii) the unpaid contract price plus incidental damages but minus expenses saved as a result of the buyer's breach. UCC § 2-723 sets forth standards for proving at trial the market price at the time and place for tender.

In the event that a court determines that contract-market differential damages are inadequate to place the seller "in as good a position as [the buyer's] performance would have done," then the seller's measure of damages will be "the profit (including reasonable overhead) which the seller would have made" had the buyer fully performed its obligations under the breached contract plus any recoverable incidental damages and plus any costs reasonably incurred by the seller but less any payments or proceeds of resale. UCC § 2-708(2). *See, e.g.*, the extensive discussion of this "lost profits" measure of damages in 1 James J. White and Robert S. Summers, *Uniform Commercial Code*, §§ 7-8 to 7-14 (4th ed. 1995).

8. Action for the Price. In three limited circumstances, the vendor of goods to a defaulting troubled supplier may sue for and recover the unpaid contract price for those goods plus any incidental damages. UCC § 2-709. These circumstances are as follows:

- (a) where the defaulting buyer has "accepted"⁴ the goods;
- (b) where the risk of loss has passed to the buyer and the goods were lost or damaged within a reasonable time after risk of loss has passed to the buyer; or
- (c) when the goods have been identified to the contract, have not been shipped to the buyer and the seller is unable to resell them.

⁴ Section 2-606 defines what constitutes acceptance of goods in the context of a contract for their sale.

UCC § 2-709(1).

If the seller commences an action to recover the contract price from the defaulting buyer, the seller must retain any goods identified to the contract still in the seller's control. UCC § 2-709(2). However, if the seller is thereafter able to resell these goods, the resale may be made at any time before the seller collects its money judgment from the buyer. Upon such a resale, the buyer is entitled to receive a credit against the judgment for the net resale proceeds. If the buyer satisfies the judgment, the seller must deliver to the buyer any such goods remaining in its possession.

Finally, in the event that a seller fails to qualify for recovery of lost profits on account of a buyer's wrongful rejection or revoked acceptance of goods, the seller will nonetheless be entitled to recover damages computed according to the "contract-market differential" rules of section 2-708 of the Code. UCC § 2-708(3). The same result occurs when the buyer fails to make a payment due under the contract or repudiates the contract under section 2-610 of the Code.

9. **Cancellation of the Contract.** The final remedy specified in UCC § 2-703 for a vendor of goods to a troubled supplier upon the supplier's breach is cancellation of the contract. UCC § 2-703(f). The term, "cancellation," is defined in UCC § 2-106(4) as occurring when either party to a contract for the sale of goods "puts an end to the contract for breach by the other." Cancellation is tantamount to "termination"⁵ of a contract except that the canceling party "retains any remedy for breach of the whole contract or any unperformed balance." *Id.* As discussed in Section VI(B)(1)(a), a party to an executory contract with a Chapter 11 debtor will be prohibited by the automatic stay provisions of the Bankruptcy Code from canceling the contract.

D. Buyer's Remedies Under Article 2

1. **In General.** In the event that a troubled supplier/seller fails to deliver the goods or repudiates the contract under UCC § 2-610 or where the buyer rightfully rejects goods⁶ or justifiably revokes acceptance of goods, then the buyer may cancel the contract, recover the portion of the contract price previously paid to the seller, and take one of the following two actions:

- affect "cover" under UCC § 2-712 concerning all goods even those that have not been "identified to the contract;" or

⁵ "Termination" of a contract for the sale of goods occurs "when either party pursuant to a power created by agreement or law puts an end to the contract otherwise than for its breach." UCC § 2-106(3) (emphasis supplied). Upon termination, all executory obligations of the parties will be discharged but "any right based on prior breach or performance" will survive. *Id.*

⁶ As a general rule, a buyer of goods may reject them only when they do not conform to the contract. UCC § 2-601. Rejection must be made within a "reasonable time" after they are tendered to the buyer. UCC § 2-602(1). Absent reasonable rejection, any later rejection will be ineffective. *Id.* The rights and obligations of the buyer and seller of goods upon a rightful rejection are set forth in UCC §§ 2-602(b), 2-603, 2-604 and 2-605.

- recover damages for nondelivery as calculated pursuant to UCC § 2-713.

UCC § 2-711(1). In addition, when the seller fails to deliver the contract goods or repudiates the contract under UCC § 2-610, the buyer may resort to one of the two alternative remedies:

- where the goods have been “identified,” the buyer may recover them as provided in UCC § 2-502; or
- in a “proper case,” the buyer may obtain specific performance requiring delivery of the goods or replevy those goods. UCC §§ 2-711(2), 2-716.

2. **Buyer’s Security Interest in Goods.** Where the buyer rightfully rejects or revokes acceptance of nonconforming goods previously delivered by a troubled supplier/seller, the buyer will hold a security interest in those goods still in the buyer’s possession or control. UCC § 2-711(3). This lien secures (i) any payments made by the seller on their price; and (ii) any expenses reasonably incurred by the buyer “in their inspection, receipt, transportation, care and custody.” *Id.* The buyer may resell these in the manner described in UCC § 2-706, which permits an aggrieved seller to resell goods.

3. **Cost of Cover.** Once the seller’s breach, the buyer may obtain substitute goods from another source. This remedy is provided in UCC §2-712 and is known as “cover.” The buyer must purchase substitute goods in “good faith and without unreasonable delay”. *Id.* The buyer may then recover from the seller as damages the difference between the cost of cover and the contract price together with any incidental or consequential damages but less expenses saved in consequence of the seller’s breach. If the buyer does not “cover”, it will not be barred from exercising other remedies. UCC § 2-712(3). Where a buyer could have covered and its failure creates higher damages that could have been avoided, the buyer may be denied recovery of the avoidable consequential damages. UCC § 2-715(2)(a).

Thus, if the troubled supplier fails to deliver goods, the customer may find an alternative source and purchase the goods from that source. The customer may recover from the supplier the difference in cost of the goods, if the price is higher, as well as other incidental costs such as increased transportation. The customer is entitled to be placed in the identical economic position that performance by the supplier would have placed it. To comply with the requirements of UCC § 2-712, the customer must purchase cover goods that are commercially used as reasonable substitutes for the original goods under the circumstances.

4. **Actions for Specific Performance.** If the troubled supplier fails to deliver goods as required by the contract, the customer may elect to cover by obtaining substitute goods from an alternative source. This may be the easiest way for the customer to maintain production levels and to avoid additional costs and legal expenses. There may be circumstances, however, where the goods are available only from the breaching seller and without those goods, the customer’s assembly line would be shut down. In these circumstances, the buyer may have no option except to sue the defaulting seller for

specific performance under UCC § 2-716(1) and to request in such an action a preliminary injunction mandating the seller to continue performance under the contract. Specific performance is allowed where the goods are “unique” or where “other proper circumstances” require this outcome. The order for specific performance may include such terms and conditions as to payment of the price, damages and other relief the court concludes is appropriate. UCC § 2-716(2).

What are “unique goods”? Official Comment 2 to § 2-716 suggests that the decision will be based upon the totality of the circumstances. This comment further notes that output and requirements contracts involving a particular or peculiarly available source or market present the typical commercial specific performance situation. Nevertheless, uniqueness is not the only test for specific performance and an inability of the buyer to effect cover “is strong evidence of ‘other proper circumstances.’” For example, one court held that in circumstances where a buyer borrowed \$96,000 to pay for a machine, the machine failed to function and the buyer was unable to borrow sufficient funds to purchase a replacement machine, the buyer was entitled to specific performance. *Stephan’s Machine & Tool, Inc. v. H & H Machinery Consultants, Inc.*, 65 Ohio App.2d 197, 417 N.E. 2d 579 (1979).

5. **Special Property Interests in Goods.** The buyer who has paid to an insolvent seller part of the purchase price may hold what is identified by the UCC as a “special property” interest in the subject goods even though the goods have not been delivered. UCC § 2-502. This potential remedy may be of particular interest to a buyer who has a substantial need for these goods and will not be satisfied with merely obtaining a money judgment against the insolvent seller. If the seller of the goods becomes insolvent within ten (10) days after receipt of the first installment of the payment for the goods, the buyer will obtain a special property interest in the goods under UCC § 2-502. If these goods are identified to the contract and are conforming, the buyer may recover these goods from the seller. UCC §§ 2-502(2), 2-711(2)(a). This interest, however, may be unenforceable in a subsequent bankruptcy case of the seller. *See In re G. Paoletti, Inc.*, 205 B.R. 251 (Bankr. N.D. Cal. 1997) (UCC § 2-502 special property rights are trumped by section 365 of the Bankruptcy Code; buyer holds only an unsecured claim against seller).

6. **Breaches of Installment Contracts.** An “installment contract” is a contract which requires or authorizes the delivery of goods in separate lots to be separately accepted, even though the contract states that “each delivery is a separate contract” or its equivalent. UCC § 2-612(1). Frequently, buyers will enter into installment contracts to obtain a standard price over a multi-month or multi-year period. The buyer may reject any installment of nonconforming goods if the non-conformity substantially impairs the value of that installment and cannot be cured. UCC § 2-612(2). If the nonconforming installment can be effectively cured, and the seller gives adequate assurance of such cure, the buyer must accept the nonconforming installment. If the non-conformity or default of one installment substantially impairs the value of the entire contract, however, the whole contract is in breach. UCC § 2-612(3). Nevertheless, a buyer who accepts a non-conforming installment and does not notify the seller of

cancellation within a reasonable time may not bring an action for breach and will be deemed to have reinstated the entire contract. UCC § 2-612(3).

7. **Remedies for Breach When Buyer Accepts Goods.** A buyer that accepts goods sold by the buyer and thereafter gives the buyer notice of their nonconformity within a reasonable time⁷ (e.g., where the nonconformity is caused by the failure of a manufactured part or system to meet contract specifications), the disappointed customer may recover from the seller as damages “the loss resulting in the ordinary course of events from the seller’s breach as determined in any manner which is reasonable.” UCC § 2-714(1). When a breach of warranty is involved, the customer’s measure of damages is the difference at the time and place of acceptance between (i) the value of the accepted goods, and (ii) their value absent the breach of warranty unless “special circumstances show proximate damages of a different amount.” UCC § 2-714(2). Incidental and consequential damages may also be recovered by the buyer “in a proper case.” UCC § 2-714(3).

8. **Buyer’s Right of Recoupment.** Section 2-717 of the UCC specifically recognizes a disappointed buyer’s right to deduct “all or any part of the damages,” including incidental and consequential damages, resulting from the seller’s breach of contract from any remaining sums due by the buyer under that contract.

9. **Buyer’s Incidental and Consequential Damages.** As previously noted, Article 2 of the UCC permits a customer to recover in certain instances incidental and consequential damages from a seller of goods that breaches the sales contract. Incidental damages include the following categories: (i) expenses reasonably incurred in the inspection, receipt, transportation and care and custody of goods properly rejected; (ii) commercially reasonable charges; (iii) expenses or commissions incurred in effecting cover; and (iv) other reasonable expenses related to the delay or other breach. UCC § 2-715(1).

Consequential damages suffered by a customer may be massive in the event that the seller’s breach of contract to deliver goods results in a line shutdown. Section 2-715(2) of the UCC defines consequential damages as including the following:

(a) any loss resulting from “general or particular requirements and needs” that the seller had reason to know of at the time of contracting. In order to be recoverable, however, these losses could not reasonably have been prevented “by cover or otherwise;” and

(b) any injury to person or property proximately resulting from a breach of warranty.

The parties may contractually limit or exclude the seller’s liability for consequential damages.

⁷ UCC § 2-607(3)(a).

10. **Liquidated Damages Provisions.** The troubled supplier and its customer may agree in the contract to liquidate breach of contract damages that may be claimed by either party but only at a reasonable amount as determined with reference to the following factors: (i) the anticipated or actual harm caused by the breach; (ii) the difficulties of proof of loss; and (iii) the inconvenience or unfeasibility of otherwise obtaining an adequate remedy. UCC § 2-719(1). A contractual term that fixes “unreasonably large liquidated damages” will not be enforced as a penalty.

11. **Limitation and Exclusion of Buyer’s Right to Recover Consequential Damages.** Section 2-719(3) permits the parties in their contract for the sale of goods to agree to a provision limiting or excluding the right of a buyer to recover consequential damages from a breaching seller and this provision will be enforced by a court unless it is deemed “unconscionable.” Limitation of consequential damages where the losses are “commercial” losses are not deemed prima facie unconscionable, unlike a limitation of damages for personal injuries. UCC § 2-719(3). However, where the contract for sale of goods limits the buyer’s remedies for the seller’s breach or provides an exclusive remedy for that breach and where any such remedy is determined by a court to “fail of its essential purpose” under UCC § 2-719(2), a clause limiting or excluding consequential damages in the same contract may also be avoided by the court when the limitation of remedy and limitation of damages clauses are regarded as integrated provisions.

12. **Commercial Impracticability.** Prior to the adoption of Article 2 of the Uniform Commercial Code, the common law of many states provided that a seller of goods would be excused from performing its obligations under a contract for the sale of goods if it was found to be “impossible” for the seller to perform. *Chemetron Corp. v. McLouth Steel Corp.*, 381 F.Supp. 245 (N.D. Ill. 1974), *aff’d*, 522 F.2d 469 (7th Cir. 1975). This common-law test has been liberalized in section 2-615 of the UCC and, even though the statutory language applies only to sellers, courts have applied this Code section to buyers in appropriate cases.

Section 2-615 of the UCC permits a seller (and a buyer) to be excused from a delay in delivery or non-delivery of goods, in whole or in part, subject to a sales contract in the following circumstances:

- (a) performance of the seller or buyer’s duties under the contract has been rendered “impracticable by the occurrence of a contingency;”
- (b) the non-occurrence of this contingency was a basic assumption on which the contract was made or by good faith compliance with “any applicable foreign or domestic governmental regulation or order.”

UCC § 2-615(a). A seller so excused must notify its buyer “seasonably” of the anticipated delay or non-delivery of the goods subject to the contract. UCC § 2-615(c). Upon such notification, the buyer may proceed to terminate or modify the contract as set forth in UCC 2-616.

A mere increase or decrease in market price, without more, has been held not to excuse performance of contractual duties under UCC § 2-615. If, however, the increased cost “is due to some unforeseen contingency [other than a rise or a collapse of the market] which alters the essential nature of the performance,” the seller might have grounds for excused performance under this section. Official Comment 4 to UCC § 2-615. This Official Comment indicates some circumstances that might permit a court to excuse performance:

“[A] severe shortage of raw materials or of supplies due to a contingency such as war, embargo, local crop failure, unforeseen shutdown of major sources of supply or the like, which either causes a marked increase in cost or altogether prevents the seller from securing supplies necessary to his performance, is within the contemplation of this section.”

Courts have excused performance under UCC § 2-615 when the contracting parties have agreed upon a specific source of supply and that supplier is unable to deliver the required goods to the seller for manufacture and delivery to the buyer. Consequently, a troubled supplier may be excused from delivering parts or systems to its customers when its contracts with its customers specify a source for the goods to be fabricated by the troubled supplier and that source is unable to deliver due to its own financial difficulties or shutdown.

In the event that commercial impracticability affects only a portion of the seller’s capacity to perform under its contract with the customer, the seller will be required to allocate production and delivery among all of its customers “but may at its option include regular customers not then under contract as well as his own requirements for further manufacture.” UCC § 2-615(b). This allocation must be made in a manner that is “fair and reasonable.” Notice of such proposed allocation must be given to the buyer seasonably. UCC § 2-615(c). Upon receipt of this notice, the buyer may elect to either terminate the contract or modify the contract in accordance with UCC § 2-616.

III. PACA: The Perishable Agricultural Commodities Act, 7 U.S.C. § 499(a) *et seq.*

A. Historical Context: New Deal legislation that creates a floating trust which protects sellers of perishable agricultural commodities. Commodities must not be processed. Produce may not be canned and probably not frozen. PACA rights give the seller trust rights in both the goods and proceeds derived from their sale.

B. The PACA Trust gives the seller a secured status equivalent to that of an Article 9 secured party.

C. How to Qualify for PACA Trust

1. Short Payment Terms: PACA specifies that payment must be in cash or within 10 days from the date of acceptance

2. Exception: A buyer and seller may agree to extended terms as long as the agreement is made in writing prior to the transaction and the terms are reflected on the

invoice and all other billing documents. The agreed-upon payment terms cannot exceed 30 days from the date of acceptance to qualify for trust protection. A produce supplier who enters into a written post-default agreement with a dealer that extends the dealer's time for payment beyond 30 days is ineligible to assert PACA trust rights.

3. Notice to Buyer: Seller must provide proper notice to the buyer.

(a) Magic Words: "The perishable agricultural commodities listed on this invoice are sold subject to the statutory trust authorized by Section 5(c) of the Perishable Agricultural Commodities Act, 1930 (7 U.S.C. 4993(c)). The seller of these commodities retains a trust claim over these commodities, all inventories of food or other products derived from these commodities, and any receivables or proceeds from the sale of these commodities until full payment is received."

or

(b) Other produce sellers must provide the buyer with a written notice of their intent to preserve trust benefits under the PACA within 30 days from the date that payment was past due or notification was received that a payment instrument was dishonored.

D. Can Payment Terms be Extended Past 30 days?

1. Short term credit requirement is **mandatory**, and the 7th Circuit previously ruled that a seller who enters into a written agreement to extend the credit terms beyond 30 days is no longer eligible to assert its PACA trust rights. *Greg Orchards & Produce, Inc. v. Roncone*, 180 F.3d 888 (7th Cir. 1999).

2. Oral extension may be acceptable but not advisable. See *Patterson Frozen Foods, Inc. v. Crown Foods International, Inc.*, 307 F.3d 666, 669 (7th Cir. 2002); *Idahoan Fresh v. Advantage Produce, Inc.*, 157 F.3d 197, 205 (3d Cir. 1998); *Hull Co. v. Hauser's Foods, Inc.*, 924 F.2d 777, 781-82 (8th Cir. 1991).

E. Enforcement of PACA Trust Rights

1. Complaint filed in District Court
2. Complaint filed with the United States Department of Agriculture
3. Bankruptcy by the Buyer
 - (a) Inform the Buyer/Debtor of your PACA position
 - (b) File Secured Proof of Claim