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VENDOR WORKOUTS: IMPLICATIONS OF THE BANKRUPTCY CODE

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Suppliers in the chain of commerce worldwide need to be concerned with the financial condition of their customers. This article addresses the impact of bankruptcy on the supplier's relationship with an insolvent customer struggling to stay in business and reorganize.

A. Interplay with the UCC. In all 50 of the United States, the relationship between sellers and buyers of goods and services in the commercial setting is generally governed by the Uniform Commercial Code which is commonly referred to as the "UCC." The UCC in one form or another has been adopted by all 50 states. The basic rights and remedies of sellers, including suppliers of goods and services, and their customers can generally be found in Article 2 of the UCC. The remedies for suppliers when a customer is bankrupt or otherwise insolvent can be found in Subchapter 7 of Article 2. These UCC remedies are ***recall*** of goods in transit and ***reclamation*** of goods received.

(1) **Recall of Goods.** UCC § 2-705 provides suppliers with the right to stop delivery of goods in the possession of a carrier if he discovers the buyer to be insolvent. This right applies to delivery of all sizes, no matter how small or large. A second and related right to recall goods in transit under the same provision of the UCC allows for the stoppage of the delivery by carload, truckload, planeload or larger shipments in the additional situations where the buyer repudiates or fails to make payment due before delivery or if for any other reason the supplier has the right to withhold or reclaim the goods. In either case, the goods must not yet have been received by the buyer. Thus, once a supplier becomes aware of a buyer's insolvency, the prudent action is to determine immediately whether there are goods in transit that one may wish to recall. Recall under UCC § 2-705 is generally not a violation of the automatic stay for the simple reason that the goods have not yet become the property of the debtor/buyer.

(2) **Refusal and Reclamation**. UCC § 2-702 provides a supplier with two very important remedies once it is discovered that a buyer in receipt of goods is insolvent. The basic remedy is that the supplier may refuse delivery, except for cash, or may stop further delivery altogether. Thus, it is common practice for suppliers in a bankruptcy setting to refuse to continue providing goods or services other than on a C.O.D. basis. This right under UCC § 2-702 also serves as the basis for renegotiation of trade terms after a bankruptcy filing. The other right provided to suppliers under UCC § 2-702 is the right to reclaim goods that are already received.

The UCC provides that where a seller discovers that the buyer has received goods on credit while insolvent, he may reclaim the goods upon demand made within 10 days after the receipt. Additionally, if there is a misrepresentation of solvency made to the supplier in writing within three months before the delivery, the 10-day limitation does not apply at all.

B. Expansion of UCC Remedies in Bankruptcy. The Bankruptcy Code expands on supplier's rights under the UCC by enhancing ***reclamation remedies***, by providing special treatment for ***20 day claims*** - sums due for goods and services provided within 20 days prior to a bankruptcy filing and by allowing ***setoff and recoupment*** against sums due by the supplier to the customer.

(1) **Reclamation in Bankruptcy.** The Bankruptcy Code was recently amended to extend this 10-day period to 45 days. Bankruptcy Code § 546(c)(1) expands the reach back to 45 days, and also provides additional time - up to 20 days after the filing date - to make a reclamation demand for goods shipped within the 45 days prior to the

bankruptcy filing. On its face, it appears that the reclamation benefits under the Bankruptcy Code substantially improved the position of suppliers in the bankruptcy context. However, recent court decisions highlight a number of very substantial hurdles confronting a supplier seeking to assert the right to reclaim goods already received. In order to recover, the supplier must make a detailed written demand within the required time frame, which is 10 days after receipt outside of bankruptcy and 20 days if the buyer has filed bankruptcy. In addition, the supplier must be able to establish that he did not become aware of the insolvency until after receipt of the goods. This would apply as to each particular shipment at issue. Most significantly are a number of cases recently decided which tend to establish that the right of reclamation is subject to the rights of other creditors who have obtained liens on the buyer's inventory and which extend to the supplier's goods upon receipt by the debtor. Essentially, where the supplier has an inventory finance arrangement by a bank or other financial source, the right to reclamation has proven to be essentially illusory.

(2) 20 Day Claims. In 2005, Congress dramatically improved the rights of suppliers by amending the Bankruptcy Code with the insertion of § 503(b)(9) to enhance the standing of suppliers with respect to sums due for goods shipped within 20 days prior to the filing of the bankruptcy. Even though the so-called "20 day claims" continue as pre-petition unsecured claims in the bankruptcy case, § 503(b)(9) elevated the status of these unsecured claims and assigned to these claims a priority in the bankruptcy payment scheme equal to that of all other administrative claims. This special claim status is provided with respect to "the value of any goods received by the debtor within 20 days before the date of the commencement of a case . . . in which the goods have been sold to the debtor in the ordinary course of the debtor's business." The elevated priority for a supplier's 20 day claims under § 503(b)(9) is certainly a welcomed benefit. However, the suppliers need to temper the expectations for prompt payment. Court decisions since the enactment of § 503(b)(9) have resulted in delays and other roadblocks to the receipt of timely payment by suppliers with 20 day claims. For example, the priority for payment matters only if the customer is successful in reorganizing, or is liquidating in chapter 11. If the customer ends up not exiting from bankruptcy, or gets sold and the case gets converted to a chapter 7 liquidation, this benefit may be difficult to realize.

(3) Setoff and Recoupment. Generally speaking, if at the time of the filing of bankruptcy there are mutual debts due by both supplier and customer to the other, the supplier can offset the amount it owes to the customer against what the customer owes to the supplier, thereby relieving the supplier's obligation to the customer to that extent. The operative provision of the Bankruptcy Code is § 543(a). Before the supplier can take this step, it must give the customer notice and get the court's permission to act. Failure to get permission from the court is a violation of the automatic stay.

If the debt of the supplier to the customer does not arise until after the bankruptcy filing, the right of set off under § 543 does not help the supplier, because it applies only to mutual debts were both arose prior to bankruptcy. However, the supplier whose mutual debt arises post bankruptcy may be able to set that debt off against the money due by the customer using a remedy called "recoupment". Recoupment is not found in the Bankruptcy Code, but is one of those "otherwise applicable non-bankruptcy law" concepts that apply in the bankruptcy setting, because it is not prohibited by the Bankruptcy Code. To enforce a right to recoup a mutual debt, the law requires that both debts arise out of the same transaction. Recoupment is a useful remedy for a franchisor or other supplier seeking to avoid payment of rebates and other incentive obligations when continuing to do business with a franchisee-buyer while in bankruptcy.

C. Post Petition Considerations. Once the customer/vendee is in Chapter 11, the supplier is immediately confronted with the dilemma of whether to continue to supply on credit. This is obviously a difficult decision that is to be made after careful consideration of the known risks and potential rewards. The bankruptcy issues center on questions of ***administrative priority,*** the availability of a ***critical vendor's program***, and exposure to ***preference claims*** and other avoidance actions available to the Chapter 11 debtors.

(1) Administrative Priority. Suppliers who ship on credit during the Chapter 11 case get paid on a priority basis over the suppliers with pre bankruptcy claims, under § 503(b)(1) of the Bankruptcy Code, which provides for payment of the "actual and necessary cost and expenses of preserving the estate." Moreover, in some, but not

all, reorganization cases, vendors do better in the short term, because they often get better terms of payment post petition, which shortens the time for conversion of receivables to cash. However, contrary to popular belief, there is no guaranty for payment of post bankruptcy extensions of credit. There still has to be money to pay and the banks, which are likely providing revolving credit to fund the operations in bankruptcy, generally have a super-priority claim so that in the event of a post-bankruptcy insolvency, the suppliers could still get stuck. Suppliers are advised to limit the credit balance and watch the payment cycle closely to make sure they do not get extended beyond normal terms during the course of the bankruptcy.

(2) Critical Vendor Programs. It has become vogue in recent years for some vendee's in bankruptcy to seek to induce favorable post-petition trade terms through the application of what is commonly referred to as a critical vendors program. Drawing from pre-code cases under the doctrine of necessity, some courts allow debtors to pay pre-petition obligations of those suppliers with whom the debtor can not operate without. The more common practice lately is for the debtor to agree to designate a supplier as a critical vendor and pay open invoices for pre-bankruptcy shipments, if the supplier will extend favorable terms going forward and just continue to ship in the ordinary course as if nothing had changes. The benefits are obvious and the risks to the supplier are numerous. Rarely does critical vendor treatment come without strings attached. The supplier will have to agree not to tighten trade terms, and the debtor will reserve the entire panoply of debtor's rights in bankruptcy, including the right to recharacterize the payment of pre-petition invoices to payment of post-petition invoices under § 503(b), and reservation of all avoidance actions in case the situation develops that the debtor is not able to reorganize and exit from bankruptcy. The so-called critical vendor is well advised to enter with eyes open and obtain the assistance of competent counsel before signing off on any of these programs. The supplier should take no consolation that the critical vendor program has been approve by a judge, and always understand that the plans are worded to protect the vendee/debtor not the supplier.

(3) Avoidance Actions/Preference Claims. Suppliers who expose themselves to recapture of payments and other transfers made outside of the ordinary course of business when dealing in workout situations with customers who are insolvent or rendered insolvent by deals made with creditors in the lead up to bankruptcy. Avoidance actions under Chapter 5 of the Bankruptcy Code are available to debtors in possession, bankruptcy trustees in Chapter 11 and Chapter 7 cases, liquating agents under Chapter 11 plans and sometimes unsecured creditors' committees, all in the quest to bring back into the estate money and other assets to be redistributed in accordance with the Bankruptcy Code's distribution priorities. The most common of these co-called "strong-arm" threats confronting suppliers of goods and services is a "preference" action under § 547 of the Bankruptcy Code, which reads, in pertinent part, as follows (italics are not in the original text, and are for emphasis only):

§ 547. Preferences

(a) In this section—

…

(2) "*new value*" *means money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation*;

…

(b) Except as provided in subsections (c) and (i) of this section, *the trustee may avoid any transfer of an interest of the debtor in property--*

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made--

(A) on or within 90 days before the date of the filing of the petition; or

(B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if--

(A) the case were a case under chapter 7 of this title [11 USCS §§ 701 et seq.];

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title [11 USCS §§ 101 et seq.].

(c) The trustee may not avoid under this section a transfer--

(1) to the extent that such transfer was--

(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a *contemporaneous exchange for new value given to the debtor;* and

(B) in fact a substantially contemporaneous exchange;

(2) to the extent that such transfer was in payment of a debt incurred by the debtor in the *ordinary course of business or financial affairs of the debtor and the transferee*, and such transfer was--

(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or

(B) made according to ordinary business terms;

(3) that creates a security interest in property acquired by the debtor--

(A) to the extent such security interest secures new value that was--

(i) given at or after the signing of a security agreement that contains a description of such property as collateral;

(ii) given by or on behalf of the secured party under such agreement;

(iii) given to enable the debtor to acquire such property; and

(iv) in fact used by the debtor to acquire such property; and

(B) that is perfected on or before 30 days after the debtor receives possession of such property;

(4) to or for the benefit of a creditor, to the extent that, after such transfer, such *creditor gave new value* to or for the benefit of the debtor--

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;

…

(f) *For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition*.

(g) For the purposes of this section, the trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section, and the creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the nonavoidability of a transfer under subsection (c) of this section.

D. Conclusion. Suppliers of goods and services are cautioned to exercise diligence in these difficult economic times for buyers of their goods and services on credit. If a customer becomes insolvent, prompt action is required to take advantage of a few basic remedies available to the supplier. By diligently paying attention to trends and patterns of payment, a supplier can stay in position to take advantage of rights to (1) recall goods in transit not yet received by an insolvent buyer, (2) reclaim goods received by an insolvent buyer within 10 days of delivery outside of bankruptcy and 45 days of delivery to a buyer who has filed bankruptcy, (3) assert an unsecured claim with administrative priority and enhanced prospects for payment on account of goods received by an insolvent buyer within 20 days prior to the filing of bankruptcy, (4) set off or recoup mutual debts owed to the buyer who has received goods or services without payment, and (5) stop deliveries altogether or demand COD or other payment term modifications when a buyer is found to be insolvent or as a condition for provision of goods or services after a bankruptcy is filed. There are issues and risks with all of these remedies and a thorough review of all options with competent bankruptcy counsel is recommended before action is taken. Nonetheless, the price of inaction can be dramatic so the watch word for suppliers is to remain ever diligent in dealings with customers in an economically distressed economy.

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