

Retail Failures Give Rise to Reclamation Claims: “Get The Goods or Get Paid” From Your Insolvent Customer!*

* This is the second in a three-part series on retail insolvency issues.

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WHAT TO DO BEFORE THE “STUFF” HITS THE FAN

Here is a partial list of the failures in 2016 alone:

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|-------------------------------------|---------------------------------------|---|
| 223 Barnes & Noble (through 2023) | 50 Express (through 2015) | years”) |
| 265 Body Central / Body Shop | 31 Frederick’s of Hollywood | 100 Pier One (by 2017) |
| 66 Bottom Dollar Food | 50 Fresh & Easy Grocey Stores | 20 Pick 'n Save (by 2017) |
| 25 Build-A-Bear (through 2015) | 14 Friendly’s | 1,784 Radio Shack |
| 32 C. Wonder | 65 Future Shop (Best Buy Canada) | 13 Ruby Tuesday |
| 21 Cache | 54 Golf Galaxy (by 2016) | 77 Sears |
| 120 Chico’s (through 2017) | 50 Guess (through 2015) | 10 SpartanNash Grocery Stores |
| 200 Children’s Place (through 2017) | 26 Gymboree | 55 Staples (2015) |
| 17 Christopher & Banks | 40 JCPenney | 133 Target, Canada (bankruptcy) |
| 70 Coach (fiscal 2015) | 127 Jones New York Outlet | 31 Tiger Direct |
| 70 Coco’s /Carrows | 10 Just Baked | 200 Walgreens (by 2017) |
| 300 Deb Shops | 28 Kate Spade Saturday & Jack Spade | 10 West Marine |
| 92 Delia’s | 14 Macy’s | 338 Wet Seal |
| 340 Dollar Tree/Family Dollar | 400 Office Depot/Office Max (by 2016) | 80 Wolverine World Wide (2015 – Stride Rite & Keds) |
| 39 Einstein Bros. Bagels | 63 Pep Boys (“in the coming | |

There is good news, but it requires diligence on your part. The most basic thing that a Seller can do pre-petition to avoid having to seek reclamation of its goods later is to be aware of Buyer’s financial condition: Has the Buyer recently started to pay late? Has the Buyer started to increase its orders over historical amounts? Has the Buyer experienced recent layoffs? Has there been a general downturn in the Buyer’s industry (which may also be Seller’s industry)? If there is any evidence of the foregoing, Sellers

should try to: (1) tighten terms by allowing for no more than 20-days open shipping, thus ensuring that all (or most) of the money owed will be treated as an administrative expense; (2) eliminate all open terms and go to pre-payments or COD; (3) obtain advance payment in full for all orders; or (3) a combination of foregoing to reduce exposure for a large unpaid AR.

Trade creditors can seek to negotiate security interests with retailers and secure collateral to protect their credit. The sooner the security interest is perfected by a proper Security Agreement and a UCC-1 Filing with the Secretary of State (requirements vary State to State) the better because in a chapter 11, or chapter 7 bankruptcy filing, that security interest can be set aside as a Preferential Transfer, if perfected 90 days, or less prior to the bankruptcy filing. A security interest may also be established in conjunction with a Letter of Credit Agreement and a UCC-1 Filing with the Secretary of State (depending on applicable State Law requirements). Those, too, provide may provide security and can help protect trade creditors from liability for Preferential Transfers, if in place 90 days or more before a bankruptcy filing.



THE POWER OF THE UCC AND THE BANKRUPTCY CODE TO RECLAIM GOODS

Under both the UCC as enacted in most states and under the Bankruptcy Code amendments, some vendors may be able to take advantage of a special, although limited, right to get back or "reclaim" certain goods where payment has not been received.

Your Powers Under the UCC to Reclaim Goods

Under the UCC, "insolvent" means: (A) having generally ceased to pay debts in the ordinary course of business other than as a result of good faith dispute; (B) being unable to pay debts as they become due; or (C) being insolvent within the meaning of federal bankruptcy law.

After the October, 2005-Amendments under the Federal Bankruptcy Code ("BAPCPA") insolvent means that the entity's debts exceed the value of its assets at a fair valuation. This is essentially a balance sheet test but, importantly, one using market value and not financial reporting standards such as GAAP. Because they are prepared for a different purpose, GAAP balance sheets tend to overstate asset values and understate actual liabilities compared to the bankruptcy balance sheet test. Companies that might seem solvent under GAAP could be insolvent under the UCC, or the Bankruptcy Code. The UCC employs a 10-day period from receipt of goods by the

insolvent Buyer from the Seller for reclamation, if the goods are purchased on credit terms and not paid for by insolvent Buyer. If the insolvent Buyer misrepresented its solvency in writing during the three-months before the delivery of the goods in question, then the 10-day limitation does not apply.

The Uniform Commercial Code (UCC), as adopted in virtually every state, provides that when a seller of goods ("Seller") discovers that its buyer ("Buyer") is insolvent, Seller may seek to "reclaim" those goods (i.e., actually get the goods back from Buyer). In order to do so, Seller first must send a written demand to Buyer within 10-days (if there has been no misrepresentation of solvency in writing during the three-months before delivery of the goods as stated above) after the Buyer receives the goods. The Buyer: (1) must still have the goods in its possession; (2) the goods must be identifiable as such and not have been incorporated into another product; and, further, (3) the Seller's ability to actually recover the goods is subject to the rights of other parties, particularly "buyers in the ordinary course" (i.e., customers of the buyer who have purchased the goods from the buyer) and "good faith purchasers."

Given the relatively narrow time window (10-days), there is a good chance that the Buyer: (1) will still be in possession of the goods; (2) will not have incorporated the goods into another product; and (3) will not have sold the goods to a buyer in good faith. The real obstacle to getting the goods back, however, is the "good faith purchaser" provision. The term "good faith purchaser" has been defined to include a secured creditor (usually a Bank) with a senior in time Blanket Lien on the debtor's/Buyer's assets. Thus, even when (1), (2) and (3) above are all in the Seller's favor, the Seller's rights remain subject or subordinate to those of a senior lien holder. What does this mean? In practice, it does not mean that the Seller's reclamation claim is necessarily extinguished, but only that the Seller's right of reclamation may be rendered valueless, if the secured creditor has satisfied its claim out of the goods, or if the Senior lien amount is greater than the value of the goods, rendering no equity for the Seller to realize a recovery on its junior secured claim. It may be advisable, therefore, if the Seller is negotiating credit terms with a Buyer, to obtain a personal guarantee of the debt by an Officer, or Officers of the Buyer in their individual capacities as a separate means of recovery on the debt.

Your Rights Under the Bankruptcy Code to Reclaim Goods Or Assert A Priority Claim

If a bankruptcy case has already been filed, resort must be made to Creditor Rights and Remedies under the Bankruptcy Code. Because of changes made in the October, 2005-Amendments to the Bankruptcy Code, applicable to all bankruptcy cases filed on or after October 17, 2005, the filing of a bankruptcy now actually expands a vendor's reclamation rights. These new provisions apply in both Chapter 11

reorganization cases, in Chapter 7 liquidation cases, and in Chapter 13 small business cases. Some of the key changes include:

A new, 45-day bankruptcy reclamation right has been added to Section 546(c) of the Bankruptcy Code. Prior to this change, the Bankruptcy Code had merely incorporated the UCC's 10-day period. Now, once a bankruptcy is filed, a vendor can assert a reclamation demand for goods received within 45-days of the bankruptcy filing.

The goods must have been sold in the "ordinary course" of the vendor's business and the debtor must have received the goods while insolvent (using the Bankruptcy Code's definition of insolvent discussed above). The reclamation demand must be in writing and made within 45-days of the receipt of the goods by the customer (now the debtor in bankruptcy). If the 45-day period expires after the bankruptcy case is filed, the vendor must make the reclamation demand within 20 days after the bankruptcy filing.



As with pre-bankruptcy demands under the UCC, the demand should identify the goods being reclaimed, include a general statement reclaiming all goods received by the debtor from the vendor during the 45-day period, and demand that the goods be segregated. Vendors may also want to file a notice of reclamation with the bankruptcy court.

However, there is some bad news which has to be mentioned. Whether before or after a bankruptcy filing, a vendor will lose its right to reclaim any goods that the customer sells before or after receiving the vendor's reclamation demand. This "sold goods" problem has probably become more important because BAPCPA removed language from the prior version of Section 546(c) that had allowed a bankruptcy court to give a reclaiming vendor an administrative claim (with priority over unsecured claims and certain other claims) in lieu of a return of the goods. Both the UCC and the Bankruptcy Code require that the debtor itself must have received the goods for them to be reclaimed. Thus, goods that are drop shipped or otherwise delivered first to the debtor's own customer likely will not be able to be reclaimed.

If the debtor made a misrepresentation of its solvency and then filed bankruptcy, it is unclear whether the 45-day rule in bankruptcy will govern or whether, like under the UCC, no time limit will apply. Keep in mind, however, that often goods shipped as far back as 45-days, or longer, and sometimes even as few as 10 -days for debtors with fast inventory turns, may already have been sold and thus will not be subject to reclamation.

So what happens if the debtor cannot return goods, what options are available to creditors? If the reclamation creditor fails to send written notice of reclamation within

45-days, or if the goods are no longer in the possession of the debtor, then the alternative is to file an administrative claim. This is covered under Section 503(b)(9) of the Bankruptcy Code. This new subsection of the Bankruptcy Code grants vendors the right to receive an administrative expense claim for the value of goods delivered within 20-days prior to the debtor's bankruptcy filing — as long as the goods were sold in the ordinary course of business. Administrative claims have the highest priority, and therefore, they provide creditors with a higher degree of protection than a General Unsecured Seller. However, requesting allowance and payment of an administrative claim is more complicated than simply mailing a written reclamation demand to the debtor. A section 503(b)(9) administrative claim is a sophisticated legal document that requires an attorney's assistance and often a court hearing, on notice to all creditors and parties in interest.

A vendor's reclamation right is further limited by the possibility that the debtor may have granted a bank or other creditor a security interest in the goods, which will be senior to the reclamation right. As amended in 2005, Section 546(c) now expressly makes reclamation rights subject to the prior rights of a secured creditor with a security interest in goods or their proceeds, that may exceed the amount of equity above that senior lien, as discussed earlier. In addition, the company in bankruptcy, if closed, or liquidated in chapter 11 or 7, may not have sufficient funds to pay any administrative claims to vendors who delivered goods 20-days prior to the bankruptcy filing.

In summary, reclamation can involve a number of twists and turns. Vendors who think they may have reclamation rights should be sure to get legal advice immediately upon learning of a customer's insolvency or bankruptcy to protect their interests, just as debtors should to know their own rights in response to reclamation demands. Many vendors have had the unfortunate experience of a customer filing for bankruptcy. If it has not happened to you yet, it probably will at some point in the future. There are certain steps a vendor should (or must) take to protect itself and maximize its opportunity to collect any debts owed by the customer. Vendors that take advantage of these protections can maximize recoveries, better preserve their positions in their dealings with the debtor, and avoid pitfalls inherent in the bankruptcy process. Vendors, and their attorneys, should use this checklist and take immediate action when a customer files for bankruptcy.

