

**LoFaro & Reiser, L.L.P.**  
**55 Hudson Street**  
**Hackensack, New Jersey**  
**07601**  
**Tel: (201) 498-0400**  
**Fax: (201) 498-0016**  
**E-Mail: [lr.law@verizon.net](mailto:lr.law@verizon.net)**  
**Web Site:**  
**[www.njlawconnect.com](http://www.njlawconnect.com)**

## **RECLAMATION – THE SELLER’S MAGIC REMEDY**

- A. Remedy Defined:** Reclamation refers to the right of a creditor to reclaim property sold to the debtor immediately before the filing of a bankruptcy. Under certain circumstances, when a seller discovers, after it delivers goods to a buyer, that the buyer is insolvent, the seller can demand that the goods be returned to the seller. All sellers should be aware of the nature of this right of reclamation and the steps necessary to assert the right. Once a seller discovers that its buyer is insolvent, the seller generally must move very quickly to assert its rights. In addition, there are certain actions that a vigilant seller can take which will provide additional protection when its customer becomes insolvent. The right of reclamation also provides a particularly useful weapon to the seller under certain circumstances after a buyer has declared bankruptcy.
- 1) Reclamation Requirements.** Reclamation applies only if the buyer is insolvent at the time the buyer receives the goods. A buyer is "insolvent" for purposes of the right of reclamation if that buyer either:
- a)** has ceased to pay its debts in the ordinary course of its business (a current analysis);
  - b)** is unable to pay its debts as they become due (a short-term future analysis); or
  - c)** has debts which exceed the fair valuation of the buyer’s total assets (a balance sheet analysis).
- B. Hypothetical Reclamation Situation.** You just shipped out \$100,000 of goods Monday on normal credit terms to a regular customer. The goods arrived at the customer’s business on Wednesday and now they belong to the customer. You have a fat receivable due in 30 days. On Thursday, you run into another supplier who tells you that she just heard the customer’s bank has declared their loan in default and bankruptcy may be on the horizon. We all know that means you are out of luck and your company is probably out \$100,000. Right?

Not necessarily! You may have reclamation rights, but only if you act quickly.

Ownership of goods sold on credit transfers to the buyer when the goods are delivered. True . . . but, what if the Seller discovers the buyer is insolvent? The seller who acts quickly may nonetheless be able to recover (or reclaim) the goods. Reclamation is a special remedy available to the knowledgeable and vigilant seller - a remedy that works even if the buyer files bankruptcy.

**C. Applicable Law Governing Reclamation Claims.**

1) **Section 2-702 of the Uniform Commercial Code.** This law, adopted in all states of the United States, provides that, when an unpaid seller of goods discovers that the buyer was insolvent at the time of delivery of the goods, the seller may reclaim the goods upon demand made within ten (10) days after the receipt by the buyer of the goods. If the buyer misrepresented in writing his or her insolvency within three months priority to delivery, the ten day limitation does not apply. The right of reclamation cannot be exercised against a good faith buyer or a buyer in the ordinary course of business.

a) The effect of section 2-207 is preserved in the context of Section 546(c) of the United States Bankruptcy Code.

2) **Section 546(c) of the Bankruptcy Code.** This Section provides that the rights of the trustee to defeat interests in or claims to the property of a bankrupt are subject to any statutory or common law right of a seller, who in the ordinary course of business has sold goods to the debtor, to reclaim the goods upon demand in writing within ten days of receipt of the goods by the debtor.

a) **Comparison to state law:**

i) The Bankruptcy Code provides that the reclaiming seller's claim must be against an "insolvent" seller. (However, in bankruptcy, the term "insolvent" means only that the buyer's debts exceed the fair valuation of its assets (balance sheet insolvency)).

ii) The Bankruptcy Code specifies that the reclaiming seller must make a written demand for reclamation. The same ten-day rule applies as under state law but, unlike state law, the reclamation window is not

extended by a misrepresentation of solvency made by the buyer prior to delivery.

- iii) **Recent Amendment to Bankruptcy Code Extends 10-day Period:** A recent amendment to Section 546 of the Bankruptcy Code does recognize that sellers are often unaware of a bankruptcy filing until the ten-day window has closed. To ensure that sellers have a proper opportunity to assert their reclamation rights, the Bankruptcy Code amendment expanded the time during which sellers can make their reclamation demand in bankruptcy. If the tenth day of the reclamation period comes after the bankruptcy is filed, the reclamation period is automatically extended to twenty days after receipt of the goods. This amendment helps tremendously in cases where a buyer "loads up" on inventory in the days shortly before the bankruptcy filing and sticks the unsuspecting seller with a large unsecured claim in the bankruptcy. The Bankruptcy Code now gives the selling creditor sufficient time to assert the reclamation demand after the filing. Assuming the demand is properly made and the buyer was insolvent when the goods were received, the seller may receive an administrative claim in the bankruptcy for the reclamation amount. This administrative claim has a higher priority and is paid before general unsecured claims.
- iv) **Other Remedies in Lieu of Reclamation.** In deciding reclamation claims, the bankruptcy court may order, in lieu of reclamation, a lien in favor of the seller or grant to the seller a priority on the basis of an expense of administration.

### 3) **Limitations of Reclamation.**

- a) **Secured Creditors Have Priority.** The right of reclamation is subject to any security interest in the goods that has priority under state law. Once the property delivered is no long in the possession of the buyer, the right of reclamation is lost.
- b) **Good Faith Buyer in the Ordinary Course is Protected.** The reclaiming seller's claim on the goods is subject to the rights of a buyer who, in the ordinary course of its business,

purchases the goods in good faith from the original buyer. The reclaimed goods cannot be chased into the hands of the subsequent good faith purchaser. In addition, the reclamation claim on the goods may be second in priority to the rights of a lien holder (usually a lender) who holds a previously perfected lien in the inventory of the buyer. Practically, the reclaiming seller should move aggressively even when such an inventory lien is present.

#### **D. Reclamation Letter and Procedures**

- 1) Address the reclamation letter to corporate headquarters to the attention of a specific person, preferably the Chief Executive Officer. If you know their legal counsel, copy counsel. If buyer is in bankruptcy, copy bankruptcy counsel. Also send a copy to the address where the goods were delivered, to the attention of a particular person, if a name is known.
- 2) Identify your company and all names by which you are known under which you have sold or shipped goods to the insolvent buyer.
- 3) Indicate that this letter is a demand for reclamation pursuant to Section 2-702 of the Uniform Commercial Code (and Section 546 of the Bankruptcy Code if buyer is in bankruptcy).
- 4) Indicate that all goods shipped within the reclamation period are identified on the attached schedule (or copies of invoices) showing date shipped/received, description of goods, and location to which shipped. Make your description as complete as possible. (In the reclamation demand, the seller must adequately describe the goods that were shipped so they can be identified. Since the reclamation right is in the nature of a lien on the shipped goods, the goods must still be in the possession of the buyer or his agent. The best practice is to include in the reclamation notice letter a request that the reclaimed goods be immediately segregated and that the buyer refrain from disposing of the reclaimed goods. If practical, the seller should follow up with an immediate visit to the buyer's premises. The purpose of this visit is to count and inspect the goods and see that they are segregated until they can be returned or consensual arrangements made for their disposition and payment of proceeds directly to the reclaiming seller. The reclamation notice alone usually is not sufficient to ensure that the seller's rights are fully protected. At a minimum, the seller should obtain a written statement from the buyer indicating what goods are on hand at the time the notice is received).

- 5) Demand that goods shipped by your company to this buyer be accounted for and an inventory taken of your goods on hand at the time your demand was received. Indicate that the result of this inventory should be immediately supplied to you and the goods segregated until appropriate arrangements can be made for return of the goods. If buyer is in bankruptcy, goods are to be segregated until action can be taken under Section 546 of the Code to acknowledge your reclamation claim as an administrative claim.
- 6) Send the letter by facsimile and retain the fax confirmation sheet showing the number to which it was sent and proof that it was received. Send another copy by overnight mail, signature required.
- 7) If buyer is in bankruptcy, immediately file a Notice of Reclamation with the bankruptcy court and follow, as appropriate, with a motion or adversary proceeding. (Once the reclamation demand is made in a bankruptcy, the reclaiming creditor should contact bankruptcy counsel to be sure the claim is properly pursued in the bankruptcy court. The seller must obtain a court order recognizing the seller's right of reclamation before actually reclaiming the goods or receiving an administrative claim. Note also that if the buyer has declared bankruptcy under Chapter 7 (liquidation), the written demand for reclamation must be delivered to the bankruptcy trustee, rather than to the buyer. The best practice is to deliver the demand to both.)

#### **E. Pre-Bankruptcy Reclamation Planning**

- 1) **Periodically Obtain a Representation of Solvency From Buyer To Extend 10-Day Window.** Some sellers send a request for certification of solvency out to their purchasers every three months to create the longer reclamation window.
- 2) **Include Boilerplate Written Demand for Reclamation on All Invoices and Bills of Lading.**
  - a) **Example:** As a condition of Seller allowing Buyer (insert name of customer) to accept delivery of goods (identify goods) on credit, Buyer represents to Seller that it is solvent and is not presently a debtor in any insolvency proceeding or any bankruptcy proceeding in any court of competent jurisdiction. In the event of insolvency, this (invoice/bill of lading) shall constitute a demand by Seller for reclamation of the goods (identify goods) in accordance with Uniform Commercial Code

Section 2-702 and Section 546 (c)(1) of the United States Bankruptcy Code. In the event of insolvency, Buyer agrees to promptly notify Seller of such insolvency and Buyer hereby waives any defenses to Seller's right of reclamation to the goods (identify goods), and Buyer shall promptly return possession of the goods (identify goods) to Seller. **(Please note that this is merely a suggestion. The law firm of LoFaro & Reiser makes no representations that such a provision would be enforceable in state court or bankruptcy court).**

**Disclaimer: This article is provided for informational purposes only, and is not intended to provide specific legal advice to any particular situation. This article also is not intended to create any attorney-client relationship between the law firm of LoFaro & Reiser, L.L.P. and any user of this web site.**