BANKRUPTCY ARTICLE

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# Trade Vendors: Are Recent Bankruptcy Code Revisions an Elixir or a Placebo?

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When Congress revised the Bankruptcy Code effective October 17, 2005, trade vendors initially considered the revised Code to significantly improve their rights. Among other changes, the revised Code (1) permitted sellers to seek to reclaim goods received by the debtor 45 days before bankruptcy, rather than 10 days, (2) gave sellers administrative expense priority claims for goods received by the debtor within 20 days before the bankruptcy filing, and (3) reduced the burden of proof for the ordinary course of business defense to preference claims. Now, a year and a half later, trade vendors are learning that these revisions may not have improved their rights as much in practice as they did in theory.

Reclamation is a remedy permitting a seller to reclaim goods delivered to an insolvent buyer. The revised Code appeared to improve the reclamation remedy in bankruptcy by permitting a seller to seek to reclaim goods received by the debtor 45 days before bankruptcy, if the seller makes a timely written reclamation demand. Prior law limited the reclamation remedy to the goods received by a debtor during only the 10 days before bankruptcy.

Despite this longer reclamation period, practical issues should temper a seller's expectations about its "improved" reclamation rights. First, a seller's reclamation rights are subject to the rights of a secured creditor with a perfected lien on the debtor's inventory, such that the reclamation right will be valueless if goods delivered to the debtor are subject to an undersecured lender's senior lien. Second, under prior law, a court could deny a seller the right to reclaim goods if the seller received an administrative expense claim for the goods' value. The revised Code has taken away the seller's right to such a claim, and the seller's only remedy is the return of the goods. This revision ignores the practical reality that reclaiming sellers almost always want payment for the goods supplied, not the goods. Moreover, a debtor rarely will have goods in inventory identifiable to a particular reclaiming seller up to 45 days after its receipt of the goods. Thus, the longer time period for reclamation may be of little practical value to sellers.

For those sellers delivering goods to a debtor in the 20 days before bankruptcy, there is some good news. The revised Code contains a new section granting a seller an administrative expense priority claim for the goods' value if the debtor received the goods within 20 days before the bankruptcy and acquired them in the ordinary course of its business. Sellers benefit from this new provision because administrative expense claims are second-priority claims and must be paid before distributions are made to lower priority claims, including general unsecured claims. Unlike reclamation, a seller is not required to make a written demand on the debtor within any specified timeframe. For business or operational reasons, a debtor may choose to voluntarily pay the claim immediately, but is not required to do so. A seller may need to file papers with the bankruptcy court to have its claim allowed, but courts generally will not require a debtor to immediately pay the claim. Although a Chapter 11 debtor must pay administrative claims in full for its reorganization plan to be confirmed, a debtor may delay paying those claims until confirmation.

A seller can increase its chances of being promptly paid if it is willing to continue to supply the debtor post-petition. In cases decided under the revised Code, debtors have been willing to settle with sellers, whether reclaiming sellers or sellers with 20-day claims, to retain the goods supplied pre-petition and to receive post-petition shipments from these sellers. When a seller had only a 20-day claim, the debtor usually agreed to pay the claim immediately in exchange for the seller's agreement to continue supplying the debtor on specified credit, pricing and payment terms, including a post-petition credit line equal to the payment. When a seller also had timely made a valid reclamation demand for product supplied during the "21-45" day pre-filing period, debtors sometimes agreed to pay immediately the 20-day claim in exchange for the seller's waiver of its reclamation rights for the "21-45" day product but retention of an unsecured claim for that product. Other times, debtors agreed to pay immediately the 20-day claim and grant an allowed administrative expense claim for a portion of the seller's remaining reclamation claim payable upon confirmation, subject to a secured creditor's inventory lien. In each case, the seller was required to continue shipping goods to the debtor under specified credit, pricing and payment terms.

If unable to arrange immediate payment of a 20-day claim, a seller should expect a debtor to later object to the 20-day administrative claim until the seller has either repaid or settled any potential preference liability. A debtor makes this objection to prevent a seller from "double dipping" by receiving an administrative expense claim for the 20-day product and claiming that the same 20-day supply also constitutes new value supplied to the debtor resulting in reduced preference liability. Although a seller cannot engage in this "double-dipping," a seller should wisely consider whether to use the value of the 20-day product as new value in the preference suit or as the basis for an administrative expense claim. The decision will need to be made on a case-by-case basis and will depend on many variables (such as the projected distribution to unsecured creditors and other potential preference defenses). From solely a balance sheet perspective, a seller more likely will see greater benefit from asserting the 20-day administrative claim.

The revised Code also seems to soften a seller's proof for the ordinary course of business defense to a preference claim. As under the prior law, a seller still has to prove that a preferential payment paid a debt incurred in the ordinary course of business of the debtor and seller. Under prior law, a seller needed to prove that the payment (i) was made in the ordinary course of business between itself and the debtor, which

requires a subjective analysis of the pre-petition business relationship between the debtor and seller, and (ii) was made according to ordinary business terms, which set an objective standard regarding the particular industry involved. Now, the seller must prove one or the other, not both; this change appears to lower the bar for a seller to prove ordinary course of business payments, particularly because a seller often had to obtain and pay for expert trial testimony on the industry standard.

As with the other revised Code provisions discussed above, this lower proof burden may, perhaps, not be as beneficial in practice as in theory. Sellers may not yet have been able to use this lower proof burden in cases, but that day will come. This “new” ordinary course defense applies, it is generally though not universally believed, when the debtor’s bankruptcy case, not just the preference lawsuit, was filed after October 17, 2005. Additionally, in most settlement discussions, preference plaintiffs have not historically focused too much on the objective element under prior law. Thus, softening the defense likely will not have much effect on settlement negotiations. And, the sole court to comment in a published decision (in North Carolina, no less) on what a seller must prove to meet the objective standard under the “new” ordinary course defense has said that the seller must show that the transaction was not only ordinary in the seller’s industry but also met generally accepted business standards common to all business transactions in all industries. Under prior law, a seller typically had to prove that the transaction was consistent with the standards in only the creditor’s industry.

Thus, while unsecured sellers of goods are afforded more protection under the revised Code, they continue to face practical challenges in dealing with customers in bankruptcy.

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