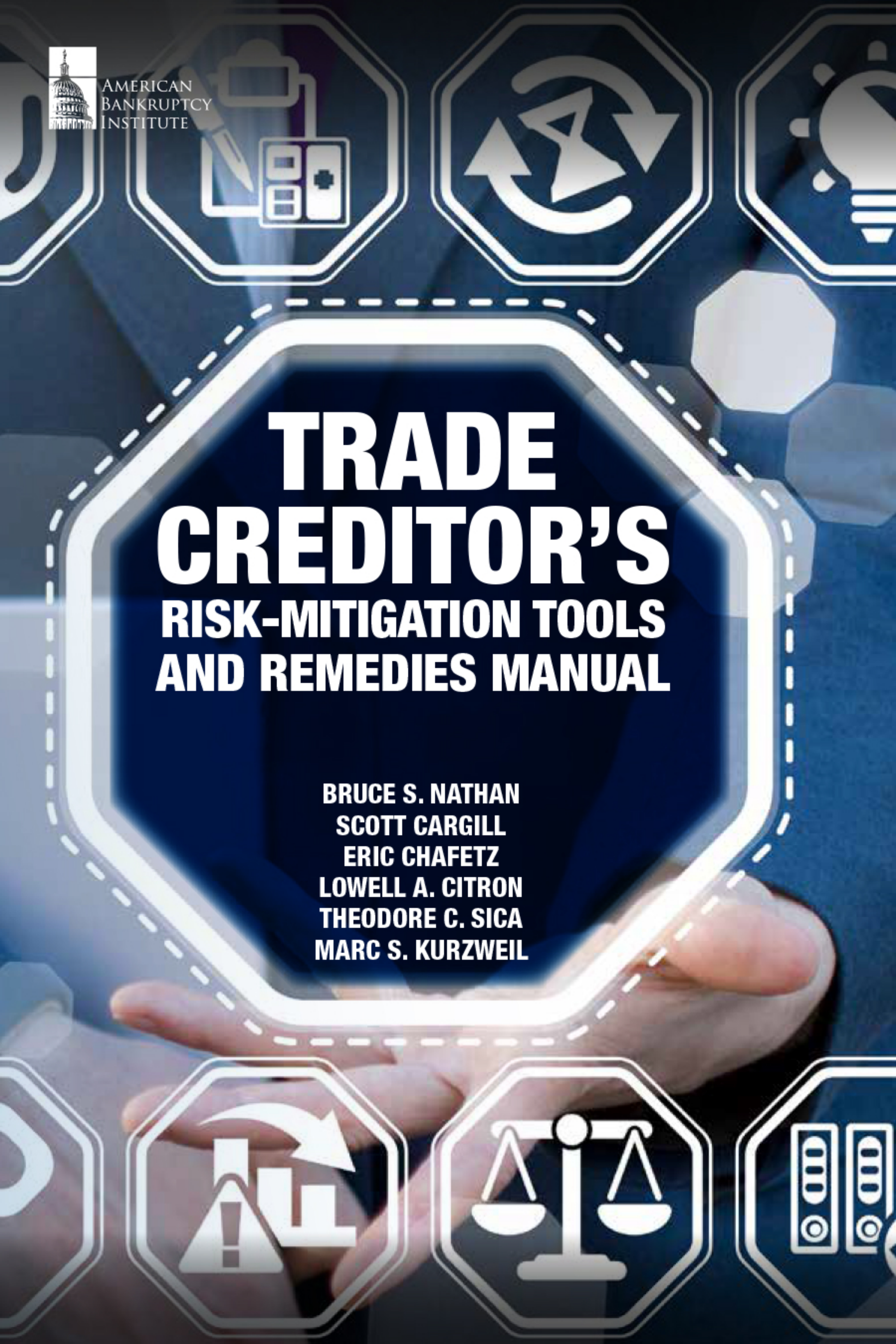

AMERICAN
BANKRUPTCY
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TRADE CREDITOR'S
RISK-MITIGATION TOOLS AND REMEDIES MANUAL

BRUCE S. NATHAN
SCOTT CARGILL
ERIC CHAFETZ
LOWELL A. CITRON
THEODORE C. SICA
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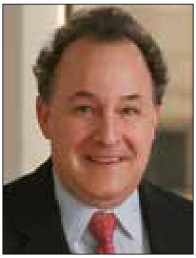

Bruce S. Nathan is a partner with Lowenstein Sandler LLP in New York and a member of the firm's Bankruptcy, Financial Reorganization and Creditors' Rights group. He has more than 35 years of experience in the bankruptcy and insolvency field and has expertise on trade creditor rights and the representation of trade creditors in bankruptcy and other legal matters, having represented trade and other unsecured creditors, unsecured creditors' committees, secured creditors and other interested parties in many of the larger chapter 11 cases that have been filed. He also negotiates and prepares letters of credit, guaranties, securities, consignments, bailments, tolling and other agreements for the credit departments of institutional clients. Mr. Nathan is a former member of ABI's Board of Directors and a former co-chair of ABI's Unsecured Trade Creditors Committee, and he has contributed to the *ABI Journal's* Last in Line column. A frequent speaker on bankruptcy, insolvency and creditors' rights issues, he is a member of the New York Bar Association and the National Association of Credit Management, is a member of NACM's General Editorial Advisory Board and Government Affairs Committee, is a regular contributor to NACM's *Business Credit* magazine, is a contributing editor of NACM's *Manual of Credit and Commercial Laws,* and frequently contributes to publications of The Credit Research Foundation (CRF), including CRF's journal, *The Credit and Financial Management Review,* as well as to *CRF News* and other publications. Mr. Nathan received his B.A. from the University of Rochester, his J.D. from the University of Pennsylvania Law School and his M.B.A. from the Wharton School of Finance and Business.

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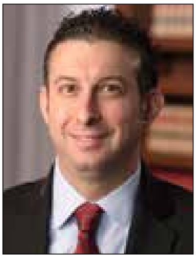
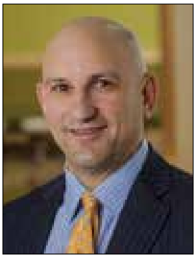
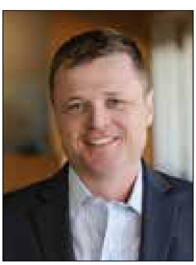


Eric Chafetz is counsel in Lowenstein Sandler LLP's Bankruptcy, Financial Reorganization and Creditors' Rights group in New York and provides strategic counsel on creditors' rights to creditors' committees, trade creditors, asset-purchasers and plan administrators/liquidating trustees involved in complex bankruptcies. Mr. Chafetz frequently negotiates cash-collateral and debtor-in-possession financing orders, bid procedures/bid-procedure orders, sale orders and their underlying corporate transaction documents, plans of reorganization/liquidation and related plan-supplement documents, liquidation trust agreements, plan-support agreements and rights-offering procedures. He is a member of the leadership committee of ABI's Unsecured Trade Creditors Committee and a member of TMA's Education Committee. He also participated in the ABI Commission to Study the Reform of Chapter 11's Avoidance Power Subcommittee's study of the aspects of the Bankruptcy Code involving preferences, creditors' reclamation rights and creditors' rights under Bankruptcy Code § 503(b)(9). Mr. Chafetz is a prolific author and speaker and has published numerous articles addressing various cutting-edge issues in journals geared toward trade creditors, as well as spoken to numerous industry groups. Active in Lowenstein Sandler's *pro bono* efforts, he has represented several individuals who filed for chapter 7 bankruptcy protection, as well as veterans before the Department of Veterans Affairs. Mr. Chafetz is admitted to the Bars of New York and New Jersey. He received his B.A. in 2000 from the University of Michigan and his J.D. *cum laude* in 2004 from Brooklyn Law School.



Lowell A. Citron is a partner with Lowenstein Sandler LLP's Corporate group in New York and chairs the firm's Debt Finance group. He represents a wide range of commercial clients, including large trade creditors, hedge and private-equity funds, large operating companies, investment banks, money center financial institutions, REITs and commercial finance companies. Mr. Citron advises on debtor and creditor risk-mitigation tools and negotiates and prepares letters of credit, guaranties, purchase-money securities, consignments, bailments, tolling and other agreements for the credit departments of institutional clients, including transactions ranging from acquisition financing to recapitalization and convertible-debt financing, as well as Term B loans, workouts, debtor-in-possession financings, leveraged loans and mezzanine loans. He also handles asset-based financing transactions, and structures and closes cash-flow transactions. In addition, he co-chairs the New York office's summer program and is an active member of the firm's *Pro Bono* Committee. Mr. Citron received his B.A. in economics with honors in 1991 from the State University of New York at Binghamton and his J.D. *cum laude* in 1994 from Fordham University School of Law.



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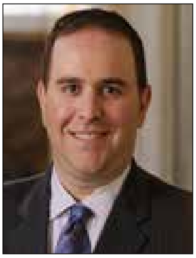

Marc S. Kurzweil is a partner in Lowenstein Sandler LLP's New York office and a member of its Corporate group. He represents agent banks, lenders, corporate borrowers, private-equity funds, hedge funds, REITs and high-net-worth individuals in a variety of complex financing transactions, including syndicated and bilateral term and revolving-credit facilities, acquisition financings, asset-based and cash-flow financings, capital call subscription credit facilities, first- and second-lien financings, recapitalizations and other leveraged financings, workouts and debtor-in-possession financings. Mr. Kurzweil's clients include international and U.S.-based lenders and borrowers from a range of industries, including insurance, paper and forest products, pharmaceuticals, real estate, financial services, telecommunications, manufacturing, health care, technology, and diamonds and jewelry. He received his B.B.A. in finance in 2002 from The George Washington University, his J.D. in 2005 from New York Law School and his LL.M. in 2006 from Fordham University School of Law.

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INTRODUCTION

Trade creditors dealing with financially troubled customers often have difficulty collecting their claims. Unpaid sellers and service providers must refrain from collection efforts against a buyer that files for bankruptcy unless specifically authorized to take action by the bankruptcy court or the Bankruptcy Code. Instead, they frequently have a general unsecured claim against the buyer in bankruptcy with the right to file a proof of claim with the bankruptcy court. Trade creditors usually obtain little or no recovery on their unsecured claims because the value of the debtor's assets is frequently significantly reduced when they are liquidated in bankruptcy. In addition, the Bankruptcy Code's priority rules require the full payment of more senior secured and administrative priority claims before any distribution can be made to holders of general unsecured claims. Further, due to the inherent delays in administering a typical bankruptcy case, any dividend will likely only be received long after a bankruptcy case is filed.

This *Manual* is designed to provide trade creditors with a single resource to help obtain payment of their claims against their financially distressed customers both prior to, and after, the customer's bankruptcy filing. The *Manual* discusses various risk-mitigation tools that trade creditors can request from their buyers, or purchase from third parties, to secure payment of their claims prior to the filing of their buyer's bankruptcy. This *Manual* then assists trade creditors by helping them determine and enforce their rights against a financially distressed buyer under the Uniform Commercial Code (UCC) and the Bankruptcy Code.

The first section of this *Manual* provides the user with information about potential warning signs that a financially distressed buyer may exhibit, and the sources of such information. Quickly obtaining such information is critical to a trade creditor's efforts to mitigate the risk of nonpayment of their claims owing to them by a financially distressed buyer.

The second section of this *Manual* provides information about certain risk-mitigation tools available to trade creditors when dealing with a buyer in varying degrees of financial distress. This section covers letters of credit, purchase-money security interests and consignments, guaranties, credit insurance, and put agreements, each of which is a risk-mitigation tool that trade creditors can use to secure recovery of all or a portion of their claims.

The third section of this *Manual* discusses a trade creditor's state law UCC rights, and other remedies against a financially troubled buyer, that can be exercised prior to and after the buyer's bankruptcy filing. These rights and remedies include a seller's right to demand that a buyer provide assurances that the buyer can perform under an open contract, even before the seller ships goods to, or provides services for, the buyer, and notwithstanding the fact that the buyer has not breached the contract. This remedy can be turned to in situations where the creditor has legitimate concerns about the buyer's ability to pay for the goods or services the creditor provided on credit terms under their contract. This section also discusses a seller's right to stop delivery of goods that are still in the seller's possession or in the possession of a carrier, warehouser or other third party, and includes a detailed discussion of a seller's rights after the goods are in the buyer's possession, including the seller's right to demand reclamation of the goods (*i.e.*, return of goods) that an insolvent buyer had received. Next, there is a discussion of when a seller may properly deem a contract repudiated by the buyer, the manner in which a seller can resell goods following the buyer's breach of the contract in order to determine the seller's damage claim against the buyer, and other trade creditor remedies. This section concludes with a review of the rights of setoff and recoupment, how they are exercised, and their respective limitations.

The fourth section of this *Manual* discusses the significant rights that the Bankruptcy Code grants to trade creditors after a buyer files for bankruptcy protection. For instance, the Bankruptcy Code recognizes a goods seller's reclamation rights, but has sufficiently circumscribed those rights as to vitiate reclamation as an effective remedy. The Bankruptcy Code also grants goods sellers (not service providers), including those sellers who fail to comply with the requirements for reclamation (or are not otherwise entitled to relief on their reclamation claims), an administrative priority claim under Bankruptcy Code § 503(b)(9) that is a step up in priority status over the seller's otherwise-lower-priority pre-petition general unsecured claim. This administrative priority claim is for the value of goods the buyer had received in the ordinary course within 20 days of its bankruptcy filing. This includes a discussion of the current state of the law concerning the extent of § 503(b)(9) claims, the manner in which trade creditors can assert this claim, the numerous court rulings that have defined the scope of the claims eligible for this administrative priority, and the related defenses available to a debtor or trustee to reduce or eliminate the priority status afforded these claims.

This *Manual* concludes with a review of the issues unique to trade creditors that have executory contracts with buyers who file for bankruptcy. These issues include the rights and obligations of sellers or service providers dealing with buyers in bankruptcy, how they can best protect themselves when forced to continue to conduct business with their debtors/buyers, and those contract provisions that are unenforceable under the Bankruptcy Code.

Finally, the Appendix to this *Manual* includes a number of legal forms and sample agreements that provide a model for negotiating contracts to secure trade creditor protections and to exercise rights under state law and the Bankruptcy Code.

Chapter I

WARNING SIGNALS IN DECIDING WHETHER TO EXERCISE TRADE CREDITOR REMEDIES

Sellers of goods and service providers to financially distressed buyers should vigilantly watch for, and quickly react to, warning signs that frequently appear in the weeks, months and sometimes even years prior to a distressed buyer's eventual bankruptcy filing. Frequently, trade creditors wait until after a buyer's bankruptcy filing before attempting to exercise their state law rights, such as demanding adequate assurance of future performance, stopping delivery of goods (either in the seller's possession or in transit to the buyer), or demanding reclamation of their goods. Delaying action may result in an unpaid seller or service provider realizing a far smaller recovery on its claim.

As will be more fully discussed in this *Manual*, a financially troubled buyer does not have to file bankruptcy for a creditor to exercise its state law UCC remedies. In fact, the effectiveness of many trade creditor remedies may be significantly reduced upon a buyer's bankruptcy filing. News of events disruptive to the buyer's operations, or portending a financially distressed buyer's inability to timely pay other creditors, may be the basis for a creditor's demand for adequate assurance of future performance under a contract, even when the buyer is not past due on the creditor's invoices. Moreover, when a trade creditor discovers a buyer's insolvency, the creditor can stop delivery of its goods or make a reclamation demand, even before the buyer files for bankruptcy.

Any one or a combination of the following warning signals may indicate a buyer's financial distress and/or insolvency that would justify a trade creditor's invocation of certain remedies:

- A buyer is not paying invoices when it should have surplus cash (*e.g.*, a retailer not paying trade creditors in late December and January following the Christmas season);
- The buyer holds or post-dates checks (*e.g.*, a buyer holds checks or dates checks long before their delivery, or a buyer requests that the trade creditor hold checks because of insufficient funds);
- A buyer's checks are returned for insufficient funds;
- The creditor confirms that other vendors/factors have withdrawn trade credit that was previously offered to the buyer;
- The buyer increasingly relies on debt to fund its operations (declining cash flow, declining margins and failure to adequately invest in capital expenditures);
- There is disclosure of significant financial problems in the buyer's industry;
- There is an upcoming principal or interest payment on bond debt, upcoming maturity of bond debt, or bond default;
- Credit insurance covering the buyer has been restricted or withdrawn;
- The buyer is slower to make payments;
- The buyer delays, or refuses to provide, financial information that was previously provided;
- A going-concern qualification is included in the buyer's audited financial statements;

- Credit-rating agencies issue downgrades to junk status on the buyer's outstanding debt and/or the buyer is placed on credit watch;
- There is an imminent expiration of the buyer's financing arrangements with its lender;
- There is a significant decline in the buyer's stock price or the price of bonds issued by the buyer;
- The buyer's CEO, CFO and/or financial personnel are terminated or resign;
- The buyer's board members resign;
- The buyer's new board members or officers (*e.g.*, a chief restructuring officer) have an insolvency or bankruptcy background;
- There is an increased number of credit reference requests concerning the buyer;
- The buyer becomes increasingly inaccessible (*e.g.,* senior management ceases communications with major vendors/becomes unavailable to answer questions);
- The trade creditor's contact in the purchasing department resigns or is reassigned to another department;
- The trade creditor's sales force is less optimistic about the buyer and/or is resigned to financial problems not being resolved;
- The buyer breaches its loan covenants and enters into forbearance agreement(s) with its lender;
- Accounts receivable put coverage on the buyer becomes much more expensive to purchase or is no longer available;
- The buyer grants new security interests in its assets to third parties, such as increased frequency of purchase-money security interests and consignments in favor of certain vendors, and the grant of sec-

ond and third liens in the buyer's assets in favor of financial creditors, such as bondholders;

- Tax and/or other liens are filed against the buyer's property/assets;
- Collection lawsuits are filed/judgments are entered against the buyer;
- The buyer is the subject of environmental, asbestos or other tort-related litigation;
- The buyer has significant underfunded pension liabilities;
- The buyer uses rumors of the sale of its business/assets as a reason for delaying payment;
- Ad hoc committee(s) of the buyer's bondholders are formed and retain bankruptcy professionals;
- An unofficial unsecured creditors' committee for the buyer is formed;
- The buyer retains a chief restructuring officer, crisis manager and/or insolvency professionals;
- News reports surface of the buyer negotiating a chapter 11 financing arrangement;
- There are rumors of a bankruptcy filing by, or against, the buyer; and/or
- The buyer requests a payment moratorium, extends payment time for past-due invoices, or is paying only a portion of a seller's claim.

Many of these warning signs can occur long before the buyer's bankruptcy filing. Trade creditors should be vigilant and carefully watch out for these warning signs. If appropriate, trade creditors should be prepared to quickly obtain from the buyer or third parties protection to secure payment of their claims and/or exercise their remedies in order to minimize their losses and maximize recovery on their claims.

There is a wide assortment of databases and information-tracking services available to assist a trade creditor in identifying and monitoring these warning signs. One of the most common, and cost-free, tools is the automated information tracking systems available from internet search engine providers. For example, Google Alerts (www.google.com/alerts) has a system that sends users an e-mail notification whenever a specified search term, such as a customer's name, appears in new website pages, news articles or blog postings. The frequency of these electronic notifications can be set by the user to be sent weekly, daily or even "as it happens," depending on how closely the credit is being monitored. This tool is particularly useful in alerting credit professionals to information about a buyer that may be covered in greater detail by smaller local media outlets in the city or town where a buyer has offices or manufacturing facilities. These alerts can also help provide insight into the buyer's financial performance, workforce reductions, merger and acquisition activity, divestments and plant closings, regulatory and environmental issues, labor disputes, changes in management, and how the company is perceived by its peers in the industry.

Companies that have publicly traded securities are required by federal securities law to file periodic reports with the U.S. Securities and Exchange Commission (SEC). These reports are made publicly available through the SEC's website at www.sec.gov. The reports contain a significant amount of detailed information about the issuer, including audited financial information, corporate structure and governance, outstanding debt obligations, material contracts, revenue sources, industry trends, and management's discussion of business challenges and operational execution risks. A buyer's failure to timely file its SEC reports when due, or a going concerning qualification by auditors contained in a report, is a clear warning signal that should merit further investigation and trade creditor action.

Many companies that file reports with the SEC also maintain an "Investor" page on the company's website that can be an important resource for identifying potential warning signs. Often, these websites will allow users to register to receive notifications whenever the company files reports with the SEC and/or releases material information about its operations to the public. These websites will also often archive SEC reports, press releases and financial information, and have information about registering for upcoming investor teleconferences and transcripts of prior teleconferences, as well as provide historic stock and bond prices, among other corporate-governance information.

There are also many fee-based service providers that prepare reports for creditors based on publicly available UCC filings, state and federal tax lien filings, and listings of pending litigation against a company. The UCC filings may help to provide better insight into how much of the customer's assets are encumbered and which creditors would have priority in payment in the event the customer becomes insolvent. A buyer with significant delinquent taxes that have resulted in the taxing authorities filing liens, or buyers with multiple lawsuits filed by other creditors seeking to collect debts, should immediately raise red flags and counsel against extending unsecured credit to the buyer.

Websites run by agencies in various states (often by the Office of the Secretary of State) provide access to publicly available filings. These websites generally charge a fee for such information. There are also a wide range of subscription-fee services that are focused on monitoring and tracking larger distressed companies and specific industries. Among the more widely known services are Bloomberg, Debtwire, S&P Capital IQ, Reorg Research, *The Deal*, *Daily Bankruptcy Review*, Thomson Reuters and Markit. Many of these subscription-based services not only provide publicly available financial information, press releases and SEC reports, they also supplement this data with insights from investors, industry professionals and various other sources of market "gossip." While this additional information might not always be as accurate or verifiable as compared to formal press releases or SEC reports, it helps to provide a more complete picture of any financial distress a company may be experiencing, how the company is responding, and how other creditors are addressing/analyzing the situation. In addition, many of these subscription-based services will often conduct a comprehensive analysis of a company's financial information, highlighting trends over time, making comparisons to the performance of industry peers, and highlighting upcoming material financial milestones and targets for the target company.

Finally, if the buyer is a smaller organization and does not file reports with the SEC, a trade creditor should consider incorporating a provision into its contracts with its buyers that requires the buyer to periodically provide the trade creditor with financial statements and supporting financial information. The provision should specify that failure to timely provide such information is a breach of the agreement and grounds for termination. Such a requirement should be negotiated at the outset of the relationship with a new buyer, as a buyer that is already in financial distress is far less likely to agree to such a provision. Periodic review of a buyer's financial information (preferably audited) can assist in identifying negative trends or areas of concern long before they become acute financial issues.

Chapter II

RISK-MITIGATION TOOLS

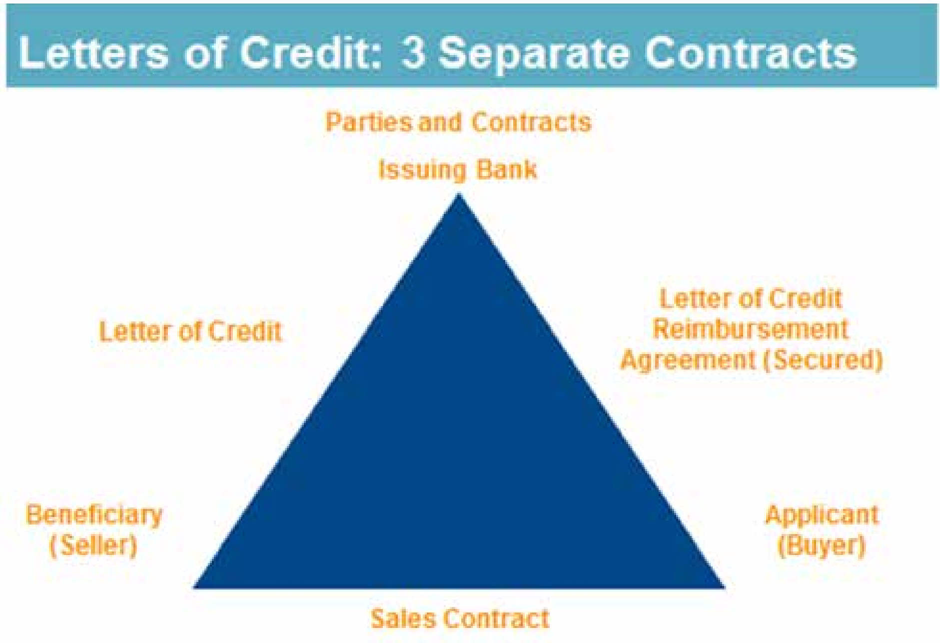
A. Letters of Credit

Trade creditors frequently rely on letters of credit as a backstop to protect them from a default in connection with transactions with their buyer, the letter of credit applicant. A letter of credit is a valuable and versatile risk-mitigation tool for trade creditors in commercial transactions, as the letter of credit issuer, typically a commercial bank, is contractually obligated to make payments upon the satisfaction of certain documentary requirements. Parties use letters of credit as a method of shifting the credit risk from the buyer to the financial institution issuing the letter of credit.

Article 5 of the UCC generally governs the use and interpretation of letters of credit. The UCC defines a letter of credit as "a definite undertaking that satisfies the requirements of Section 5-104 [of the UCC] by an issuer to a beneficiary at the request or for the account of an applicant ... to honor a documentary presentation by payment or delivery of an item of value." Letters of credit may also be governed by the Uniform Customs and Practice for Documentary Credits (UCP 600) and by the International Standby Practices (ISP 98). There is no particular form required for a letter of credit to be effective, other than that it must be in writing and signed by the issuer.

A letter-of-credit arrangement typically involves three parties and three independent contracts. The first contract is between the letter of credit applicant and the beneficiary. Their underlying agreement could be for the sale of goods or the provision of services where the beneficiary is frequently the seller. The second contract is the issuing bank's agreement with its customer, frequently the buyer, referred to as the "letter of credit applicant." This includes the bank's agreement to issue the letter of credit, the terms of the letter of credit, the buyer's obligation to reimburse the bank for payments made to the beneficiary/seller pursuant to the letter of credit's terms, the bank's charges and commissions earned from issuing the letter of credit, and the collateral security for the buyer's reimbursement obligation to the bank. The third contract is the letter of credit that the bank issues in favor of the beneficiary/seller. When the beneficiary/seller submits documents to the issuing bank, the bank's only duty is to examine the documents and determine whether they comply with the specific terms and conditions of the letter of credit. When the bank determines that the beneficiary/seller has presented all of the required documents, the issuing bank must pay the amount requested by the beneficiary/seller. If the bank rejects a beneficiary's/seller's presentation of conforming documents, the bank is in breach of its obligation to pay on account of the letter of credit and is subject to the beneficiary's/seller's assertion of a wrongful dishonor claim.

The following diagram illustrates the three separate contracts underlying a letter of credit transaction:



One of the central tenets of letter of credit law is the independence principle: A letter of credit is distinct from the underlying contract it backstops. Therefore, if the beneficiary presents all of the documents required by the letter of credit, the issuing bank must honor the beneficiary's request for payment, regardless of (1) any disputes between the beneficiary/seller and the bank's customer/applicant/buyer in their underlying transaction, and/or (2) between the applicant/buyer and the issuing bank, including the buyer's/applicant's inability to reimburse the issuing bank for letter of credit payments. If the issuing bank pays the beneficiary/seller based on the beneficiary's/seller's presentation of noncomplying documents, the bank's customer/applicant/buyer is not obligated to reimburse the bank for that payment unless its agreement with the issuing bank limits this right. As such, the parties involved should be mindful that the letter of credit's documentary requirements entirely conform to the terms of the underlying contract.

Another central tenet of letter of credit law is the doctrine of strict compliance. A bank that issues a letter of credit must determine whether the beneficiary/seller presented documents that comply precisely with all of the requirements of the letter of credit. The bank deals only in documents presented by the beneficiary/seller when deciding whether to pay on account of a letter of credit. If the documents comply, the bank must pay the beneficiary/seller; if the documents do not comply, the bank cannot make payments to the beneficiary/seller unless the applicant/buyer agrees otherwise. Most courts follow the strict-compliance standard in determining compliance — *e.g.*, the presented documents must strictly comply with the letter of credit's documentary requirements before the issuing bank can pay the beneficiary/seller. However, a minority of courts follow the less rigorous "substantial compliance" rule, which allows some deviation.

Standby letters of credit, frequently used for domestic business, generally secure a buyer's performance under a commercial agreement rather than provide for a direct payment of the buyer's obligation. Standby letters of credit provide similar comfort and protections as collateral in a secured transaction, as the trigger to draw on the letter of credit is usually the applicant's/buyer's default on its obligations to the beneficiary/seller. Appropriately drafted, standby letters of credit can also provide beneficiaries/sellers with protection against the risk of their buyer's bankruptcy filing. Beneficiaries/sellers should also be able to draw on a letter of credit to protect them from preference claims under Bankruptcy Code § 547. If a beneficiary/seller receives payment from the issuing bank, the payment is generally not subject to avoidance as a preference even if the applicant/buyer files for bankruptcy within 90 days after the payment is made under the letter of credit. Courts have determined that the beneficiary/seller receives funds from the letter of credit issuer and not from the debtor/applicant/buyer. Therefore, no transfer of property of the debtor/applicant/buyer has occurred when the letter of credit is drawn upon and paid.

On the other hand, commercial letters of credit, which are frequently used in international sales, are drawn upon to make a payment against documents, such as invoices, bills of lading, insurance certificates, inspection certificates and customs invoices. Upon presentation of documents that conform with the requirements of a letter of credit, the beneficiary/seller receives payment under the letter of credit and the applicant, in turn, receives control of the applicable goods. The letter of credit's issuing bank receives a buyer security interest in, or retains title to, the goods until the bank is reimbursed under the letter of credit's reimbursement agreement. The duration of a commercial letter of credit is generally only long enough for the beneficiary/seller to procure or manufacture and ship the goods ordered pursuant to the underlying commercial agreement.

A letter of credit is a valuable risk-mitigation device that a trade creditor can use to increase the likelihood of payment of its claim. A bank cannot invoke its buyer's bankruptcy filing as a basis for dishonoring the beneficiary's/seller's compliant draw on the letter of credit. While letters of credit make it possible to reduce risk while continuing to do business, they should be carefully reviewed to ensure compatibility with the underlying commercial agreement, as well as the business arrangement among the parties involved. An example of a standby letter of credit is included as Form 1 in the Appendix.

B. Consignments and Purchase-Money Security Interests in Inventory

Consignment arrangements and purchase-money security interests are two other risk-mitigation tools that vendors can utilize to enhance their ability to obtain payment of their claims. If the proper procedures are followed, the use of either a consignment or purchase-money security interest (PMSI) gives a vendor priority in payment for the goods it delivers to its buyer over the rights of the buyer's prior perfected secured creditor and increases the likelihood of payment by a financially distressed buyer.

1. Purchase-Money Security Interests

In a sale transaction, a seller can obtain a PMSI in goods sold on credit to a buyer. The purchaser becomes the debtor, and the seller becomes a secured party, with respect to the inventory being purchased. PMSIs are governed by Article 9 of the UCC. According to UCC § 9-103, a PMSI in inventory arises (1) to the extent the inventory secures an obligation incurred to pay all or part of the purchase price of the inventory collateral, or for value given to enable the debtor to acquire rights in or the use of the inventory collateral, if the value is in fact used with respect to that security interest; and (2) to the extent that the security interest secures the obligation to pay the purchase price of other inventory in which the secured party holds or held a PMSI. An Official Comment to UCC § 9-103 states that a PMSI requires a close nexus between the acquisition of the collateral and the secured obligation.[1]

A PMSI transaction is governed by the terms of a written PMSI agreement that must be executed by the debtor. The PMSI agreement must adequately describe the goods subject to a PMSI and must contain a provision with a clause granting the seller a security interest in the specified goods, as well as all proceeds from the disposition of the goods.

2. Consignments

A consignment arrangement is another powerful risk-mitigation tool available to trade creditors selling on credit terms to a financially distressed buyer. The vendor, known as a consignor, delivers inventory to its buyer, or the consignee, pursuant to the terms of a written consignment agreement. The consignor retains title to the inventory and agrees to defer payment by the consignee until the consignee sells or otherwise uses the consigned inventory. The consignor usually issues an invoice, containing the payment terms, to the consignee after the consignee provides notice to the consign-

1 Although in a different context, PMSIs are often utilized when an individual purchases an automobile and obtains financing from the manufacturer for the specific purpose of purchasing the subject automobile.

or of the sale or use of the inventory. If the consignee cannot sell or otherwise use the inventory, the governing agreement will often provide that the consignee return the consigned inventory to the consignor. Generally, the consignor does not book a sale until the consignee reports that it has sold or has used the consigned inventory. Some consignment agreements provide that the consigned goods are deemed to be sold to the consignee if the goods were not sold or otherwise used after a specified period of time.

Consignment arrangements are often, but not always, governed by Article 9 of the UCC and are treated the same as a PMSI. To be governed by the UCC, the terms of the arrangements must comply with UCC § 9-102(a)(20). According to this section, a consignment is a transaction in which a person delivers inventory to a merchant for purposes of sale, and (1) the merchant deals in inventory of that kind under a name other than the name of the person making delivery, is not an auctioneer, and is not generally known to be substantially engaged in selling the inventory of others; (2) the inventory must have a value of at least $1,000 at the time of delivery; (3) the inventory is not consumer inventory immediately before delivery; and (4) the transaction does not create a security interest.

3. Super-Priority Status of Purchase-Money Secured Creditors and Consignors

Consignors and sellers with a PMSI enjoy priority over other previously perfected parties that have a valid security interest in the consignee's inventory and in identifiable proceeds (except the accounts arising from the sale of the inventory) by satisfying the following requirements under UCC § 9-324:

First, the PMSI or consignment interest must be perfected prior to, and not later than, when the debtor/buyer receives possession of the inventory. A consignor or purchase-money seller perfects its interest by filing a UCC financing statement describing the inventory in the correct jurisdiction.

Second, the secured party must send an authenticated notification to all holders of prior security interests in the consignee's inventory. This requires the consignor/seller to order UCC lien searches in all applicable jurisdictions to confirm the existence of secured lenders with a prior security interest in the subject inventory. The notification must state that the person sending the notification has, or expects to acquire, a PMSI or consignment interest in inventory owned by the debtor and describe the inventory.

Third, the holder of the prior security interest must receive the notification within five years prior to the consignee/buyer receiving possession of the inventory.

Purchase-money security interests in goods other than inventory do not need to satisfy the above notification requirements as a condition for obtaining priority in the collateral. They only require perfection when the consignee/buyer obtains possession of the goods, or within 20 days thereafter.

If a consignor or purchase-money seller fails to perfect its security interest, such as by properly filing a UCC financing statement in a required jurisdiction, the consignee/buyer's other creditors may obtain judicial liens and security interests in the inventory with priority over the consignor/seller's unperfected security or consignment interest. Any judicial lien creditor, including a bankruptcy trustee or debtor-in-possession, also has priority over an unperfected creditor, which may relegate the consignor and PMSI seller to being a lower-priority general unsecured creditor.

4. "True" Consignments

Parties that are involved in consignment arrangements but have not perfected their interests in compliance with UCC Article 9, including the requirement to file a UCC financing statement describing the consigned goods and providing notice of the consignment to the consignee's other creditors with a blanket security interest in inventory, have attempted to argue that their transactions are "true consignments." The rationale is that these transactions need not comply with Article 9 because the consignor was delivering inventory to a merchant that is generally known by its creditors to be engaged in the sale of consigned inventory. While this exception has been recognized in certain circumstances, it is very fact-dependent, is usually difficult to prove, and has rarely been invoked successfully.

Consignors with unperfected interests in the consigned goods of a consignee that has filed for bankruptcy protection have been able to leverage their purported consignor status to seek a higher priority of payment. They can object to the debtor's sale of the consigned goods free and clear of their consignment interests on the ground that the consignors, not the debtor, hold title to the consigned goods. Indeed, some bankruptcy courts have refused to authorize the sale of consigned goods until determining which party actually holds title to the goods. These courts reason that Bankruptcy Code § 363(b) allows a debtor to sell only property of the debtor's bankruptcy estate (not the property of consignors). These courts have also ruled that the determination of ownership of consigned goods cannot be made in the context of a debtor's sale motion, but rather the debtor and/or the debtor's secured lender must commence individual adversary proceedings against each consignor to determine proper ownership of the consigned goods to be sold.[2]

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2 *In re Whitehall Jewelers Holdings Inc.*, 2008 WL 2951974 (Bankr. D. Del. 2008) (issues regarding ownership and perfection of consigned goods can only be resolved in adversary proceeding, not through § 363 sale); *but see WYNIT Distribution LLC, et al.*, Case No. 17-42726 (Bankr. D. Minn. Sept. 8, 2017) (authorizing sale of allegedly consigned inventory through § 363 sale motion and not requiring the debtor to commence individual adversary proceedings to determine ownership of the consigned goods).

In having to address an objection to a sale of goods through a § 363 sale, the debtor faces the prospect of a substantial delay and limitations on the ability to sell or otherwise dispose of the proceeds of its consigned goods while litigating numerous separate lawsuits over whether the consigned goods are property of the bankruptcy estate. This may shift the balance of power in a bankruptcy case in favor of the unperfected consignors, especially in the case of seasonal or other goods that need to be sold quickly, allowing for favorable settlements of consignment claims.

For example, Sports Authority and several affiliates filed for chapter 11 protection in March 2016 in the U.S. Bankruptcy Court for the District of Delaware. Upon filing, Sports Authority was in possession of 8.5 million units of consigned goods, obtained from 170 consignors, at a cost of more than $84 million. While Sports Authority frequently entered into its standard form of consignment agreement with its consignors, most consignors failed to file UCC financing statements.

Sports Authority filed a motion for authority to sell pre-petition consigned goods free and clear of all liens, claims and interests, including consignment interests, and sought to grant a "replacement lien" in the sales proceeds of the consigned goods only to those consignors that had previously satisfied all of the UCC Article 9 consignment requirements.

Numerous consignors that did not properly perfect their consignment interests in accordance with UCC Article 9 objected to the motion. They argued that Sports Authority could not sell their consigned goods because the consigned goods were not property of Sports Authority's bankruptcy estate. The consignors further argued that (1) they had retained title to the consigned goods under their consignment agreements, and were therefore entitled to recover their goods, and (2) the consigned goods could not be sold until the bankruptcy court had determined who had prior rights to the consigned goods, either the consignors or Sports Authority as consignee and Sports Authority's secured lenders, which were owed approximately

$276 million and had a prior blanket security interest in Sports Authority's inventory.[3]

The bankruptcy court ruled that, pending adjudication of the lawsuits, Sports Authority had three options to deal with the consigned goods: (1) Cease all sales of the goods; (2) sell the goods according to the terms of the consignment agreements, which required paying the agreed-upon invoice price to the consignors upon the sale of any consigned goods; or (3) settle with the consignors. Sports Authority continued to sell the consigned goods and remitted the invoice price of the goods to the consignors according to the terms of the consignment agreements. The court also ruled that the term loan lenders could seek recovery of the sale proceeds from the consignors if the court ultimately decided that the lenders had superior rights to the consigned goods and their proceeds.

The term loan lenders appealed the bankruptcy court's ruling and joined in the pending lawsuits against each of the consignors. In the lawsuits, the lenders sought a declaration by the bankruptcy court that the lenders had a superior interest in the consigned goods (and all sale proceeds thereof) of those consignors that failed to perfect their consignment interests and otherwise comply with the requirements of UCC Article 9. The lenders also sought a court order requiring the consignors to pay all proceeds they had received to the term lenders in the event the court ruled in the lenders' favor.

Many of the consignment litigations ultimately settled, with most claimants receiving between 25-40 percent of the proceeds of the sales of the consigned goods that they would have been entitled to receive under their consignment agreements, and with the secured lenders receiving the balance of the proceeds. Certain consignors received as much as 45 percent

3 Unlike *Sports Authority*, the U.S. Bankruptcy Court for the District of Minnesota, in *In re Wynit Distribution LLC, et al.*, reached the opposite conclusion and authorized the sale of alleged consignment inventory in a § 363 sale. The court did not require the filing of adversary proceedings/lawsuits against each consignor and instead entered a sale order without making a determination for each consignor as to whether the debtors actually owned the subject inventory, or if the inventory was, in fact, truly consigned.

to approximately 50 percent of the proceeds of the sales of their consigned goods.

A few consignors that failed to file UCC financing statements, including MJ Soffe, LLC (Soffe), refused to settle. The term loan lenders filed a motion for partial summary judgment on the pleadings against Soffe seeking a declaration that the lenders held prior rights in the goods that Soffe had consigned to Sports Authority and that all proceeds of the sale of those goods were senior to Soffe's unperfected consignment interest. The lenders also sought disgorgement of the proceeds Soffe had received. Soffe argued that its consignment arrangement was not covered by the UCC because Sports Authority was generally known by its creditors to be substantially engaged in selling the goods of others and the lenders had actual knowledge of Soffe's consignment arrangement with Sports Authority.

The court denied the lenders' motion for judgment on the pleadings.[4] The court found disputed issues of fact concerning whether Soffe's consignment agreement with Sports Authority was a "true" consignment that was not governed by UCC Article 9. If Sports Authority was generally known to be selling the goods of others, or the term lenders had knowledge that Sports Authority was selling Soffe's consignment goods, then the consignment arrangement was a "true" consignment and Soffe was not required to file a UCC financing statement and comply with UCC Article 9's other requirements in order to have superior rights over the term lenders in the consigned goods.

The bankruptcy court considered the rights of unperfected consignors in a pair of decisions resolving cross-motions for summary judgment.[5] In the first case, the court held that the consignor, Performance Apparel Corp. (PAC), which had allowed its UCC financing statement covering PAC's consigned goods to lapse pre-petition, still retained a superior interest in

4 *In re TSAWD Holdings Inc.*, 565 B.R. 292 (Bankr. D. Del. 2017).

5 *TSA Stores Inc. v. Performance Apparel Corp. (In re TSAWD Holdings Inc.)*, 2018 WL 6839743 (Bankr. D. Del. Nov. 26, 2018); *TSA Stores Inc. v. M J Soffe, LLC (In re TSA WD Holdings Inc.)*, 2018 WL 6885922 (Bankr. D. Del. Nov. 26, 2018).

its consigned goods that prevailed over the blanket security interest in the inventory of Sports Authority's secured lenders. The court relied on the secured lenders' actual knowledge of the consignment arrangement. When the lenders had made their loans to Sports Authority, the consignment arrangement was expressly identified as a permitted lien on a schedule to the loan documents. There was also testimony that the lenders and their agent had known that PAC held a perfected consignment interest at the time the loan was made. The second case involved Soffe, which did not file a UCC financing statement with respect to its consigned goods until one month prior to the bankruptcy filing. Soffe also argued that it did not have to file a UCC financing statement to have priority over the lenders' blanket security interest because the lenders had actual knowledge of the consignment arrangement. The court rejected Soffe's argument, finding, unlike the *Performance Apparel* case, that there was insufficient evidence in the record to demonstrate that the lenders had actual knowledge of Soffe's consignment program.

The bottom line is that the best practice is for consignors to follow the requirements of UCC Article 9 for obtaining priority rights to their consigned goods. That increases the likelihood of a full recovery on their consignment claims and avoids the significant fees required to prove the existence of a "true" consignment when the consignor fails to comply with UCC Article 9.

5. Responding to a Chapter 11 Filing

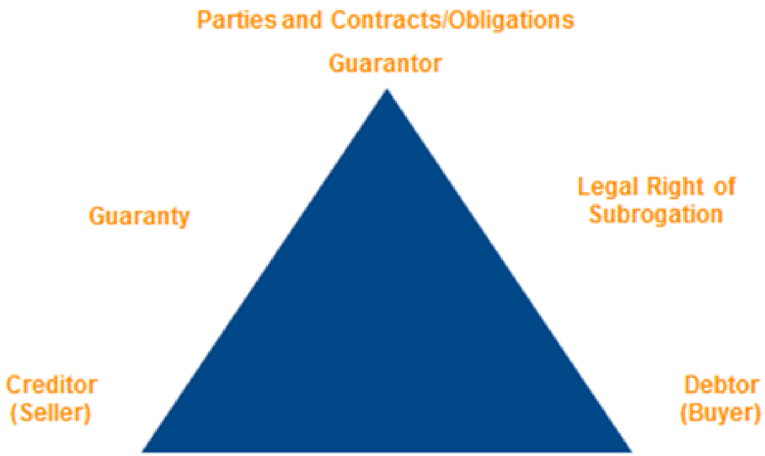
If a trade creditor's customer files for bankruptcy and the trade creditor is either a party to a consignment arraignment or holds a PMSI in inventory, the trade creditor must act quickly and diligently to preserve its rights in the bankruptcy proceeding. It is imperative to review all DIP-financing and cash collateral orders that seek to eliminate or impair interests in the customer's inventory. Equally important is objecting to any § 363 motion by the debtor/customer to sell consignment inventory, or to sell inventory subject to a PMSI, to a third party. Often a debtor will want to swiftly consummate a sale of the goods while providing the minimum required amount of notice to creditors. By timely objecting to such a sale, and raising issues concerning the ownership of the goods and priority rights to their proceeds, a trade creditor can maximize its leverage to negotiate a favorable settlement in exchange for consenting to a sale. Failure to be proactive and timely assert rights could result in a trade creditor either waiving rights and/or substantially decreasing negotiating power, resulting in a diminished or no recovery. An example of a purchase-money security agreement is included as Form 2 in the Appendix.

C. Guaranties

A trade creditor extending credit to a buyer will often require additional security in the form of a guaranty. Trade creditors request guaranties in order to have additional sources of repayment when the buyer is unable to pay for the goods and/or services they had purchased from the trade creditor.

A guaranty is an undertaking by the guarantor to pay the obligations or perform the duties of a third party in the event of the third party's default. A guaranty should contain language that increases the likelihood of collection of the guaranty and minimizes the risk of the assertion of defenses. A trade creditor should request a guaranty of payment and not a guaranty of collection. A guarantor is primarily liable under a guaranty of payment. This allows a trade creditor to collect from a guarantor without having to first seek to collect from the buyer. A guaranty should also be (1) a "continuing" guaranty so as to be enforceable while there is any outstanding guaranteed indebtedness, (2) absolute and unconditional, and (3) payable "without offset, defense or counterclaim." Further, a guaranty should include a provision for the recovery of attorneys' fees and other collection costs, adequate notice of termination and protection for pre-termination liabilities, and reinstatement of prior buyer payments in the event of the buyer's bankruptcy filing to protect against preference and other risks.

Guaranty



D. Personal Guaranties

Having a guaranty does not ensure that a trade creditor will be repaid. Thus, it is necessary to assess a guarantor's credit to the extent that the trade creditor is relying on the guarantor's independent ability to pay. The guarantor's financial well-being may be closely tied to that of the business. Business owners will often use their personal financial resources to aid the business during financially unfavorable times. Therefore, the business owners acting as guarantors may have a similar inability to repay when the business is struggling. For this reason, it is important to continuously evaluate the business and the guarantor's credit profiles to avoid such a situation.

Even if both the business's and the guarantor's financial health diminish, trade creditors with personal guaranties are in a much better position to collect on their claims than those without personal guaranties. Guarantors are likely to have the buyer prioritize payment of those invoices that are the subject of a personal guaranty, and as a result, these invoices are more likely to be paid. Additionally, if it is apparent that the business is going to fail, guarantors are incentivized to have the buyer pay off those debts that are personally guaranteed, such as by the debtor's principal, over those that are not secured by a personal guaranty. Thus, trade creditors with personal guaranties might have all or a portion of their claims paid, while those without guaranties might not obtain any payment of their claims. This holds true when the business is in good financial health; invoices that are personally guaranteed will generally be granted higher priority in timing of payment than those invoices that are not guarantied.

Personal guaranties are most easily obtained when a business is first asking for credit, as they are easily included in a credit application. Personal guaranties can also readily be obtained when a business requests a higher credit limit. It is good practice to try to obtain personal guaranties in either of these situations rather than wait until the business has fallen behind on payments due to liquidity issues, at which point personal guaranties are less likely to be offered.

E. Spousal Guaranties

The person giving a guaranty will frequently be the business owner. However, if after an evaluation of the business owner's credit it is determined that the business owner's creditworthiness is insufficient, it is prudent to look to other individuals to provide a guaranty. This will often be the business owner's spouse.

Trade creditors considering obtaining a guaranty from a principal's spouse will have to navigate the requirements of the Equal Credit Opportunity Act (ECOA) and its accompanying Regulation B. Because there is some uncertainty in the circuit courts regarding the applicability of ECOA and Regulation B to spousal guaranties, trade creditors should follow Regulation B until the U.S. Supreme Court finally weighs in to resolve the circuit split on this issue.

The ECOA provides that it is "unlawful for any creditor to discriminate against any applicant, with respect to some aspect of a credit transaction ... on the basis of marital status."[6] Therefore, only applicants with respect to any aspect of a credit transaction have a cause of action under the ECOA. The ECOA defines "applicant" as "any person who applies to a creditor directly for an extension, renewal, or continuation of credit, or applies to a creditor indirectly by use of an existing credit plan for an amount exceeding a previously established credit limit."[7] Trade creditors who are found to have violated provisions of the ECOA are subject to claims for recovery of actual damages, punitive damages and attorneys' fees.

While the ECOA applies to applicants for credit, it is unclear whether it includes guarantors, as there is conflicting case law on this issue. Regulation B was adopted by the Federal Reserve Board (FRB) to assist in implementing the ECOA. After the FRB amended Regulation B to expand the definition of an applicant to include guarantors, creditors were prohibited from requiring a spouse's guaranty even where a principal's personal guaranty was required. There are, however, limited exceptions where (1) the applicant requires unsecured credit and is relying, in part, on property that the applicant and spouse jointly own, and (2) where a married applicant requests unsecured credit and resides in a community property state, or if the property on which the applicant is relying in its credit decision is located in a community property state. Creditors who improperly obtain spousal guaranties are subject to the aforementioned monetary damages.

The courts of appeals are split on the enforceability of Regulation B's limits on spousal guaranties. The Eighth Circuit Court of Appeals in *Hawkins v. Community Bank of Raymore*[8] rejected the applicability of Regulation B's limits on spousal guaranties, deciding that the ECOA's definition of an applicant is unambiguous and does not include guarantors. In contrast, the U.S. Court of Appeals for the Sixth Circuit, in *RL BB Acquisition LLC v.*

6 *See* 15 U.S.C. § 1691(a).

7 *See* 15 U.S.C. § 1691(a)(b).

8 *Hawkins v. Cmty. Bank of Raymore*, 761 F.3d 937 (8th Cir. 2014).

Bridgemill Commons Development Group,[9] upheld the limits on spousal guaranties that Regulation B imposes, deciding that ECOA's definition of an applicant is sufficiently ambiguous to include a guarantor. In 2016, the U.S. Supreme Court, in a 4-4 split decision,[10] affirmed the Eighth Circuit's holding that rejected Regulation B's limit on, and the applicability of ECOA protections to, spousal guaranties because a guarantor is not an applicant. This holding is binding only on courts in the Eighth Circuit and does not enjoy nationwide enforceability. It will be left for the U.S. Supreme Court, with its full coterie of nine justices, to finally resolve the enforceability of Regulation B's limits on spousal guaranties.

Trade creditors should therefore continue to tread carefully when they seek spousal guaranties. Until the U.S. Supreme Court finally decides whether a guarantor is an applicant entitled to ECOA's protections, as well as on the enforceability of Regulation B's inclusion of guarantors as applicants, trade creditors seeking a spousal guaranty should continue to follow Regulation B's requirements or, alternatively, look to another risk-mitigation tool to increase the likelihood of payment of their claim.

F. Affiliate Guaranties

Trade creditors may also choose to seek guaranties from their buyer's parent company, subsidiaries and/or affiliates. Since businesses operations are often structured across multiple entities at different levels, it is important for trade creditors to understand how a particular buyer's business identifies potential guarantors. For example, a business may have separate entities that purchase goods and/or services and another entity that pays for goods and services purchased by subsidiaries and affiliates. Trade creditors should therefore carefully research and examine how a debtor's business is

9 *RL BB Acquisition LLC v. Bridgemill Commons Development Group LLC*, 754 F.3d 380 (6th Cir. 2014).

10 *Hawkins v. Cmty. Bank of Raymore,* 136 S. Ct. 1072 (2016).

organized, and use this analysis to determine whether to obtain guaranties from its customer's parent company, subsidiaries and/or affiliates.

Guaranties from parents, subsidiaries and affiliates can also play a key role if any one or more of these entities files a bankruptcy case. While holders of parent, subsidiary and affiliate guaranties might enjoy enhanced distribution prospects while the buyer is in bankruptcy, it is important to be mindful that such guaranties, particularly for upstream guaranties (*i.e.*, when a subsidiary guaranties debt of its parent) and affiliate guaranties (*i.e.*, where an affiliate guaranties the debt of another affiliate), could be avoided as fraudulent conveyances by a bankruptcy court under certain circumstances. Downstream guaranties (*i.e.*, where a parent guaranties the debt of a subsidiary) raise less of a fraudulent conveyance risk. Research and investigation are necessary to avoid potential negative consequences from subsidiary and affiliate guaranties in the event the subsidiary and/or affiliate files for bankruptcy.

A guaranty could be attacked as a fraudulent conveyance/transfer under § 548 of the Bankruptcy Code, or based on state fraudulent conveyance law arising under the Uniform Fraudulent Transfer Act, Uniform Fraudulent Conveyance Act or the recently promulgated Uniform Voidable Transfer Act. Bankruptcy Code § 548(a)(1) provides that a trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, such as a guaranty, that was made or incurred on or within two years before the date of the filing of the debtor's bankruptcy case as either an actual fraudulent transfer or as a constructively fraudulent transfer.[11]

Bankruptcy Code § 544 grants the trustee the right to avoid any transfer of property of the debtor or any obligation incurred by the debtor, such as a guaranty, to the extent it is avoidable under applicable state law.[12] This provides a trustee a longer four-to-six-year state law statute of limitations (depending on which state's law applies) to challenge fraudulent conveyances or transfers.

According to Bankruptcy Code § 548(a)(1)(A), a trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within two years before the date of the filing of the debtor's bankruptcy petition, if the debtor voluntarily or involuntarily made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud its creditors. This provision, unlike the

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11 Bankruptcy Code § 548(a)(1) provides, in relevant part:

> "The trustee may avoid any transfer ... of an interest of the debtor in property, or any obligation ... incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily —
>
> > (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
> >
> > (B)
> >
> > > (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
> > >
> > > (ii)
> > >
> > > > (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
> > > >
> > > > (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
> > > >
> > > > (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured;…

12 Bankruptcy Code § 544(b)(1) provides, in relevant part, that "the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim…."

constructive fraud provision in Bankruptcy Code § 548(a)(1)(B), requires a higher burden of proving that the transfer was made with actual fraudulent intent; it does not just require proof of insolvency, undercapitalization or receipt of less than reasonably equivalent value.

Bankruptcy Code § 548(a)(1)(B) enables a trustee to avoid several categories of transfers made, or obligations incurred on or within two years of the debtor's bankruptcy filing, where the debtor did not receive reasonably equivalent value for the transfer or obligation and the debtor was (1) insolvent at the time of the transfer or was rendered insolvent thereby; (2) engaged in business or a transaction, or was about to so engage, for which the debtor's remaining property constituted unreasonably small capital; or (3) intended to incur, or believed that it would incur, debts beyond the debtor's ability to pay as they matured.

A significant issue in constructive fraudulent conveyance litigation is whether a guarantor received reasonably equivalent value from the trade creditor in exchange for its guaranty. As discussed, upstream and affiliate guaranties are more susceptible to fraudulent conveyance risk because of the increased difficulty of proving that the guarantors benefitted from the guaranties. Central to a fraudulent transfer analysis among affiliated entities is determining what consideration the guarantor received in exchange for providing the guaranty. For instance, if a buyer's subsidiary is required to provide a guaranty to a trade creditor to backstop the buyer parent's purchase of the goods on credit terms and the subsidiary has not benefitted from the transaction, the issuance of the guaranty would be subject to attack as a constructively fraudulent transfer for lack of reasonably equivalent value to the subsidiary guarantor.

There has also been significant litigation over what constitutes unreasonably small capital. Many courts have defined unreasonably small capital as financial difficulty that falls short of, but will eventually lead to, insolvency. These courts have relied on an analysis of a debtor's working capital and ability to generate sufficient cash flow from its operations and sales of assets to regularly pay its debts and otherwise continue as a going concern. A debtor may be found to have unreasonably small capital where the debtor's projections were unjustifiably optimistic and inconsistent with the debtor's historical operating results. However, a debtor's failure to generate positive cash flow contrary to its projections does not suggest unreasonably small capital where its projections were reasonable and prudent at the time of the transfer. An example of a guaranty agreement is included as Form 3 in the Appendix.

G. Credit Insurance

While companies generally purchase insurance to protect them from risks of major losses on their buildings and equipment, in many instances their largest asset and a major source of risk — their accounts receivable — goes uninsured. Credit insurance is an option for trade creditors wishing to insure against that risk.

Credit insurance can be a useful tool to manage the risk of nonpayment from a buyer. However, it is important to fully understand the key provisions of credit insurance policies. This requires negotiating with carriers to resolve ambiguities in a policy's terms and obtaining an insurance policy that maximizes the amount of coverage and minimizes the risk of claim denials.

At a basic level, credit insurance protects a trade creditor from the risk of nonpayment that arises from the creditor's extension of credit terms to its buyer. While the policy will provide specific circumstances that will trigger credit insurance coverage, credit insurance is usually designed to insure against commercial risks or political or country risks. Examples of commercial risks include buyers' nonpayment, insolvency (including bankruptcy) and other defaults and, if stated in the policy, preference claims asserted by a bankruptcy trustee or debtor. Examples of political or country risks include the risk that an insured's foreign buyer, even if solvent and willing to pay, is unable to make payment because of some foreign government action preventing payment (*i.e.*, an embargo, war, insurrection or currency valuation issues).

Trade creditors buying credit insurance can tailor their policy to specific accounts. While insurers generally do not insure just the risky accounts that a trade creditor has "cherry-picked" for coverage, insurers often do insure categories of accounts. Credit insurance policies that insure all of a trade creditor's accounts (including creditworthy and credit-risky accounts) are referred to as "whole turnover." Credit insurance can also cover a portion of a trade creditor's accounts. For example, the majority of the business of many companies comes from a small portion of buyers, making a default by one of those buyers a threat to the trade creditor's continued solvency. In such a situation, a trade creditor might be able to insure its key concentration accounts. A trade creditor may also want to insure a single account or a single contract or sale.

1. Two Types of Credit Insurance Policies

There are two basic types of credit insurance policies: cancelable and non-cancellable. When a trade creditor buys cancellable insurance, the insurance company works with the other protocols the trade creditor already has in place. Credit insurers maintain databases, covering many large companies and their insureds' buyers, that allow insurers to observe the buyers' creditworthiness and alert insureds of changes in their buyers' outlook.

When a trade creditor purchases cancellable insurance, the insurance company sets the credit limits for each account of an insured based on how the insurer rates the account's credit risk. Typically, a trade creditor can make an online request for the insurer to set a credit limit for a particular account. If the credit limit requested is at or below the insurer's predetermined limit, approval is automatically granted. If the amount requested exceeds the predetermined limit, the insurer's underwriters review the request and determine whether or not such request should be approved.

While monitoring a particular account, if the insurer observes a diminution of the buyer's creditworthiness, the insurer may cancel or reduce the credit limit it had previously approved, hence the term "cancellable." As long as the policy is appropriately drafted, and the insurer is acting in good faith, such a reduction in, or cancellation of, credit limits will apply only to future transactions but will likely not affect transactions that precede the insurer's notification of the reduction or cancellation. Additionally, while the reduction or cancellation in credit limits increases exposure to the trade creditor for future transactions with the buyer, the trade creditor is at least made aware of potential additional credit risk, enabling the trade creditor to make an educated decision as to whether to extend additional credit to the relevant buyer going forward.

The second type of insurance is non-cancellable. As the name suggests, an insurer cannot unilaterally reduce or cancel the credit limit assigned to a particular buyer. When an insurer sells non-cancellable insurance, the insurer basically trusts the trade creditor's credit-management practices. As a result, unlike cancellable insurance, where the insurer is actively involved in credit decisions, an insurer's underwriting of a non-cancellable policy tends to be more "hands-off." A trade creditor might negotiate for greater "discretionary credit limits" in order to have more control in assigning credit limits to its accounts (though larger buyers might require insurer approval).

2. Benefits of Credit Insurance

A properly negotiated credit insurance policy can provide a trade creditor with multiple financial benefits, but these benefits are not automatic. Instead, they require that a trade creditor be proactive to ensure that its credit insurance policy is the best that could be negotiated and takes into account the trade creditor's contracts with its buyers.

When properly implemented and understood, credit insurance can be a safety net against losses stemming from nonpayment of accounts receivable. More realistically, it can be a dependable credit-management tool, bolstered by the monitoring resources of global insurance carriers. Trade creditors with credit insurance may also be able to increase sales under the fact-specific circumstances due to their ability to extend more favorable credit terms to existing buyers and extend credit to new buyers with a thoroughly crafted insurance policy backstopping those sales. An insured trade creditor may also have increased access to borrowing or reduced interest rates, as lenders see credit insurance as additional security for their loans.

3. Understanding a Credit Insurance Policy

A trade creditor should be proactive to maximize and obtain the benefits of credit insurance. It is insufficient to simply purchase a policy and then place it in a drawer and otherwise ignore it until a loss occurs. Rather, a trade creditor should understand and review its policies at the purchase and renewal stages. Failure to do so could result in an unwelcome surprise (*i.e.*, no coverage) when a buyer defaults by becoming insolvent or otherwise fails to pay the trade creditor.

Insurers rely on technicalities to avoid paying claims, because credit insurance policies are usually not drafted in a straightforward manner and may contain many obscure requirements and limitations. A proactive trade creditor can protect itself by fully understanding (1) the policy terms and conditions, (2) the precise accounts and sales of goods and/or services that are covered, (3) the accounts and risks that are not covered, (4) any affirmative obligations required to maintain coverage and (5) opportunities to eliminate or modify policy provisions that increase the likelihood of coverage denial.

4. Components of a Credit Insurance Policy

A credit insurance policy, like most insurance policies, will be typically comprised of a declarations page, a main coverage form and endorsements. The declarations page (or dec page) is a summary of the policy's fundamental terms. It identifies the insured, the term of the policy, the premium (or how it will be calculated), the limits of liability (*i.e.*, the maximum financial obligation of the insurer), and the deductible and/or co-insurance (which are amounts the insured must pay in the event of a loss).

The main coverage form is the crux of the insurance policy. Often, it is a standardized form that contains the technical policy language, defines the scope of coverage and imposes obligations on the insured. The form includes an insuring agreement that should specifically define the types of losses that are covered by the policy and the events that trigger an insurance claim.

Exclusions in the policy list those losses that the policy does not cover through the insuring agreement and are frequently the grounds for denial of insurance coverage. Theoretically, exclusions should clearly articulate the specific losses that are not covered. Common exclusions include claims that are not filed with the insurer in a timely fashion, sales that occur after the trade creditor discovers the buyer's default or insolvency, the trade creditor's agreement to extend terms or agree to a payment plan with a defaulting buyer without the insurer's consent, and the trade creditor's failure to report on a past due or insolvent buyer. Generally, transactions or sales that a buyer disputes are also excluded. Disputed transactions often only become covered under a policy after the trade creditor has vindicated its right to payment through legal action against its buyer and the entry of a final judgment covering what remains outstanding.

Policies incorporate terms that are defined in the definition section of the main coverage form because of the technical nature of insurance contracts. A trade creditor must have a good understanding of the definitions in an insurance policy in order to have a proper understanding of the policy itself. The ordinary and common meaning of a word can be meaningfully changed by a specific policy definition. As may be expected, terms are often defined in a manner that limits coverage.

Policy endorsements, which are amendments to the main coverage form, are used to customize a policy to a particular trade creditor's needs because the main coverage form typically contains boilerplate language. Endorsements are the means by which an insurer and the insured agree on the addition of negotiated terms for the policy.

When reviewing a credit insurance policy, it is also important to be aware of the following key issues:

- *Avoid Uncertainty.* Provisions in a policy that are vague or otherwise unclear should be redrafted to ensure that they are precise when a policy is purchased or renewed. Insurers often use unclear language to limit their obligations and to potentially deny claims. By seeking clarification at the outset, or prior to the renewal of a policy, a trade creditor can eliminate avenues that an insurer can use in the future to deny claims.

- *The Trigger of Coverage Should Conform to the Trade Creditor's Practices and Agreements.* Policies vary in how they provide coverage for the sale of goods at different stages of the delivery process. Many policies are triggered upon the "shipment" of goods. It is important that a trade creditor review the definition of "shipment" to ensure that it aligns with the trade creditor's actual delivery practices and contract terms. For example, some policies provide that "shipment" only occurs when the product leaves an insured's control and passes into the buyer's exclusive physical possession. This may be problematic for a trade creditor that ships its goods to a third party, such as a drop shipment of goods, as coverage will not be triggered once the goods leave the trade creditor's control. It is important that these issues are given careful consideration when negotiating the policy terms.

- *Deductible and Co-Insurance.* It is extremely rare for a credit insurance policy to make an insured completely whole. Policies almost always contain deductibles and co-insurance. A deductible is a fixed dollar amount that the trade creditor must fund before the insurance company is required to pay. Once a deductible is triggered, co-insurance is the percentage of the loss that the trade creditor must bear. It is important to understand the order in which the deductible and co-insurance apply, as this will affect the ultimate amount of recovery. For example, if there is a claim for $1 million where the policy has a $100,000 deductible and 10 percent co-insurance, the trade creditor would recover $810,000 if the deductible is applied first. By contrast, the trade creditor would recover $800,000 if the 10 percent co-insurance is first applied.

- *Preference Risk.* When a financially distressed buyer makes a payment to a trade creditor within 90 days of the buyer's bankruptcy filing, a bankruptcy trustee or a debtor can seek to recover that payment as a preference. Some insurance policies exclude preference risk, while others are silent. Some policies do insure for preference risk, which is something trade creditors should seek to obtain. It is especially important that the trade creditor complies with the policy requirements regarding their exposure on preference claims to minimize the risk of a claim being denied. Policy requirements include immediately providing notice to the carrier of the preference claim, pursuing "all defenses" and legal "remedies available," and securing insurer approval for "each action" taken to defend the claim and of any settlement of the preference claim. In addition, the trade creditor should be aware of provisions requiring retention of the identical policy with the same insurer and renewing the policy as a condition to retain the insurance for preference risk.

- *Notice.* Policies contain strict notice requirements. Failure to comply with these requirements could result in a denial of coverage for an otherwise valid claim. The trade creditor should timely notify the insurer about buyers that are insolvent or past due on their obligations. As soon as a default occurs, the trade creditor must timely notify the carrier, then timely file its claim.

- *Sharing Recoveries.* A trade creditor should carefully review the policy provision dealing with recoveries from the buyer. The trade creditor should reject any provision that enables the insurer to first recover all payments it had made to the trade creditor. The trade creditor should push for an equitable sharing of recoveries based on the allocation of the loss between the insurer and the trade creditor.

- *Subrogation.* Credit insurance policies generally give the insurer subrogation rights, which allow the insurer to step into the shoes of the trade creditor to try to recover unpaid amounts from the buyer. These rights may violate anti-assignment provisions in the insured's contracts with its buyers. A trade creditor can work around this scenario by negotiating for a subrogation provision that only allows assignment of the trade creditor's right to proceeds, rather than all of the trade creditor's rights under the contract with the buyer.

While credit insurance can be a powerful tool for protecting a trade creditor's accounts receivable, it is a tool that must be well understood and handled with care. Because coverage is not always what it appears, a trade creditor that fails to fully understand a credit policy's content could end up jeopardizing its largest asset: robust coverage under the policy.

H. Accounts Receivable Put Agreements

A trade creditor can purchase an "accounts receivable put" (a put) to more quickly monetize its claim and increase the likelihood of a recovery on its claim. A trade creditor typically purchases a put from a financial institution or large investment fund.

A put allows a trade creditor to purchase the right to "put" (*i.e.*, sell) and assign outstanding receivables owed by a financially distressed buyer to a put counterparty and compel that put counterparty to purchase the receivables in accordance with the terms of the put agreement. The purpose of a put is to protect a trade creditor if its buyer experiences an adverse credit event identified in the put agreement. An adverse credit event could include a bankruptcy filing by or against the buyer, a foreclosure on all of the buyer's assets, or a liquidation. Put coverage usually only covers a single financially distressed company, but it can cover affiliated entities if there is enough public information available and the companies are actively traded on the loan, bond or credit default swaps markets.

Put coverage is usually available for all or a portion of the outstanding receivables owed by a buyer, subject to a cap in coverage and other restrictions contained in the put agreement. This contrasts with "credit insurance" coverage, which is limited to accounts that arise after the inception of insurance coverage. Also in contrast to credit insurance, a put usually does not cover protracted nonpayment and preference risks. Unlike credit insurance, a put is not subject to cancellation or modification of its terms.

The primary benefit of entering into a put is to allow a trade creditor to receive cash immediately on its accounts receivable, rather than dealing with a several-year delay while the bankruptcy case unfolds and potentially receiving no distribution on a claim. A trade creditor may also book a profit on a claim that may have already been written down for accounting and/or tax reasons to an amount that is less than the sale price of the claim. A sale of the claim for cash also avoids the risk that the trade creditor's sole recovery on its unsecured claim is stock or other instruments issued by the reorganized debtor.

Parties that sell put coverage are motivated by the large fees put transactions generally demand. They are also gambling that an adverse credit event defined in the put agreement will not occur prior to the termination of the put. Put counterparties might also be incentivized by the prospect of making a profit on the claims they purchase; this profit would be based on the difference between the purchase price they pay the trade creditor for the accounts receivable and the anticipated dividend to be paid by the debtor on the claim. A put counterparty might also want to acquire claims to gain control of the debtor. If a put counterparty obtains a significant portion of the debtor's unsecured claims, it may act as the proponent of a bankruptcy plan that substitutes equity for debt. Under these circumstances, a put counterparty could either manage or sell the debtor following emergence from bankruptcy.

A put is typically very costly because it is usually purchased to cover a certain amount of receivables owing by a single financially distressed buyer. The riskier the credit, the more expensive the coverage. Put coverage is usually priced monthly and is either paid monthly or all up front. Put coverage is often far more expensive than the cost of obtaining credit insurance. A trade creditor's risk-mitigation options narrow when credit insurance coverage is reduced or no longer available, leaving a put as the only option to protect against nonpayment risk.

Following the occurrence of an adverse credit event, a trade creditor can exercise its rights under the put agreement. Following satisfaction of all the conditions for closing on the put, the trade creditor assigns the outstanding accounts receivable to the put counterparty.

The timing of a put counterparty's obligation to pay the purchase price is based on the terms of the put agreement. Once a trade creditor satisfies these terms, the put counterparty pays the trade creditor the par value (100 percent) of the creditor's claim subject to the put, or a pre-determined purchase rate based on a percentage of the face amount of the claim. This contrasts with credit insurance, where recovery is reduced by a deductible and potential co-insurance involving a sharing of the loss between the insurer and insured.

The agreement governing a put is very technical and frequently contains numerous pitfalls, conditions and technical requirements that could result in the trade creditor's inability to ever actually exercise the put. It is important for trade creditors to consult a legal advisor with extensive experience negotiating put agreements to review and negotiate the terms of the agreement. This will help to ensure that the thousands of dollars spent on put protection will buy coverage that can actually be used following an adverse credit event.

The more important issues to consider regarding put arrangements are:

1. *A put can only be exercised during its term.* If no adverse credit event occurs prior to its termination, the trade creditor is out of luck. The triggering event is usually the buyer's bankruptcy. The creditor should also attempt to negotiate the broadest possible definition of a triggering event. Such events should include the insolvency of, the filing of an assignment for the benefit of creditors by, the filing of a voluntary bankruptcy case by the buyer, an involuntary bankruptcy case being filed against the counterparty, the appointment of a receiver for the buyer's assets, a secured party's foreclosure on the customer's assets, or similar events. It is unlikely a trade creditor will successfully negotiate put coverage based solely on nonpayment of the trade creditor's claim.

2. *The put counterparty usually only wants to purchase the most recent invoices owing by the buyer.* These invoices will likely include administrative priority claims under Bankruptcy Code § 503(b)(9), covering goods that the trade creditor had sold and delivered to the buyer within 20 days of the buyer's bankruptcy filing. These claims have a far greater likelihood of recovery in bankruptcy based on their administrative priority status. On the other hand, a trade creditor would prefer to first sell its older, less valuable, invoices and retain the more valuable § 503(b)(9) invoices.

3. *A trade creditor should ensure that it is purchasing put coverage on the correct buyer entity.* A trade creditor might be doing business with a buyer with many affiliated entities. It is imperative that put coverage be purchased for the company from which the accounts subject to the put are actually due and owing. Otherwise, put cov-

erage will likely be disclaimed by the put counterparty and end up being worthless.

4. *A trade creditor's ability to assign its claims might be hindered by the bankruptcy court's approval of an order restricting trading of claims.* The put agreement could contain a provision that prevents a closing on the put, or that permits the put counterparty to compel the trade creditor to repurchase the claim upon the entry of an order restricting claims trading. These are extremely technical provisions and should be reviewed by experienced legal counsel.

5. *Put agreements might include several conditions on the put counterparty's obligation to close, including sending notices and supplying information to the put counterparty, such as invoices, bills of lading and other sale-related documents.* It is important to understand exactly which documents and notices need to be delivered and when.

It is also important that the trade creditor be able to close on the put when it delivers the documentation in support of its claim, and certainly not later than the filing of the schedules of assets and liabilities in a bankruptcy case reflecting the receivable subject to the put as a liability of the buyer. Put agreements often condition a put counterparty's obligation to close upon the bankruptcy court's approval of a final order allowing the claims subject to the put. This will likely delay payment for months or years and preclude payment if there is no final order entered allowing the claim. The trade creditor will also likely have to pay significant attorneys' fees to obtain an order allowing the claim.

Put coverage might also be available for accounts receivable owing by a buyer in chapter 11 based on credit extended to the buyer during the bankruptcy case. A trade creditor should carefully review the conditions that must be satisfied for exercising a put to compel the purchase of a chapter 11 administrative claim. For example, a put agreement for the purchase of a chapter 11 administrative claim could condition the trade creditor's exercise of the put on the occurrence of any one of the following events:

(1) a court order converting the buyer's chapter 11 case to a chapter 7 case; (2) the authorization of the buyer not to pay administrative expense claims incurred in the ordinary course of the buyer's business; or (3) the confirmation of a chapter 11 liquidating plan.

It is rare that a put agreement will condition a trade creditor's ability to compel the purchase of its chapter 11 administrative priority claim upon the buyer's failure to timely pay the post-petition claim. Unless the put agreement enables the trade creditor to exercise the put and compel the purchase of its chapter 11 administrative claim at a fixed purchase price upon the buyer's failure to timely pay the claim, or the buyer places a moratorium on payment of all post-petition vendor claims, the put might never be exercisable.

A put agreement could also condition the closing on the purchase of a chapter 11 administrative claim on the purchaser's receipt of an acknowledgment from the buyer that the claim is an administrative claim that is due and owing and not disputed. Alternatively, the agreement might require the filing of schedules showing the administrative claim in the correct amount and not disputed. Neither condition might be capable of ever being satisfied. The agreement might also condition closing on the put on the bankruptcy court's approval of an order allowing the administrative claim. The creditor might not be able to satisfy this condition without retaining counsel, and there could be significant costs and delays in obtaining such an order.

The actual sale of a claim is confirmed through an assignment-of-claim agreement entered into between the trade creditor and the put counterparty. The agreement provides for the put counterparty's purchase of the entire claim. The trade creditor should negotiate for the put counterparty to immediately pay the purchase price based on the face amount of the claim at the closing. The trade creditor should also negotiate for an obligation to repurchase (*i.e.*, the trade creditor must buy back) the claim only upon disallowance of the claim, as opposed to an easier-to-satisfy "impairment" of the claim standard, and seek to minimize the amount of interest payable upon repurchase.

The full purchase price of the claim might not be immediately payable. The amount that the put counterparty is obligated to pay upon the closing on the sale of the claim subject to the put might be based on the undisputed amount of the trade creditor's claim, as set forth in the buyer's bankruptcy schedules. The put agreement should compel the purchaser to pay the disputed portion of the claim based on the purchase price in the assignment-of-claim agreement once the disputed claim is allowed by the bankruptcy court, which might not occur until several years after the sale of the claim. Beware of an agreement that omits any of these protections and gives the put counterparty the option to pay for the disputed portion of the claim after it is allowed. For all practical purposes, this provision enables the put counterparty to avoid paying for the disputed portion of the claim in the event that all or a portion of the claim is eventually allowed.

Since the put counterparty will likely be recognized by the buyer as the claimant, the trade creditor should make sure that the put agreement requires the put counterparty to give the trade creditor notice of any objection to the claim and the opportunity to defend the objection. Otherwise, the put counterparty will have little motivation to defend the objection, and the trade creditor will either be compelled to repurchase the disallowed portion of the claim or lose the opportunity to obtain allowance of any portion of the disputed claim.

Finally, a trade creditor considering entering into a put agreement should be cognizant of the put counterparty's financial condition. By entering into a put agreement, the trade creditor is replacing the unsecured obligation of the buyer to pay the claim with the put counterparty's unsecured obligation to purchase the claim upon exercising the put.

Before entering into a put agreement and paying an expensive put fee, the trade creditor should have sufficient financial information confirming the put counterparty's ability to purchase the creditor's claim upon a trigger event. Otherwise, the creditor risks paying a high put fee and obtaining worthless put coverage as a result of an uncollectible claim against the put counterparty.

A trade creditor might be able to monetize its claim by entering into a put agreement, but while this will provide some protection, the trade creditor should retain experienced legal counsel and read the fine print of the agreement, and otherwise be satisfied that it will actually get the benefit of its bargain.

Chapter III

STATE LAW RIGHTS AND REMEDIES

A. Adequate Assurance Under UCC § 2-609

Trade creditors will inevitably hear reports from various sources about the financial troubles of some of their buyers, including credit downgrades, loss of market share, liquidity issues, debt defaults and forbearance arrangements, significant decreases in stock and bond prices, termination or resignation of a key employee, formation of a bondholders' committee, the loss of a major customer, etc. While these reports might be based on unfounded rumors or industry gossip, persistent reports of a buyer's financial struggles, especially from trustworthy sources, could justifiably prompt a trade creditor to fear that its buyer's distressed financial condition will leave the buyer unable to perform under its contract with the trade creditor. For example, a trade creditor may discover (through credible sources in the industry, news accounts, informal investigation, etc.) that a financially distressed buyer is contemplating a bankruptcy filing.

The trade creditor might have a legitimate concern that if it sells goods on credit terms to the buyer according to the terms of their contract, the buyer might not timely pay for the goods and instead leave the trade creditor with a general unsecured claim, with little recovery potential in the buyer's bankruptcy case. Under these circumstances, the trade creditor is not necessarily required to choose between either (1) risking breaching its contract with the buyer by stopping delivery of goods or provision of services (or switching to cash-in-advance terms), or (2) risking nonpayment by a buyer that ends up filing for bankruptcy. Instead, the trade creditor can proactively protect against its risk of loss by demanding that the buyer provide adequate assurance of performance under their contract. A trade creditor's right to adequate assurance of the buyer's performance under their contract arises under UCC § 2-609(1), which states as follows:

> A contract for sale imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either party, the other may in writing demand adequate assurance of due performance and until he receives the assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return.

In order for a trade creditor to avail itself of the right to compel adequate assurance of a buyer's ability to perform all of its obligations under its contract with the trade creditor, including timely payment of the trade creditor's claim, the trade creditor must have "reasonable grounds for insecurity" that its buyer will be unable to pay the seller (trade creditor). If the requisite reasonable grounds for insecurity exist, the seller can demand a wide range of accommodations from the buyer to provide assurance that the buyer can perform under the contract (*e.g.,* make timely payment). For instance, the trade creditor can request that the buyer post a letter of credit in the trade creditor's favor, switch the payment terms of the transaction to cash in advance of delivery, seek the issuance of a third-party guarantee by a creditworthy third party in the trade creditor's favor, or request something as simple as written confirmation that the buyer's conduct that created the insecurity will not be repeated. Once the trade creditor sends its demand for adequate assurance, the trade creditor can suspend performance of its obligations under its contract with the buyer pending a suitable response from the buyer. The buyer then has up to 30 days to respond to the demand. The buyer's failure to timely respond to the demand is considered a repudiation (*i.e.,* termination of the contract) by the buyer, and the trade creditor is free to sue the buyer for breach of contract.

A trade creditor that suspends performance of its obligations under its contract with a financially distressed buyer minimizes the risk of loss that may subsequently occur if the buyer defaults and is unable to pay the trade creditor's invoices. A trade creditor's demand for adequate assurance could prevent a small loss from becoming a large loss that seriously disrupts the trade creditor's cash flow and overall business. At a minimum, a trade creditor's exercise of its adequate assurance rights also gives the trade creditor the opportunity to negotiate changes to its contract with the buyer (*e.g.,* by reducing credit terms or obtaining a cash deposit, letter of credit or guarantee) to help minimize the trade creditor's potential losses.

There is an additional strategic benefit to a trade creditor requesting adequate assurance from a buyer on the verge of filing for bankruptcy. As discussed, if the trade creditor requests adequate assurance and the buyer fails to timely provide it, the trade creditor can repudiate the contract. A contract that is repudiated cannot be assumed (*i.e.,* reaffirmed) by the buyer if the buyer later files for bankruptcy. Moreover, in bankruptcy, a trade creditor is usually obligated to perform according to the terms of the contract up until the conclusion of the bankruptcy, at which time the buyer must decide whether to assume or reject the contract. Demanding adequate assurance prior to the buyer's bankruptcy may allow the trade creditor to avoid being locked into a contract with a buyer in bankruptcy. A detailed discussion of a trade creditor's rights under its pending executory contract with a buyer in bankruptcy is contained in Chapter IV of this *Manual*.

The requirements of UCC § 2-609 appear on their face to be simple and straightforward. However, a trade creditor must carefully determine whether and how to satisfy each of these requirements prior to exercising this remedy. For example:

- What are the trade creditor's specific reasonable grounds for insecurity?
- How does the trade creditor make a proper demand for adequate assurance?

- What types of adequate assurance might a trade creditor reasonably request?
- How long does the buyer have to respond to the trade creditor's adequate assurance demand?
- What can the trade creditor do if the buyer fails to respond to the trade creditor's adequate assurance demand, or the buyer's response is inadequate?

1. Grounds for the Trade Creditor's Insecurity

Although the phrase "reasonable grounds for insecurity" is rather vague, the courts and the Official Comments to the UCC provide the following guidance for trade creditors that wish to make an adequate assurance demand:

- *"Insecurity" is fact-sensitive.* Whether a trade creditor has reasonable grounds for insecurity will depend on the specific facts surrounding its relationship with the buyer.[13] For example, absent unusual circumstances, a single late payment from a Fortune 500 company buyer will rarely cause a trade creditor to reasonably become insecure. However, a late payment from a new buyer with a small revenue base could justify a trade creditor's request for adequate assurance from the buyer prior to performing under the contract. A trade creditor's insecurity must be based on objective facts, not a subjective feeling of insecurity.[14] The trade creditor should focus attention on the buyer's exact words or actions, the course of deal-

13 *Remuda Jet Five LLC v. Embraer-Empressa Brasileira de Aeronautica S.A.*, 2012 WL 1142296, at *9 (S.D.N.Y. Mar. 27, 2012) (in no reported case has court disposed of complaint based on § 2-609 on motion to dismiss).

14 *Universal Res. Corp. v. Panhandle Eastern Pipe Line Co.*, 813 F.2d 77, 79 (5th Cir. 1987) (demand for adequate assurance not justified when "alleged insecurity arose from purely subjective evaluations and projections and was not based on any objective, identifiable conduct").

ing or performance between the particular parties, and the nature of the industry.[15]

- *Insecurity is not contract-specific.* The grounds for insecurity do not need to arise from, or be directly related to, the agreement between the parties.[16] For example, a trade creditor can demand adequate assurance from a buyer that is not past due on the trade creditor's invoices if the buyer terminates or otherwise loses its Chief Executive Officer, Chief Financial Officer or another senior officer; loses its line of credit with its lender; or fails to pay other creditors.

- *Grounds for insecurity must arise from activity after contract formation.* A trade creditor cannot rely on events that occurred prior to the inception of its contract with the buyer as grounds for insecurity to justify invoking its UCC adequate assurance rights.[17] The rationale is that a trade creditor cannot feel threatened about pre-contract events because the trade creditor entered into the contract with knowledge of such events and they became a part of the overall bargain between the parties. For instance, a party to a contract for the sale of gas did not have a reasonable ground for insecurity where the party was aware of the risk that the supplier had lacked sufficient reserves to supply the gas in the future when they had entered into their contract.[18]

15 *Koursa Inc. v. Manroland Inc.*, 971 F. Supp. 2d 765, 790 (N.D. Ill. 2013) ("Insolvency of the other party may constitute reasonable grounds for insecurity when the circumstances surrounding the insolvency suggest that it will impair the insolvent party's ability to perform.").

16 U.C.C. § 2-609, Cmt. 3 ("[T]he grounds for insecurity need not arise from or be directly related to the contract in question."); *see also Brisbin v. Superior Valve Co.*, 398 F.3d 279, 287 (3d Cir. 2005) (request for adequate assurance "need not be tied to a contractual right"); *By-Lo Oil Co. v. ParTech Inc.,* 11 Fed. Appx. 538, 543-544 (6th Cir. 2001) ("[G]rounds need not be the actions or inactions of a contracting party — outside circumstances may be sufficient."); *Toppert v. Bunge Corp.*, 60 Ill. App. 3d 607 (failure to pay under prior contracts); *Hornell Brewing Co. Inc. v. Spry,* 174 Misc. 2d 451, 457 (Sup. Ct. 1997) ("Reasonable grounds for insecurity can arise from the sole fact that a buyer has fallen behind in his account … even where the items involved have to do with separate and legally distinct contracts....").

17 *See By-Lo Oil Co. Inc,* 11 Fed. Appx. at 544 ("The grounds that give rise to this feeling have to be something that occurred after the contract was in place."); *Universal Res. Corp.,* 813 F.2d at 77; *Nasco Inc. v. Dahltron Corp.,* 392 N.E.2d 1110 (Ill. App. Ct. 1979); *Inamco Inc. v. Celsius Servs. Corp.,* 526 So. 2d 334, 336 (La. Ct. App. 1988); *Jonnet Dev. Corp. v. Dietrich Industries Inc.,* 463 A.2d 1026, 1032-33 (Pa. Super. Ct. 1983).

18 *Universal Resources Corp.,* 813 F.2d at 79 ("[T]here was no event occurring *after* the execution of the Agreement which could have given rise to a reasonable insecurity.").

- *Commercial Standards.* Merchants[19] must use "commercial standards" to determine whether insecurity exists.[20] This requires that the trade creditor act in good faith when making its adequate assurance demand.[21] For example, a buyer's email with a subject heading referencing the cancellation of the contract justified a seller's insecurity that warranted demanding adequate assurance under commercial standards.[22]

- *Trade creditors can rely on trustworthy third-party sources.* The grounds for a trade creditor's insecurity do not have to come directly from the buyer. Rather, third parties can be the source of the information.[23] However, a trade creditor will have to determine the credibility of the source and determine, based on commercial standards, that grounds for insecurity exist to justify invocation of its adequate assurance rights. In making this determination, a trade creditor must consider that some

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19 U.C.C. § 2-104(1) defines a merchant as "person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill."

20 *See* U.C.C. § 2-609(2) ("Between merchants, the reasonableness of grounds for insecurity and the adequacy of any assurance offered shall be determined according to commercial standards."). *See also Coupled Prods. LLC v. Component Bar Prod. Inc.*, 2010 WL 4694406, at *3 (E.D. Mich. Nov. 12, 2010) (reasonable grounds for insecurity are to be determined by commercial standards); U.C.C. § 2-609, Cmt. 3; *ARB (Am. Research Bureau) Inc. v. E-Sys. Inc.*, 663 F.2d 189, 196 & n.10 (D.C. Cir. 1980); *Diskmakers Inc. v. DeWitt Equip. Corp.*, 555 F.2d 1177, 1179 (3d Cir. 1977); *Hope's Architectural Prod. Inc. v. Lundy's Constr. Inc.*, 781 F. Supp. 711, 715 (D. Kan. 1991).

21 Good faith between merchants means "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." U.C.C. § 2-103(l)(b).

22 *Validsa Inc. v. PDVSA Servs.*, 632 F. Supp. 2d 1219, 1230 (S.D. Fla. 2009), *aff'd in part and rev'd in part on other grounds,* 424 Fed. Appx. 862 (11th Cir. 2011) (affirmed lower-court holding that seller had reasonable grounds for insecurity to make written adequate assurance demand; reversed on whether buyer had provided adequate assurance of performance). The buyer's language in the email ("any pending payment … be suspended," and "effective immediately — it is ordered that [the contract] be cancelled"), "standing alone, would suffice to give any seller of goods reasonable grounds for insecurity." The seller's insecurity was bolstered by the following: (1) the email also contained a string of messages demanding the cancellation of the contract by the buyer's in-house counsel and head of its food-procurement program; and (2) the buyer was connected to a third party who demanded a kickback from the seller as a condition for continuing the contract.

23 U.C.C. § 2-609, Cmt. 3 ("[A] report from an apparently trustworthy source that the seller had shipped defective goods or was planning to ship them would normally give the buyer reasonable grounds for insecurity."); *Clem Perrin Marine Towing Inc. v. Panama Canal Co.*, 730 F.2d 186, 191 (5th Cir. 1984) (phone call from third party during which lessee learned that lessor was experiencing financial difficulties raised grounds for insecurity that justified lessee's withholding of payment due to lessor under lease/purchase agreement concerning vessel).

third parties may pass false information in the hope of gaining business after a contract is repudiated.

A trade creditor has many resources to obtain information to support a finding of insecurity in addition to direct communications from the buyer, which obviously could call into question the buyer's ability to perform under the contract. Alternative avenues that could include additional information to provide grounds for insecurity about the buyer include:

- credit check;
- information from an industry credit group;
- Standard & Poors/D&B/Moody's reports;
- UCC, judgment, lien and litigation searches;
- reporting services focusing on distressed companies, such as Reorg Research, Debtwire, *The Daily Deal*, *Daily Bankruptcy Reports*, Bloomberg reports;
- EDGAR/SEC reports;
- credible analyst reports; and/or
- information found in reputable business or trade journals.

Under certain circumstances, an individual factor may give rise to a reasonable ground for insecurity.[24] The courts have also recognized the following as potentially providing grounds for insecurity:

24 *See* the factors listed under "Warning Signals" in Chapter I of this *Manual*.

- The buyer is past due with a trade creditor;[25]
- The buyer is past due with its other creditors;[26]
- The buyer threatened not to perform under the contract and/or sought to modify the terms of the contract;[27]
- The buyer defaulted on a loan covenant or other provision of the loan agreement with its lender;[28]
- There has been no renewal of the buyer's credit line with its lender;
- The buyer delays providing financial and other information (including repeated failure to respond to phone calls);[29]
- There has been increased frequency of post-dated checks or held checks, or checks were sent without any funds in the buyer's bank account;[30]

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25 U.C.C. § 2-609, Cmt. 3 states that "[A] buyer who falls behind 'his account' with the seller, even though the items involved have to do with separate and legally distinct contracts, impairs the seller's expectation of due performance." *See Reich v. Republic of Ghana,* 2002 WL 142610, at *4 (S.D.N.Y. Jan. 31, 2002); *Easco Corp. v. Perkowski,* 1987 U.S. Dist. LEXIS 15431(E.D. Mich. Apr. 16, 1987) (reasonable grounds for insecurity when guarantor failed to make payments after customer failed to pay); *Hornell Brewing Co. v. Spry,* 664 N.Y.S.2d 698, 703 (N.Y. Sup. Ct. 1997) (a vendor may be considered reasonably insecure if the buyer is in substantial arrears with a supplier, lacks sufficient financing, bounces checks and fails to sell even a small fraction of the product supplied); *RAD Concepts Inc. v. Wilks Precision Instrument Co.,* 167 Md. App. 132, 155, 168-169 (2006) (seller had reasonable grounds for insecurity where the buyer fell behind in payment and avoided seller's phone calls); *In re Amica Inc.,* 135 B.R. 534, 551 (Bankr. N.D. Ill. 1992) (seller was "obviously insecure" due to long period of buyer's repeated nonperformance of its duty to make several required payments under a contract).

26 *Clem Perrin Marine Towing Inc.,* 730 F.2d at 191 (lessor's failure to pay mortgages on vessel subject to lease/purchase agreement were grounds for insecurity).

27 Threat not to perform may also constitute anticipatory repudiation under U.C.C. § 2-610 *(see infra* Chapter II of this *Manual*); *see also Kaiser-Francis Oil Co. v. Producer's Gas Co.,* 870 F.2d 563, 568-69 (10th Cir. 1989) (refusal to perform coupled with request for modification were grounds for insecurity); *Copylease Corp. of Am. v. Memorex Corp.,* 403 F. Supp. 625, 631 (S.D.N.Y. 1975) (declaration that contract is invalid and threatening not to perform were grounds for insecurity).

28 *McNeal v. Lebel*, 157 N.H. 458, 953 A.2d 396 (2008) (failure to make interest payments, due to lender's cessation of disbursing loan proceeds, was reasonable ground for insecurity).

29 *RAD Concepts Inc. v. Wilks Precision Instrument Co. Inc.,* 167 Md. App. 132, 155, 168-69 (2006) (noting that seller had reasonable grounds for insecurity where buyer fell behind in payments and would not take seller's telephone calls); *Erwin Weller Co. v. Talon Inc.,* 295 N.W.2d 172 (S.D. 1980) (holding that amount of credit extended by seller to buyer along with failure of buyer's president to respond to seller's attempts to discuss were reasonable grounds for insecurity).

30 *Morrsion Iron & Steel Co. v. Charal Metal Co.,* 1986 U.S. Dist. Lexis 20297 (E.D. Pa. 1986) (buyer issued checks without any funds in its bank account).

- The has been an increased frequency of bounced checks;[31]
- There is a loss of trade credit/downgrade of credit rating;[32]
- There is other evidence of the buyer's insolvency;
- There have been rumors of the buyer's bankruptcy filing;[33]
- There has been a sudden expansion of a buyer's credit line;[34]
- There has been suspicious activity by a buyer in suddenly stopping utilization of a price discount for early payments;[35] and
- The seller is found to be delivering defective products to other buyers (in circumstances where the buyer is the potentially insecure party).[36]

Although many scenarios might provide grounds for insecurity, the reasonableness of a party's insecurity remains subject to judicial review. For example, in *BAII Banking Corp. v. UPG Inc.*,[37] the court held that a buyer of petroleum had unreasonably asserted grounds for insecurity when it

31 *Hornell Brewing Co. v. Spry*, 664 N.Y.S.2d 298, 703 (N.Y. Sup. Ct. 1997).

32 *Puget Sound Energy Inc. v. Pac Gas & Elec. Co. (In re Pac. Gas & Elec. Co.),* 271 B.R. 626, 641 (N.D. Cal. 2002) (adequate basis for insecurity may be established where a company announced, in its Form 8-K, an impending bankruptcy and credit-rating downgrades from Standard & Poor's).

33 *In re JW Aluminum Co.,* 200 B.R. 64, 65 (Bankr. M.D. Fla. 1996) (seller may be considered reasonably insecure where the buyer is indebted to the seller, seller is aware of buyer's financial difficulties and "widespread rumors of potential Chapter 11 filings" persist); *In re Pac. Gas & Elec. Co.,* 271 B.R. 626, 641 (N.D. Cal. 2002) (finding that adequate basis for insecurity existed where company announced, in its Form 8-K, an impending bankruptcy, there was a downgrade of its credit rating, its bank refused to honor a borrowing request, and it failed to pay $33 million in maturing commercial paper).

34 U.C.C. § 2-609, Cmt. 4; *Cont'l Can Co., Inc. v. Poultry Processing Inc.,* 649 F. Supp. 570 (D. Me. 1986) (noting that adequate assurance request was proper where buyer's indebtedness under a five-year supply agreement exceeded its credit limit by a substantial amount).

35 U.C.C. § 2-609, Cmt. 4.

36 *AMF v. McDonald's Corp.,* 536 F.2d 1167 (7th Cir. 1976) (buyer of multi-unit computer system had reasonable grounds for insecurity with respect to seller's inability to deliver agreed-upon goods where the seller's prototype unit had performed unsatisfactorily and seller's engineers were troubled about the design); *Creusot-Loire Int'l Inc. v. Coppus Eng'g Corp.,* 585 F. Supp. 45, 49-50 (S.D.N.Y. 1983) (reasonable grounds for insecurity existed when buyer learned that seller's product, sold to another customer with similar needs as the buyer, was not operating properly); *LNS Inv. Co. v Phillips 66 Co.,* 731 F. Supp. 1484, 1487 (D. Kan. 1990) (buyer of plastic blow-molded bottles had reasonable grounds for insecurity where quantity and quality of the seller's goods were chronically poor).

37 985 F.2d 685, 701-04 (2d Cir. 1993).

was relying on its adequate assurance demand to terminate an unprofitable contract. The buyer had sent an adequate assurance demand under a contract for the sale of certain petroleum products shortly after the seller had attempted, but was unable, to timely deliver the goods because of the buyer's own actions in preventing the vessel on which the goods had been shipped from docking at the delivery location.

The buyer of the petroleum had sent a written demand for adequate assurance of due performance to the seller and set a deadline of 3:00 p.m. the next day for the seller to respond. When the seller had failed to contact the buyer prior to expiration of the deadline, the buyer notified the seller that the buyer considered the seller to have repudiated the agreement. The court concluded that the contract continued in effect because the buyer had frustrated the seller's ability to perform under the contract at issue shortly before the buyer had sent its adequate assurance demand. The court also noted that the buyer had stood to gain a large sum of money if the agreement were not performed according to its terms and had an incentive to nullify the agreement because the spot market price for the petroleum at issue had dropped below the contract price. Under these circumstances, the court held that the buyer could not rely upon its own conduct as a basis for a claim of insecurity.

The court recognized its broad discretion to guard against "flagrant use of [§] 2-609 as a weapon to avoid unprofitable contracts."[38] The parties' past course of conduct can also excuse a request for adequate assurance from a buyer who makes a payment late if the seller had previously accepted late payments during the course of their relationship.[39]

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38 *Id.* at 704. *See also United States v. Great Plains Gasification Assoc.* 819 F.2d 831 (8th Cir. 1987) (party demanding adequate assurance sought to escape its obligations under burdensome contract).

39 *See Cassidy Podell Lynch Inc. v. Snydergeneral Corp.*, 944 F2d 1131 (3d Cir. 1991) (failure to pay 30 days after delivery in accordance with contract was not grounds for insecurity as payments were previously routinely made 90 days after delivery); *Cole v. Melvin*, 441 F. Supp. 193, 203 (D. S.D. 1977) (extended delay of delivery, which was normal in the business of "exotic cattle," was found to not be ground for insecurity).

Finally, the Y2K phenomenon at the turn of the 21st Century created a fear that certain computer products would not function on and after January 1, 2000. In one case,[40] a buyer that had purchased certain computer software systems from the seller's predecessor in interest and contracted for continuing service of the software was concerned that the software might malfunction after December 31, 1999. In September 1997, the buyer wrote to the seller requesting assurance that the software would function on and after January 1, 2000. When the seller failed to respond, the buyer demanded a written commitment by January 31, 1998, that the software would not malfunction. The seller responded on January 30, 1998, stating only that it had not decided what work would be necessary to ensure that the software would function properly, but that the buyer would be notified immediately following a decision.

Unsatisfied with the assurance it was given, the buyer purchased a new computer system and software from another company in June 1998 and sued the seller for anticipatory repudiation of the contract. Unaware of the buyer's purchase of a new computer system, the seller sent the buyer a definitive answer on November 20, 1998, stating that it would supply the software updates at no cost to the buyer.

The court held that the buyer did not have reasonable grounds for insecurity and that the seller's assurances were adequate. Although the approach of January 2000, coupled with the seller's failure to return phone calls, may have created reasonable grounds for insecurity at some point before December 31, 1999, the court found no reasonable basis for the buyer's insecurity approximately two years beforehand. The court also concluded that the buyer did not have reasonable grounds for insecurity because there was no evidence of any prior unreliable service by the seller. Moreover, the buyer was not under impending time constraints to obtain new computer equipment, and the buyer had no reason to believe it would take the seller a lengthy period of time to make any required corrections to the software. The only ground for insecurity the buyer

40 *By-Lo Oil Co. Inc. v. ParTech Inc.,* 11 Fed. Appx. 538 (6th Cir. 2001).

could present was the seller's failure to timely respond to the buyer's demand letter, which the court found to be insufficient.[41]

2. Demand for Adequate Assurance of Due Performance

If a trade creditor has doubts about a buyer's ability to perform its obligations under its contract with the trade creditor, the trade creditor should make a written demand on the buyer to provide adequate assurance of the buyer's ability to perform its obligations under their contract. The following is a list of general practice points for drafting an adequate assurance demand letter:

- An adequate assurance demand should be in writing as opposed to an oral communication. A trade creditor should send a written adequate assurance demand to its financially distressed buyer in order to avoid any disputes surrounding the receipt and contents of an oral demand. Generally, courts have found oral adequate assurance demands inadequate;[42]
- The demand should reference the applicable state law section of UCC § 2-609;[43]

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41 *Id.*

42 *Nat'l Ropes Inc. v. Nat'l Diving Service Inc.,* 513 F. 2d 53 (5th Cir. 1975); *Automated Energy Sys. Inc. v. Fibers and Fabrics of Georgia Inc.,* 164 Ga. App. 772 (1982); *Scott v. Crown,* 765 P.2d 1043, 1046 (Colo. Ct. App. 1988) ("[T]he express language of the statute is followed such that a demand for assurances of performance must be in writing in order to be effective."); *Roessler v. New England Glass Enclosures Inc.*, 1993 WL 7537 at *19 (Conn. Super. Ct. Jan. 7, 1993) (buyer did not have reasonable grounds for insecurity after learning that seller abandoned its nearby facility because buyer had failed to send written demand for adequate assurance). However, it is important to note that a few courts have found a written demand was not necessary to make a demand for adequate assurance; *see ARB (American Research Bureau) Inc. v. E-Systems Inc.,* 663 F.2d 189, 196 (D.C. Cir. 1980) ("[N]o need to pinpoint the particular writing … where … the pattern of interaction — demand for assurances, assurances given, performance still non-conforming — demonstrates both parties' clear understanding that suspension of buyer's performance was the alternative to satisfactory performance by seller."); *AMF Inc.,* 536 F.2d at 1170-71; *Kunian v. Dev. Corp. of America,* 334 A.2d 427, 433 (Conn. 1973); *Toppert v. Bunge Corp.,* 377 N.E.2d 324, 328 (Ill. App. Ct. 1978); *Diskmakers Inc. v. DeWitt Equipment Corp.,* 555 F.2d 1177, 1180 (3d Cir. 1977).

43 Each state has adopted its own version of U.C.C. § 2-609.

- The demand should use clear and unequivocal language. Parties generally have the tendency to weaken the language of what they intended as an adequate assurance demand in order to avoid offending their long-time business counterparty. However, a court may find that such weakened language does not convey an adequate-assurance demand, and therefore does not provide any rights arising out of the other party's failure to respond to the demand. Therefore, the language in a demand must be specific, unequivocal and clear.[44] For example, a court concluded that the trade creditor's demand letter that included language requesting a revised delivery schedule for the original contracts did not constitute an "unequivocal demand for assurance" and denied the seller's claim for breach of contract;[45]

- The letter demanding adequate assurance should expressly identify the grounds for the trade creditor's insecurity and demand specific assurance of performance by the buyer; and

- The letter should state that the buyer's failure to timely provide adequate assurance will be deemed a repudiation of the contract by the buyer.

An example of a demand requesting adequate assurance of performance is included as Form 4 in the Appendix.

In making an adequate assurance demand, the trade creditor can request the type of assurance that is reasonable under the circumstances. The court will be the ultimate arbiter of whether an adequate assurance demand was made in good faith and was consistent with applicable commercial standards. A trade creditor's demand for adequate assurance of performance

44 *MG Ref. & Mktg. v. Knight Enters.,* 1996 U.S. Dist. LEXIS 22941 at *7-8 (S.D.N.Y. Feb. 13, 1996) (letter referencing breaches simply opened discussions, did not demand assurances); *Beeche Sys. Corp. v. D.A. Elia Constr. Corp. (In re Beeche Sys. Corp.),* 164 B.R. 12, 17 (N.D.N.Y. 1994) (letter was not a demand as it did not reference the UCC, did not track language of § 2-609(1), and did not request any assurance of performance).

45 *Lectro-Tek Servs. Inc. v. Exeter Packers Inc.,* 2010 Wash. App. LEXIS 1286 (Wash. Ct. App. June 17, 2010).

by the buyer cannot be "arbitrary or capricious."[46] Generally, courts will attempt to determine the minimum level of assurance that a reasonable trade creditor needs to be comfortable that a buyer will fulfill its obligations under the parties' contract.[47] If the assurances a trade creditor demands are more than what the court finds to be reasonable demands under the specific circumstances, and the buyer refused to provide the requested assurances, the court could find the demand for adequate assurance to be improper and reject any relief in favor of the trade creditor (*i.e.,* deny repudiation of the contract and any breach of contract claim by the trade creditor).[48]

Courts have also recognized that an adequate assurance demand can be a request for more protection from the buyer than what the contract otherwise affords a trade creditor.[49] The question is one of degree. If the demand for adequate assurance goes beyond what is reasonable under the circumstances, any action the trade creditor takes to hold the buyer in breach of the contract may be found to be improper.

While a trade creditor's demand for cash-in-advance terms, a letter of credit, collateral security, a deposit or a third-party guarantee may be appropriate, the buyer's general promise to perform its obligations under the contract might not be sufficient to quell the trade creditor's fears.[50] However, a seller's promise to both attend to the problem and avoid future problems is normally sufficient to respond to a buyer's claim of delivery of defective goods.[51] Notwithstanding, this general rule will not apply to a "known corner-cutter"

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46 *Richmond Leasing Co. v. Capital Bank N.A.,* 762 F.2d 1303, 1310 (5th Cir. 1985).

47 *Hope's Architectural Prods. Inc. v. Lundy's Constr. Inc.,* 781 F. Supp. 711, 716 (D. Kan. 1991).

48 *Hope's Architectural Prods.,* 781 F. Supp. at 716.

49 *Top of Iowa Co-op. v. Sime Farms Inc.,* 608 N.W.2d 454, 469 (Iowa 2000) (rejecting argument that § 2-609 demand was unreasonable and thus constituted anticipatory breach because it imposed conditions that went beyond contract terms).

50 *JW Aluminum Co.,* 200 B.R. at 67 (switching from credit to cash-in-advance terms, or providing letter of credit or other collateral to secure payment, may be reasonable); *Creusot-Loire Int'l Inc. v. Coppus Eng'g Corp.,* 585 F. Supp. at 50 (request for extension of contractual guarantee and letter of credit reasonable); *McNeal v. Lebel,* 157 N.H. 458 (2008) (request for escrow of funds from buyer when buyer's lenders cease funding was appropriate). *But see Louisiana Power & Light Co. v. Allegheny Ludlum Indus. Inc.,* 517 F. Supp. 1319, 1322-23 (E.D. La. 1981) (written assurance can be reasonable under certain circumstances).

51 U.C.C. § 2-609, Cmt. 4.

in the industry. Requests for additional information, including financial records, are also appropriate.[52] However, a party cannot provide adequate assurance of performance by simply delegating the performance, and all obligations required under the contract, to a third party.[53]

3. Time Period for Responding to an Adequate Assurance Demand

Under UCC § 2-609(4), a buyer has a "reasonable time," not to exceed 30 days, to respond to a seller's demand for adequate assurance of performance.[54] However, the time period for responding to an adequate assurance demand can be shorter depending on the particular circumstances. For instance, in *Hitachi Zosen Clearing Inc. v. Liberty Mut. Ins. Co.*, the court concluded that a "reasonable time" was "something less than 30 days" when a financially troubled manufacturer had repeatedly failed to respond to questions concerning its ability to complete performance by the projected, and fast-approaching, deadline.[55] The manufacturer had agreed to furnish and deliver shaft caps, elliptical heads and threaded fasteners. The buyer had sent the manufacturer a letter that the buyer had characterized as a demand for adequate assurance. In this letter, the buyer stated that the contract was expiring in four months and requested an immediate update from the manufacturer on its progress in filling the order. That same day, the manufacturer had sent the buyer a letter stating that the manufacturer's banks had cut off all of the manufacturer's operating funds, which forced the manufacturer to lay off virtually all of its shop and office personnel and cease all work. The buyer made additional written requests to the manufacturer for assurances that the manufacturer would be able to timely complete production, but the manufacturer refused to respond.

52 *Int'l Therapeutics Inc. v. McGraw-Edison Co.,* 721 F.2d 488, 492 (5th Cir. 1983) (request for financial records was reasonable).

53 *Consol. Edison Co. of New York v. Charles F. Guyon Inc.,* 471 N.Y.S.2d 269, 270 (App. Div. 1984).

54 U.C.C. § 2-609(4), Cmt. 5 ("The thirty-day limit on the time to provide assurance is laid down to free the question of reasonable time from uncertainty in later litigation.").

55 1996 WL 388432 at *7 (N.D. Ill. July 2, 1996).

The buyer then cancelled the contract and sought a replacement manufacturer prior to the expiration of the 30-day period after sending its adequate assurance demand. The manufacturer argued that the buyer could not cancel the contract because it had breached UCC § 2-609(4) by terminating the contract 28 days, rather than 30 days, after the manufacturer had received the buyer's adequate assurance demand. However, the court noted that the manufacturer's failure to respond within 28 days of the buyer's demand warranted relief in the buyer's favor and that a reasonable time to respond to an adequate assurance demand could be "something less than 30 days" under certain circumstances.

4. Trade Creditor's Ability to Suspend Performance and Exercise Remedies

Once the trade creditor sends a demand for adequate assurance to the buyer, the trade creditor can suspend performing under the contract until it receives adequate assurance of the buyer's ability to perform under the contract, if doing so would be commercially reasonable.[56] For example, a court found that where two parties entered into an oral agreement to allocate profits and losses on a construction project, and the agreement was later reduced to a writing that was inconsistent with the terms of the oral agreement, either party had the right to suspend performance pending assurances from the other party that the terms of the oral agreement would control.[57] The failure to respond or provide the requested form of reasonable adequate assurance can result in the repudiation of the contract, and the trade creditor may proceed with an action based on the buyer's breach of the contract.[58]

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56 U.C.C. § 2-609(1), Cmt. 2 ("[T]he aggrieved party is permitted to suspend his own performance and any preparation therefor, with excuse for any resulting necessary delay, until the situation has been clarified. 'Suspend performance' under this section means to hold up performance pending the outcome of the demand, and includes also the holding up of any preparatory action.").

57 *See, e.g., L.E. Spitzer Co. Inc. v. Barron*, 581 P.2d 213, 217 (Alaska 1978); *Julian v. Montana State Univ.,* 747 P.2d 196, 200 (Mont. 1987).

58 U.C.C. § 2-609(4), Cmt. 5; *Central Oil Co. v. M/V Lamma-Forest,* 821 F.2d 48, 51 (1st Cir. 1987) ("[T]he failure to give … assurances, in appropriate circumstances, constitutes an anticipatory repudiation of the contract.").

A trade creditor must be careful when it exercises its right to demand adequate assurance of the buyer's performance of their contract. If the trade creditor did not have reasonable grounds to make an adequate assurance demand in the first place, and the trade creditor suspended performance prior to making the demand, or the trade creditor refused to perform notwithstanding the buyer's promise of adequate assurance, the trade creditor risks a breach-of-contract claim by the buyer and liability for the buyer's damages.[59]

5. Applicability of Adequate Assurance Rights to Services and Leases

By its terms, UCC § 2-609 applies only to sales of goods,[60] which include manufactured goods and things that are moveable.[61] However, courts in a number of jurisdictions have held that the doctrine of adequate assurance also applies to certain contracts that are not governed by the UCC, such as service contracts.

Many of the courts expanding the doctrine of adequate assurance to those other contracts have relied on the Restatement (Second) of Contracts, § 251 (the Restatement). The Restatement is a legal treatise that summarizes the current state of contract law in the U.S. and is highly regarded by courts. The Restatement applies to all contracts, not just contracts for goods.[62] Sections 251 and 252 of the Restatement provide that a creditor that is a party to a contract is allowed to demand adequate assurance when its counterparty's financial health is in question. Section 251 provides:

> (1) Where reasonable grounds arise to believe that the obligor will commit a breach by non-performance that would of itself give the obligee a claim for damages for total breach under § 243, the

59 *Cosden Oil & Chem. Co. v. Karl O. Helm Aktiengesellschaft,* 736 F.2d 1064, 1074 (5th Cir. 1984) ("Without requesting adequate assurance … [the demanding party] was not entitled to suspend its deliveries under [the contract].").

60 U.C.C. § 2-102 ("Unless the context otherwise requires, this Article applies to transactions in goods.").

61 U.C.C. § 2-103(1)(k).

62 *In re Broadstripe,* 435 B.R. 245, 258 n. 50 (Bankr. D. Del. 2010).

obligee may demand adequate assurance of due performance and may, if reasonable, suspend any performance for which he has not already received the agreed exchange until he receives such assurance.

(2) The obligee may treat as a repudiation the obligor's failure to provide within a reasonable time such assurance of due performance as is adequate in the circumstances of the particular case.[63]

Comment a. to § 251 of the Restatement notes that both § 251 and UCC § 2-609 rest on the principle that the parties to a contract rely upon actual performance and that the promised performance will be forthcoming when due.

The seminal case in this area is the 1998 decision in *Norcon Power Partners*, in which the New York Court of Appeals adopted the UCC rule of adequate assurance as part of the common law of contracts. The court held that rights of adequate assurance apply to long-term commercial contracts for the provision of electricity services between commercial entities that are "complex and not easily susceptible of all security features being anticipated, bargained for and incorporated in the original contract."[64]

Since the New York Court of Appeals' expansion of the doctrine of adequate assurance in 1998, other courts have wrestled with defining the types of non-goods contracts to which the doctrine should be applied.[65] Courts have found that the doctrine applies to contracts analogous to a contract for

63 *Id.*

64 *Norcon Power Partners L.P. v. Niagara Mohawk Power Corp.,* 705 N.E.2d 656, 662 (1998) (applying adequate assurance rights to electricity purchase agreement); *In re Asia Global Crossing Ltd.*, 326 B.R. 240, 250 (Bankr. S.D.N.Y. 2005); *see also Carfield & Sons Inc. v. Cowling,* 616 P.2d 1008, 1010 (Colo. App. 1980) (applying adequate assurance rights to construction contracts); *Lo Re v. Tel-Air Communications Inc.,* 490 A.2d 344, 349-50 (N.J. Super. Ct. App. Div. 1985) (applying doctrine to contract for purchase of radio station); *Julian v. Montana State Univ.*, 747 P.2d 196, 200 (Mont. 1987) (applying doctrine to retirement contract).

65 *In re Broadstripe,* 435 B.R. at 258 (Bankr. D. Del. 2010) ("[I]t is a matter of unsettled/undecided state law whether a party to a contract may demand adequate assurance of future performance for non-Uniform Commercial Code … contracts.").

the sale of commercial goods.[66] By contrast, other courts have found that parties to contracts not analogous to the sale of goods were not permitted to make actionable adequate assurance demands.[67] The case law remains unsettled, and arguments can be made on both sides, based on the Restatement, that the doctrine of adequate assurance is available to parties to service contracts.

B. Other Sources of Law Providing Adequate Assurance Rights for Services

1. CISG

The Convention on Contracts for the International Sale of Goods (CISG) is a treaty that governs contracts for the international sales of goods between private businesses located in different countries that are signatories to the CISG. The CISG came into force as a multilateral treaty in 1988, and as of 2018, it has been ratified by 89 countries. Unless excluded by the express terms of the parties' contract, the CISG is deemed to be incorporated into, and supplant as necessary, the otherwise-applicable law governing the sale

66 *Palco Telecom Svc. Inc. v. Glob. Warranty Group LLC*, 2015 WL 1509598, *6 & n.1 (E.D.N.Y. Mar. 31, 2015) (applying doctrine to a phone-repair service contract); *In re Broadstripe,* 435 B.R. at 258, n. 50 (applying doctrine to an asset-purchase agreement for the sale of cable and internet assets because they are "analogous to the electricity sold in the *Norcon* line of cases and the sale of goods under the UCC").

67 *First National Bank of Pennsylvania v. Transamerica Life Insurance Co.*, 2017 WL 2880854, *15 (W.D. Pa. July 6, 2017) (refusing to apply doctrine to sale of life insurance contracts); *Peng v. Willets Point Asphalt Corp.,* 915 N.Y.S.2d 878 (N.Y. App. Div. 2d Dep't 2011) (reversing trial court's ruling that adequate assurance doctrine applied to commercial real estate contract dispute); *Merrill Lynch Intern. v. XL Capital Assur. Inc.*, 564 F. Supp. 2d 298, 306 (S.D.N.Y. 2008) (credit default swap contract "had very little in common with a sale of goods," therefore New York law would not extend doctrine to such an agreement); *Bank of New York v. River Terrace Assoc. LLC*, 804 N.Y.S.2d 728, 729 (N.Y. App. Div. 1st Dept. 2005) (long-term construction loan agreement at issue was not analogous to a sales contract, therefore court refused to extend doctrine of adequate assurances of performance to facts at issue).

of goods between parties whose places of business are located in countries that are parties to the CISG.[68]

Article 71 of the CISG addresses the rights of parties with respect to adequate assurance. It provides:

> (1) A party may suspend the performance of his obligations if, after the conclusion of the contract, it becomes apparent that the other party will not perform a substantial part of his obligations as a result of:
>
> > (a) a serious deficiency in his ability to perform or in his creditworthiness; or
> >
> > (b) his conduct in preparing to perform or in performing the contract.[69]
>
> (2) If the seller has already dispatched the goods before the grounds described in the preceding paragraph become evident, he may prevent the handing over of the goods to the buyer even though the buyer holds a document which entitles him to obtain them. The present paragraph relates only to the rights in the goods as between the buyer and the seller.
>
> (3) A party suspending performance, whether before or after dispatch of the goods, must immediately give notice of the suspension to the other party and must continue with performance if the other party provides adequate assurance of his performance.

Accordingly, trade creditors involved in transactions with international counterparties should consider their rights under the CISG when they be-

68 *Hanwha Corp. v. Cedar Petrochemicals Inc.*, 760 F. Supp. 2d 426, 430 (S.D.N.Y. 2011) (the "CISG is a self-executing treaty, binding on all signatory nations, that creates a private right of action in federal court under federal law"); *Cedar Petrochemicals Inc. v. Dongbu Hannong Chemical Co. Ltd.*, 2011 WL 4494602, *3 (S.D.N.Y. Sept. 28, 2011) (the CISG "automatically applies to international sales contracts between parties from different contracting states unless the parties agree to exclude [its] application") (internal quotations omitted).

69 *See Weihai Textile Grp. Imp. & Exp. Co. Ltd. v. Level 8 Apparel LLC*, 2014 WL 1494327, at *12 (S.D.N.Y. Mar. 28, 2014) (question of fact for jury whether plaintiff was entitled to protections of Article 71 of the CISG).

lieve the buyer might not be able to perform in accordance with the terms of their contract.

2. Lease Contracts

With respect to lease contracts governed by the UCC, the relevant provision of the UCC is § 2A-401, which provides as follows:

- A lease contract imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired.
- If reasonable grounds for insecurity arise with respect to the performance of either party, the insecure party may demand in a record adequate assurance of due performance. Until the insecure party receives that assurance, if commercially reasonable the insecure party may suspend any performance for which the insecure party has not already received the agreed return.
- A repudiation of the lease contract occurs if assurance of due performance adequate under the circumstances of the particular case is not provided to the insecure party within a reasonable time, not to exceed 30 days after receipt of a demand by the other party.
- Between merchants, the reasonableness of grounds for insecurity and the adequacy of any assurance offered must be determined according to commercial standards.
- Acceptance of any nonconforming delivery or payment does not prejudice the aggrieved party's right to demand adequate assurance of future performance.

The Official Comments state that the uniform statutory source of UCC § 2A-401 is UCC § 2-609, and indeed, the two sections are substantially similar.

3. Contract Drafting Points

When drafting a contract, the issue of how and when the parties can make a demand for adequate assurance should be considered. Trade creditors should also bear in mind that parties can alter the application of UCC § 2-609 in their agreement by, for example, waiving a trade creditor's rights under § 2-609, enlarging § 2-609's protections to some extent, defining what constitutes grounds for a party's insecurity about the other party's ability to perform under the contract, fixing a reasonable time within which requested adequate assurance must be given, defining "adequacy of the assurance" in any commercially reasonable fashion, or limiting the damages arising from a party's failure to provide adequate assurance of future performance.[70] However, any clause seeking to set up arbitrary standards for action may be deemed ineffective.[71] Accordingly, prior to entering into the contract, a trade creditor should carefully review the terms of the contract with its buyer concerning the trade creditor's UCC § 2-609 rights.

C. Trade Creditor's Right to Stop Delivery of Goods

1. Goods in Trade Creditor's Possession

The UCC provides a trade creditor, who is a goods seller, the right to stop delivery of goods sold on credit where the buyer is insolvent or in breach of the terms of its contract with the trade creditor. A trade creditor's stoppage of delivery rights effectively enables the trade creditor to

70 U.C.C. § 2-609, Cmt. 6; *see also, e.g., In re Beverage Enters. Inc.*, 1997 Bankr. LEXIS 431, at *5 n.1 (Bankr. E.D. Pa. Apr. 7, 1997) ("[T]he terms of the [contract] appear to waive the application of § 2-609 to it."); *Enron Power Mktg. v. Nev. Power Co. (In re Enron Corp.),* 2004 U.S. Dist. LEXIS 20351, at *9 (S.D.N.Y. Oct. 12, 2004) ("[P]arties may agree to vary UCC principles"; parties agreed to shorten the maximum 30-day period to respond to an adequate-assurance demand; "the parties could have drafted the contract so the downgrading of one party's credit would trigger an automatic demand for assurances").

71 U.C.C. § 2-609, Cmt. 6.

change payment terms from the extension of unsecured credit to cash-in-advance or cash-on-delivery payment, regardless of the credit terms set forth in the underlying contract.

According to UCC §§ 2-702 (1) and 2-703, if the trade creditor has not yet delivered goods to a buyer and the trade creditor discovers that the buyer is insolvent, or the buyer is in default of its contract with the trade creditor, the trade creditor could refuse to deliver goods to the buyer unless the buyer pays for such goods before or upon delivery. UCC § 1-201(23) defines "insolvency" as based on either (1) an "equity" test where the buyer cannot pay its debts in the ordinary course of business or as they mature, or (2) a "balance sheet" test, where the buyer's liabilities are greater than its assets. If the buyer is late in paying its suppliers, the buyer is insolvent on an equity basis. If the buyer's liabilities exceed its assets, the buyer is insolvent on a balance sheet basis.

Under the balance sheet test, the buyer's assets could be valued in any number of ways. The valuation method used could lead to different outcomes in determining whether the buyer is insolvent. If assets are valued on a going-concern or fair market value basis, their value is likely to be higher and lead to the conclusion that the buyer is solvent. However, if that same buyer's assets are valued on a liquidation basis, a lower value would likely be established and the buyer is more likely to be deemed insolvent.

It is often easier to prove that a buyer is insolvent using the equity test rather than the balance sheet test. A buyer is deemed insolvent under an equity test if it is not generally paying its debts on time. This circumstance may occur even if the buyer is *solvent* under the balance sheet test, because the equity test measures the sufficiency of cash flow rather than the "value" of assets.

2. Goods in Possession of Carrier, Warehouse or Other Third Party

Under UCC § 2-705, a trade creditor has the right to stop delivery of goods in the possession of a carrier, warehouse or other third party that is holding or transporting the goods. A trade creditor can stop delivery of goods in transit to the buyer upon learning of the buyer's insolvency, bankruptcy filing or failure to make a payment due before the buyer's receipt of the goods in order to prevent the "inequity of permitting the buyer to obtain possession of goods when there has been a prospective failure of the buyer's performance."[72] A trade creditor's right to stop delivery of goods held by a third party continues for as long as the buyer, or the buyer's agent, has not taken physical possession or control of the goods.

A trade creditor exercising the right to stop delivery of goods in transit must notify the carrier, warehouse or other third party of the trade creditor's decision to stop delivery before the buyer receives possession or control of the goods. The trade creditor should simultaneously notify the buyer of the decision to stop delivery. While there is no requirement for the stop delivery instruction to be in writing, it is highly recommended that the trade creditor send a written demand to the carrier, and send a copy to the buyer,[73] to avoid evidentiary disputes over how and when the stop delivery demand was communicated. A sample Stoppage of Delivery Demand form is included as Form 5 in the Appendix.

Following receipt of a trade creditor's notice to stop delivery of its goods, the carrier, warehouse or other third-party bailee of the goods must hold the goods and deliver them according to the trade creditor's instructions. The trade creditor is responsible for any charges or damages arising from

72 U.C.C. § 2-705(1), Cmt. 1; *In re National Sugar Refining Co.*, 27 B.R. 565, 568 (S.D.N.Y. 1983).

73 *Cf. In re Morrison Indus. L.P. v. Hiross Inc. (In re Morrison Indus. L.P.)*, 175 B.R. 5, 8-9 (Bankr. W.D.N.Y. 1994) (seller successfully invoked its stoppage of delivery rights by refusing to deliver goods in response to the buyer's complaint for turnover, notwithstanding seller's prior failure to notify buyer of seller's stoppage of delivery rights).

stopping delivery.[74] The trade creditor may properly refuse to release the goods until the buyer agrees to pay for them.

3. Limits on Stoppage of Delivery Rights

A trade creditor's right to stop delivery is not without its limits. The law is clear that a trade creditor loses the right to stop the delivery of goods where the buyer obtains any of the following actual or constructive possession or control of the goods:

- The buyer has received the goods;
- The warehouse or third party (other than a carrier) acknowledges that it is holding the goods on account of or for the buyer;
- The carrier acknowledges that it is holding the goods for the buyer by either reshipping the goods pursuant to the buyer's instructions or holding the goods as the buyer's warehouseman;
- A negotiable document of title (*e.g.*, a bill of lading or warehouse receipt) has been issued and has not been surrendered to the seller or has been negotiated to the buyer; or
- A non-negotiable document (*e.g.*, a bill of lading or warehouse receipt) has been issued to someone other than the trade creditor.[75]

Many of the disputes surrounding a trade creditor's attempt to stop delivery of goods in transit under UCC § 2-705 involve a factual inquiry into whether the buyer received the goods prior to the trade creditor exercising its stoppage of delivery rights.[76] "Receipt" is defined under the UCC as "taking physical possession."[77] In *In re Morrison Industries*, the buyer purchased truck bodies from the trade creditor and also leased space from the trade

74 U.C.C. § 2-705, Cmt. 5 ("The seller is responsible for any charges or losses incurred by the carrier in following the seller's orders, whether or not the carrier was obligated to do so.").

75 U.C.C. § 2-705(2)(a)-(d).

76 U.C.C. § 2-705(2)(a) (seller can stop delivery until "receipt of the goods by the buyer").

77 U.C.C. § 2-103(1)(c).

creditor where the truck bodies were manufactured.[78] The finished truck bodies were either shipped directly to the ultimate user or placed in an outside storage rack. The leased space, however, was not clearly delineated. When the truck body was ready to be delivered to the ultimate user, an employee of the trade creditor would locate the correct unit in its outdoor storage space and operate a forklift for loading. The court held that the trade creditor retained its right to stop delivery because the buyer had never "received" the truck bodies.

The agreement in *Morrison* contained a provision stating that delivery occurred once the truck bodies were transferred "to a common carrier or licensed public trucker." When the contract was entered into, it was not contemplated that the truck bodies could be delivered to, or picked up by, the buyer (the buyer had yet to lease the space from the trade creditor). Critical to the court's analysis was whether the buyer had physical possession of the truck bodies. The court held that the buyer had not received the truck bodies for purposes of UCC § 2-705 because the buyer needed the assistance of the trade creditor's employees to locate and load them.

Receipt does not occur even when a buyer arranged for the carrier to transport the seller's goods from the seller's facility. In *In re Trico Steel Co.,* the debtor, Trico, had purchased pig iron from the seller, Cargill Inc.[79] The iron was transported to New Orleans, where Trico had arranged to deliver the pig iron to its plant in Alabama by obtaining access to a barge that was operated by a third-party transport company. The goods were to be loaded onto the barge and the barge was instructed to deliver the goods to Trico's plant. When Cargill discovered that Trico was insolvent, Cargill notified the barge operator to stop delivery of the iron, while the iron was still in transit, pursuant to UCC § 2-705. A dispute ensued regarding whether Trico was already in possession of the iron when Cargill had attempted to stop delivery, that, if proven, would have resulted in the loss of Cargill's stoppage of delivery rights. The court concluded that although Trico had arranged

78 *In re Morrison Indus. L.P.*, 175 B.R. 5 (Bankr. W.D.N.Y. 1994).

79 *Trico Steel Co. L.L.C. v. Cargill Inc. (In re Trico Steel Co. L.L.C.),* 302 B.R. 489 (D. Del. 2003).

for transportation of the iron by barge, Trico had not "received" the iron because the carriers were "merely intermediaries or links in transit," not agents of Trico. Accordingly, Trico had not received the iron when Cargill had sent its stop delivery notice, therefore Cargill still had the right to stop delivery of the iron. The court analogized the situation to a warehouse:

> Even if the goods were in a warehouse during the shipment process, the only way the goods would be considered to be in the "possession" of the buyer would be if the goods were in a warehouse owned or actually rented by the buyer. If the goods were in a warehouse held for transit, then the goods would not be considered in the "possession" of the buyer.[80]

In a 2017 decision that addressed stoppage of delivery rights, *O2Cool LLC v. TSA Stores Inc.*,[81] the U.S. Bankruptcy Court for the District of Delaware refused to grant a motion to dismiss filed by TSA Stores Inc.'s secured lenders in response to a complaint filed by O2Cool LLC concerning the enforceability of O2Cool's stoppage of delivery rights for certain goods shipped to TSA Stores.

However, the same bankruptcy court, in a September 2017 decision, subsequently granted a summary judgment motion filed by TSA Stores, Yusen Logistics (Americas) Inc. (Yusen), and OOCL (USA), Inc. (OOCL) against O2Cool. In considering the summary judgment motion, the bankruptcy court initially held that O2Cool had the right to stop delivery of the goods at issue when it sent stop shipment notices because the goods were still in transit and TSA Stores did not have physical possession of the goods when the notices were sent, as required by UCC §§ 2-103(1)(c) and 2-705, cmt. 2. The court also held that the stop shipment notices were effective notwithstanding that one of the notices was served on OOCL, an agent of the carrier Orient Overseas Container Line Limited (Orient Overseas). According to the court, a notice to stop shipment served on an agent of a carrier is enforceable un-

80 *Id.*

81 *O2Cool LLC v. TSA Stores Inc. (In re TSAWD Holdings Inc.)*, Adv. No. 16-51014 (Bankr. D. Del. Sept. 20, 2017).

der Restatement (Second) of Agency § 268, comment a, which requires such notice to be "directed to the party to be affected, to his agent authorized to receive it[,] or to a person upon whom the notifier has a right to rely as one so authorized to receive such notice."

However, the court held that neither OOCL nor Orient Overseas was required to obey O2Cool's stop shipment notices because O2Cool was not listed as the consignor in the non-negotiable bill of lading issued by Orient Overseas. UCC § 2-705(3)(d) only requires a carrier's compliance with a stop shipment notice where it is received from the consignor referenced in the relevant non-negotiable bills of lading. The bills of lading did not refer to O2Cool but instead referred to an entity named Shenzen Yusen Freight Service Co. Limited-OCM as the consignor, which was the party responsible for consolidating TSA Stores' goods into containers and delivering the goods to the appropriate carriers. Thus, the bankruptcy court held that summary judgment was appropriate against O2Cool because the stop shipment notices were legally ineffective; consequently, O2Cool's goods became property of TSA Stores' bankruptcy estate when they were delivered to TSA stores.

This factual scenario is distinguishable from the *Trico* case because in that case the carriers at issue — a barge company — were "merely intermediaries or links in transit," not agents of Trico. Thus, Cargill, unlike O2Cool, did not relinquish its stoppage of delivery rights.

A trade creditor's right to stop delivery of goods in transit continues as long as the buyer has not received the goods. Passage of title and risk of loss from the trade creditor to the buyer also do not affect a trade creditor's right to stop delivery under UCC § 2-705.[82] The fact that a trade creditor has delivered goods to a common carrier on Free On Board (FOB) terms, or that its contract with

82 U.C.C. § 2-705, Cmt. 1; *In re Murdock Mach. & Eng'g Co. of Utah,* 620 F.2d 767, 773 (10th Cir. 1980) ("[W]ho has 'title' to the goods is a matter of no relevance whatsoever."); *In re Marin Motor Oil Inc.,* 740 F.2d 220, 225 (3d Cir. 1984) ("The right to stop delivery applies regardless of which party bears the risk of loss, and regardless of which party is deemed to have 'title' to the goods while they are in the carrier's possession."); *In re Kellstrom Indus. Inc.*, 282 B.R. 787, 790 (Bankr. D. Del. 2002) ("[P]assage of title does not eliminate or impair [seller]'s right to withhold and stop delivery.").

the buyer is a shipment or destination contract, is irrelevant as to whether the buyer has received the goods under UCC § 2-705.[83]

However, a trade creditor cannot stop delivery to a buyer when a bill of lading was negotiated to, and is in the possession of, the buyer.[84] Similarly, a trade creditor cannot stop delivery of a shipment after the buyer resells the product to a third party and the buyer orders the carrier to change the destination of the shipment to that third party.[85]

A good-faith purchaser of goods from the buyer does not cut off the trade creditor's right to stop delivery of the goods in the first instance.[86] In *In re Murdock Machine & Engineering Co.*, the seller, Ramco Steel Inc., sold steel on credit to buyer Murdock. Unknown to Ramco, Murdock had entered into a separate supply contract with the U.S. Government to provide steel. The steel was being stored at a warehouse for Murdock to be reshipped to another Murdock facility across the country. The contract between the U.S. Government and Murdock provided that all property acquired or produced by Murdock would immediately vest with the U.S. Government.

Upon learning of Murdock's insolvency, Ramco exercised its right to stop delivery of steel in transit from Ramco to Murdock. The U.S. Government argued that Ramco could not exercise the right to stop delivery because, under the terms of the supply agreement between Murdock and the U.S. Government, the government had title to the steel when the demand was made. The court held that the "seller's right of stoppage is not cut off by the

83 *In re Nevins Ammunition Inc.*, 79 B.R. 11, 16 (Bankr. D. Idaho 1987) ("[W]hether a contract is a 'shipment' contract or a 'destination' contract is of little or no consequence or relevance to a stoppage in transit discussion."); *Interlake Inc. v. Kansas Power and Light Co.*, 79 Ill. App. 3d 679 (1st Dist. 1979) (FOB designation not important as the bailee's notification to subpurchaser of receipt of goods cut off seller's right to stop delivery).

84 *Siderpali S.P.A. v. Judal Indus. Inc.,* 833 F. Supp. 1023, 1033 (S.D.N.Y. 1993) ("[A]s the Bill of Lading had already been negotiated to Judal, Conipost was not entitled to stop delivery of the goods.").

85 *Butts v. Glendale Plywood Co.,* 710 F.2d 504-05 (9th Cir. 1983). The court held that the sale to the third party and the destination change constituted a reshipment under § 2-705(2)(c) ("Section (2)(c) protects a subpurchaser from being affected by disputes between the buyer and the seller by ensuring that the goods he orders are delivered regardless of the financial condition of his seller (the original buyer).").

86 *In re Murdock Machine*, 620 F.2d at 773.

intervention of a third party good faith purchaser." The court distinguished the government, as a good-faith purchaser, from a "subpurchaser" by stating that in the latter circumstance, "the seller has 'acquiesced' in the third party's purchase from the insolvent buyer." Here, Ramco had no knowledge that Murdock had entered into a separate agreement to supply the steel to the government.

Similar to a good-faith purchaser, a secured lender with a blanket/floating lien in all of the buyer's present and future inventory is still subject to a trade creditor's stoppage of delivery rights.[87] In *Kellstrom Indus.*, the court held that a seller's right to stop delivery has priority over a lender's blanket security interest in the debtor's inventory. The court noted that a seller's stoppage of delivery rights is not covered by UCC § 9-110, which deals with the rights of Article 2 security interest-holders under UCC Article 9. Official Comment 5 to UCC § 9-110 deals with a seller's stoppage of delivery rights and states:

> This Article does not specifically address the conflict between (i) a security interest created by a buyer or lessee and (ii) the seller's right to withhold delivery under section 2-702(l), 2-703(a) … the seller's … right to stop delivery under section 2-705…. These conflicts are governed by the first sentence of section 2-403(i), under which the buyer's secured party obtains no greater rights in the goods than the buyer had or had power to convey….[88]

The bottom line is that a buyer's secured creditor steps into the buyer's shoes in connection with a trade creditor's attempt to exercise its stoppage of delivery rights. The buyer has insufficient rights to the goods to grant the lender a security interest that could defeat the trade creditor's stoppage of delivery rights with respect to its goods.

87 *Trico Steel Co. L.L.C.,* 302 B.R. at495; *In re Kellstrom Indus. Inc.* 282 B.R. 787 (Bankr. D. Del. 2002).

88 U.C.C. § 9-110, Cmt. 5.

If the buyer is not in bankruptcy and refuses to pay for the stopped goods, the trade creditor may request that the carrier release the goods back to the trade creditor. However, the carrier may condition releasing the goods upon the trade creditor providing an indemnity to protect the carrier against any damage claims by the intended buyer. Otherwise, the trade creditor may commence a lawsuit to direct the carrier to return the goods.

A carrier cannot ask for more than an indemnity from the trade creditor before complying with the trade creditor's instruction to stop delivery of goods. In *Petroleum Products*,[89] a supplier of natural gas liquids used a pipeline as a carrier to transport the gas. The buyer filed for bankruptcy, and the supplier requested that the owner of the pipeline stop delivery of the gas. The pipeline requested an indemnity, a hold-harmless agreement and an irrevocable letter of credit to cover any damages the pipeline might incur from complying with the supplier's stoppage of delivery request. The court held that the carrier's requests were improper because they exceeded the protections the carrier was entitled to receive under UCC § 2-705.

4. Impact of Buyer's Bankruptcy Filing on a Trade Creditor's Right to Stop Delivery

A trade creditor has the right to stop delivery of goods in transit, even when the buyer is in bankruptcy. The few court decisions that have addressed this issue have held that a trade creditor's right to stop delivery of its goods, whether in its possession or in transit, does not violate the automatic stay provisions of the Bankruptcy Code.[90] These courts have also held that the pre-bankruptcy return of goods to the trade creditor is not an avoidable transfer (*e.g.*, a preference) under the Bankruptcy Code.[91] In *In re Fabric Buys*,[92] a bankruptcy trustee sought to recover approximately $100,000

89 *See Petroleum Prod. Inc. v. Mid-Am. Pipeline Co.*, 815 F. Supp. 1421 (D. Kan. 1993).

90 *In re National Sugar Refining Co.*, 27 B.R. 565, 572-73 (S.D.N.Y. 1983) (requiring stay relief prior to enforcing right to stop delivery would "in many instances effectively deny the right of stoppage, in light of the often short period between the filing of the petition and actual or constructive delivery of the goods").

91 *Id.*

92 34 B.R. 471 (Bankr. S.D.N.Y. 1983).

from a trade creditor that had stopped delivery of goods that were to be delivered to the buyer within 90 days of the buyer's bankruptcy filing upon learning of the buyer's financial difficulties. The court rejected the bankruptcy trustee's claim that the trade creditor's exercise of its right to stop delivery pursuant to UCC § 2-705 was an avoidable preference and found in favor of the trade creditor.

A trade creditor should proceed carefully when exercising its stoppage of delivery rights following a buyer's bankruptcy filing. If the carrier refuses to return the goods, the trade creditor would have to commence an adversary proceeding in the bankruptcy court to obtain the return of the goods. The trade creditor should also review the court docket in the buyer's bankruptcy case to make sure that no order has been entered that bars, or limits the exercise of, a trade creditor's stoppage of delivery rights. In addition, except for notifying the carrier or other bailee to stop delivery of its goods, the trade creditor should take no further action to recover its goods without first moving for relief in the bankruptcy court.

D. Trade Creditor's Right to Reclaim Goods

The UCC provides trade creditors that are goods sellers with a state law right to reclaim (*i.e.*, demand the return of) goods sold and delivered to an insolvent buyer under certain circumstances. A trade creditor's reclamation rights arise under state law, specifically UCC § 2-702(2). Once the buyer files for bankruptcy, Bankruptcy Code § 546(c)(1) preserves a creditor's reclamation rights, but establishes certain additional requirements that the trade creditor must satisfy to obtain relief on its reclamation claim[93] that are not otherwise required under state law.

93 *See* Chapter III of this *Manual*.

1. Requirements for Reclamation

A trade creditor seeking to reclaim its goods from an insolvent buyer must satisfy all of the following requirements:

- The buyer must have been insolvent when it received the goods;
- The trade creditor must demand the return of the goods. If the buyer is in bankruptcy, the reclamation demand must be in writing;
- Under the UCC, the trade creditor must send its reclamation demand within 10 days after the buyer receives the goods. Under the UCC, but not the Bankruptcy Code, this 10-day period does not apply if the buyer made a written misrepresentation of solvency to the trade creditor within three months of delivery of the goods;
- The goods must have been sold to the buyer on credit terms, or on cash terms where the buyer's check for the goods bounced; and
- The buyer must still possess the goods when the demand is made.

2. Buyer's Insolvency

Under the UCC, a reclaiming trade creditor must prove that the buyer was insolvent when the buyer received the goods.[94]

3. Reclamation Demand

Once a trade creditor observes warning signs from a buyer leading the trade creditor to reasonably conclude that its buyer is insolvent, the trade creditor should consider immediately making a demand to reclaim its goods. The trade creditor should send a written reclamation demand to the buyer. The UCC does not preclude an oral reclamation demand, but an oral demand will be more difficult to prove to a court with respect to timing and the

94 *See* Chapter II of this *Manual* for a discussion of the tests for determining whether a buyer is considered insolvent under the UCC.

exact goods the trade creditor is seeking to reclaim. At least one court has held that a buyer's return of goods in response to an oral reclamation demand is subject to avoidance and recovery as a preferential transfer under Bankruptcy Code § 547(b).[95]

Although there is no official or approved form for a written reclamation demand, trade creditors should adhere to the following guidelines:

- Identify the goods being reclaimed by invoice number, date and amount. Do not delay preparing or delivering a reclamation demand to obtain exact information and supporting documentation. It is not always possible to immediately identify all goods delivered within the 10-day reclamation period. However, the schedule of invoices accompanying a demand should include all invoices issued for a reasonable time prior to the beginning of the reclamation reach-back period. The specific goods may then be determined at a later date and the demand modified accordingly.

- State that the creditor seeks to reclaim its goods.

- Address the demand to the correct legal entity purchasing the goods. A written reclamation demand delivered to a buyer that is a corporation is sufficient to cover all of the buyer's divisions. However, such a demand will not cover deliveries made to the buyer's subsidiaries and affiliates. If the trade creditor has any question about the buyer's corporate identity or structure, it should send the notice to all possible entities: the parent, subsidiaries and affiliates of, and all other known companies related to, the buyer.

- Send the demand to the buyer's corporate offices and where the goods were delivered (*e.g.*, a warehouse, manufacturing plant and/or the buyer's stores).

95 *In re M.P.G. Inc.*, 222 B.R. 862 (Bankr. W.D. Ark. 1998).

A sample reclamation demand for a buyer that has not filed bankruptcy is included as Form 6 in the Appendix.

4. When Is a Reclamation Demand Deemed Made?

The UCC does not clearly state the point in time at which a reclamation demand is deemed to be made. Most courts follow the "Dispatch Rule," holding that a trade creditor makes a reclamation demand when it sends the demand.[96] An alternative view is the "Receipt Rule," which provides that a trade creditor makes a demand upon receipt by the buyer.[97] The Dispatch Rule favors a trade creditor by considering its reclamation demand to have been made at an earlier date.

To avoid a potential legal dispute over when the demand was made, a reclaiming trade creditor should send its demand so that it will be received by the buyer as soon as possible. The fastest and recommended form of delivery is hand delivery, facsimile, email or other means of same-day delivery. Sending the demand by overnight delivery is an option, but this exposes the trade creditor to losing a day before the buyer actually receives the demand. Similarly, sending the demand by regular, certified or registered mail exposes the trade creditor to the risk of the typical delays of mail service.

A trade creditor should keep proof that the buyer actually received the demand. If the demand is sent by facsimile or email, a trade creditor should obtain and secure the confirmation of receipt. If the demand is hand-delivered, the trade creditor should obtain a delivery receipt signed by the buyer/recipient. If the demand is sent by overnight delivery or by certified mail, a trade creditor should make sure that it receives a signed receipt from the buyer confirming the date and time of delivery.

96 *See*, *e.g.*, *In re Marin Motor Oil Inc.*, 740 F.2d at 229 (a "demand" for reclamation of goods under 11 U.S.C. § 546(c) occurs on date of dispatch, not receipt); *Haywin Textile Prods. v. Bill's Dollar Stores*, 164 B.R. 471 (Bankr. D. Del. 1994); *In re Flagstaff Foodservice Corp.*, 56 B.R. 910 (Bankr. S.D.N.Y. 1986).

97 *In re Coast Trading Co.*, 82-000974 (Bankr. D. Or. 1982) (oral opinion by J. Johnson).

The creditor should also determine whether the buyer had already actually received the goods to be reclaimed when the creditor sends its demand. It has been argued that goods received following the demand are not subject to reclamation. If there is any question, the creditor should consider immediately sending another demand that would include those goods received by the buyer following the first demand. The buyer may respond that only one reclamation demand is allowed, but a creditor has nothing to lose by sending multiple demands.

5. Timing of the Reclamation Demand

a. UCC's 10-Day Rule

Under the UCC, a trade creditor must make a reclamation demand within 10 days after the buyer receives the goods.[98] As in the case of stoppage of delivery, for purposes of reclamation, receipt occurs when the buyer or its agent takes possession of the goods. Neither passage of title, risk of loss to the buyer, nor a creditor's Free On Board (FOB) delivery of goods to a common carrier has any bearing on when the buyer is deemed to have received the goods.[99]

The generally accepted method for counting the 10-day period excludes the day the goods are received and counts forward starting with the next day.[100] For example, if a buyer received the goods on January 10, excluding that day and counting 10 days forward beginning with January 11, as a general rule the creditor must make its reclamation demand no later than January 20. If January 20 is not a business day, the deadline for making the demand automatically extends to the next business day. So, if January 20 falls on a Saturday, the creditor must

98 U.C.C. § 2-702(2).

99 *In re Marin Motor Oil Inc.*, 740 F.2d 220 (3d Cir. 1984); *In re R.F. Cunningham & Co.*, 2006 Bankr. LEXIS 3650 (Bankr. E.D.N.Y. Dec. 21, 2006); *In re Maloney Enterprises Inc.*, 37 B.R. 290 (Bankr. E.D. Ky. 1983).

100 *In re Flagstaff Foodservice Corp.*, 56 B.R. 910 (Bankr. S.D.N.Y. 1986); Fed. R. Civ. P. 6(a); Fed. R. Bankr. P. 9006(a).

make its reclamation demand no later than Monday, January 22.[101] If Monday, January 22, is a holiday, the creditor has until Tuesday, January 23, to make its demand.

Some buyers have permitted trade creditors to count the reclamation period backward from the date of the reclamation demand. Under this method, the date of the demand is excluded, and counting starts with the preceding day. For example, if the trade creditor made its reclamation demand on January 20, excluding that day and counting 10 days backward, the demand would include goods that the buyer received on and after January 10.

A trade creditor might wish to count the reclamation period both forward and backward to determine which method maximizes its reclamation claim. However, note that in a litigation, a court will only count forward, not backward.

Because the reclamation period is computed based on the date the buyer received the goods, trade creditors should immediately request signed delivery receipts from the carrier that delivered the goods to determine when the buyer actually received the goods sought to be reclaimed. Carriers often discard delivery documents after a short period of time, and a delay in attempting to obtain delivery receipts makes it more difficult to obtain such proof.

A trade creditor should also directly ask the buyer when it received the goods. The buyer's records may show receipt later than the trade creditor's records. For example, goods may sit on the loading dock before being logged by the buyer as having been "received," or, at the height of the buyer's selling season, the goods may be placed on the shelves for sale quicker than the processing clerks log them in as "received." To the extent that such a lag results in a later receipt date in the buyer's records, the buyer may concede

101 *In re Meyer-Midway Inc.*, 68 B.R. 181 (N.D. Ill. 1986); *Action Indus. (Dollorama) v. Dixie Enter.*, 22 B.R. 855 (Bankr. S.D. Ohio 1982); *but see In re Enterprise Fabricators Inc.* 36 B.R. 220 (Bankr. M.D. Tenn. 1983) (reclamation time period cannot be extended even if last day falls on weekend or legal holiday).

that more goods were received during the reclamation period than other delivery records may show, which could increase the amount of the reclamation claim.

b. Exception to 10-Day Rule

Under the UCC, a trade creditor has an indefinite unlimited amount of time (and not the usual 10 days) to send a reclamation demand when the buyer misrepresents its solvency to the trade creditor. The buyer's solvency misrepresentation must be written and provided to the trade creditor within three months of delivery of the goods. However, this exception to the 10-day rule does not apply when the buyer is in bankruptcy.

The document misrepresenting the buyer's solvency does not have to be signed by the buyer; it can be any document that the buyer provided to the trade creditor upon which the trade creditor reasonably relied in agreeing to sell goods on credit terms to the buyer. The document may be a balance sheet or other type of financial statement, or even a letter that the buyer sent to the trade creditor. Financial information that the buyer supplies to a trade or credit association may also qualify. However, the reclaiming trade creditor must prove that the buyer provided the information to the trade or credit association expecting that its members would receive and rely upon it.

6. Trade Creditor's Reclamation Rights in Credit and Cash Sales

UCC § 2-702(2) affords a trade creditor that sells goods on credit terms the right of reclamation from an insolvent buyer. UCC §§ 2-507 and 2-511 also grant trade creditors that sell goods in a cash-before-delivery or cash-on-delivery transaction reclamation rights when the buyer's payment for the goods is dishonored.

7. Buyer's Possession of Identifiable Goods When Reclamation Demand Is Made

Under state law, a reclaiming creditor may reclaim only identifiable goods in the buyer's possession when the reclamation demand is made. A trade creditor must therefore satisfy two distinct requirements.

First, a trade creditor can reclaim only those goods that are in the buyer's possession at the time the trade creditor makes its reclamation demand. A trade creditor loses its right of reclamation if, at the time of the demand, the buyer no longer has possession of the goods. For example, assume a creditor sells and delivers 1,000 dresses to the buyer, but before the reclamation demand is made, the buyer had already sold and delivered 400 of the dresses to customers. The trade creditor would be entitled to recover only 600 (1,000 - 400 = 600) of the dresses. It is important to note that a trade creditor is only entitled to reclaim the actual goods delivered. A creditor's reclamation demand does not entitle the trade creditor to obtain the proceeds of goods that the buyer had sold prior to the demand.

The second requirement a reclaiming trade creditor must satisfy is that the goods must be "identifiable" at the time the creditor makes the reclamation demand. "Identifiable" goods are in their original state and have not yet been altered by the buyer.[102] For example, slaughtered cattle, bolts placed in machinery, and raw material that has been sewn or dyed, or otherwise altered or processed, are not "identifiable" and therefore are not properly subject to reclamation.

When a trade creditor learns of the buyer's financial troubles, the trade creditor should send its written reclamation demand in a manner that ensures the buyer's receipt of the demand as quickly as possible. Otherwise, the trade creditor runs the risk that the buyer will sell, alter, process or otherwise dispose of goods before receiving the demand.

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102 *In re Morken*, 182 B.R. 1007 (Bankr. D. Minn. 1995); *In re Wheeling – Pittsburgh Steel Corp.*, 74 B.R. 656 (Bankr. W.D. Pa. 1987); *In re Landy Beef Co. Inc.*, 30 B.R. 19 (Bankr. D. Mass. 1983).

Goods commingled into a fungible mass present other problems. For example, when a buyer purchases oil, jet fuel or coal, the buyer will often store it with identical goods at one or more locations. The trade creditor's goods may be just a small part of a large mass of similar, fungible goods. The trade creditor can identify its goods and recover on its reclamation claim where the creditor is the sole supplier of goods stored at that location. The trade creditor can also identify goods that are stored with identical goods purchased from other suppliers where (1) the trade creditor can trace its goods into an identifiable mass, (2) the entire mass contains the exact same type and grade of goods, and (3) the creditor can show that the entire mass is under the buyer's control.[103]

A reclaiming trade creditor has the practical problem of identifying goods in the buyer's possession. Immediately after sending its demand, a creditor should attempt to determine the buyer's position on returning the goods. The trade creditor should obtain access to the goods and send a representative, preferably with a third party, to the buyer's premises to identify its goods. The creditor should take a physical inventory of its goods, review the buyer's receiving, shipping and processing records, and photograph its goods. If possible, the trade creditor should seek to have its goods segregated from the buyer's other goods. If this cannot be done, the trade creditor should obtain written or telephonic confirmation of the goods in the buyer's possession and preserve that information for possible later use in litigation.

8. Exercise of Remedy

If the buyer refuses to grant access to its goods and/or provide records or other information relating to the receipt, location and disposition of the goods, and/or return the goods, a trade creditor should immediately contact an attorney and consider filing a lawsuit to recover the goods in the federal or local court in the state where the goods are located. If the buyer keeps the goods in several states or different localities, the trade creditor

103 *In re Charter Co.,* 54 B.R. 91 (Bankr. M.D. Fla. 1985).

must commence reclamation lawsuits in each of the jurisdictions where the goods are located.

As part of the requested relief, the trade creditor may ask that the court issue a temporary injunction prohibiting the buyer from transferring, moving, altering or selling the reclaiming trade creditor's goods and grant the creditor access to the goods and the buyer's records. The court may require the trade creditor to post a bond in the amount of the value of the goods as a condition to obtaining injunctive relief to prevent the buyer from selling or altering the goods. The bond is posted as security to compensate the buyer for its damages in the event that the reclamation claim is ultimately denied. The trade creditor will have to pay a fee to obtain the bond. The trade creditor may also be required to provide cash or other collateral to the bonding company as security for the trade creditor's obligation to reimburse the bonding company in the event that the buyer draws on the bond.

9. Buyer in Ordinary Course or Good-Faith Purchaser

Under UCC § 2-702(3), a trade creditor's right of reclamation is subject to the rights of a buyer in the ordinary course or other good-faith purchaser under UCC § 2-403. As such, a trade creditor has no right to reclaim goods sold to a buyer in the ordinary course or good-faith purchaser prior to the reclamation demand. A trade creditor also has no right to the proceeds of such sale.[104] UCC § 2-403, in turn, provides certain protections to a buyer of goods in the ordinary course. UCC § 2-702(3) further provides that a successful reclamation of goods by a trade creditor excludes all other remedies with respect to them.

For example, the buyer's sale of goods prior to the reclamation demand cuts off a creditor's reclamation rights. A secured creditor with a perfected floating security interest in all of the buyer's existing and future inventory is

104 *In re Coast Trading Co. Inc.,* 744 F.2d 686 (9th Cir. 1984); *Monfort Inc. v. Kunkel,* 182 B.R. 1007 (Bankr. D. Minn. 1995); *In re Mayer Pollack Steel Corp.* 157 B.R. 952 (Bankr. E.D. Pa. 1993).

also considered a good-faith purchaser and has rights superior to those of a reclaiming trade creditor. When the reclaiming trade creditor commences a state court action, a floating-inventory lienholder will often defeat the reclaiming creditor's claim to its goods. As discussed further herein, this same limitation applies in the bankruptcy context.

If the buyer sells or otherwise alters a trade creditor's goods after the trade creditor makes its reclamation demand, the trade creditor might not be entitled to any relief because the UCC grants the trade creditor the right to reclaim only its goods in their original form. As a result, a reclaiming trade creditor should act quickly to preserve its reclamation rights.

E. Anticipatory Repudiation Under UCC § 2-610

A party repudiates a contract when it communicates an intention to not perform in accordance with the contract or it becomes impossible for the party to continue to perform under the contract. A party's right of anticipatory repudiation arises under U.C.C § 2-610, which 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 the 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…."[105] For example, a buyer may notify the seller that it will not pay for certain goods if delivered. In that instance, the buyer is considered to have repudiated the contract and the seller can resort to any UCC or other remedy for breach of contract, including the suspension of performance under the contract.[106]

If the seller has not cancelled the contract, materially relied upon the repudiation, or indicated that the seller considers the repudiation as final, the

105 U.C.C. § 2-610(b).

106 U.C.C. § 2-610(c).

buyer can retract the repudiation.[107] The retraction must include providing any assurance demanded by the seller, as required under UCC § 2-609.[108] The retraction reinstates the seller's and buyer's rights under the contract, but must provide the aggrieved party an allowance for any delay resulting from the repudiation.[109]

1. Actions Constituting an Anticipatory Repudiation

On its face, UCC § 2-610 appears to allow a suit for breach of contract 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. Similarly, a request for modification of a contract does not amount to a repudiation. Instead, any demand containing a threat or expression of intent not to perform, except on terms outside of the contract, constitutes a repudiation.

The UCC does not define what constitutes "anticipatory repudiation." However, the Official Comments to UCC § 2-610 provide that anticipatory repudiation "centers upon an overt communication of intention or an action which renders performance impossible or demonstrates a clear determination not to continue with performance."[110] A failure to provide adequate assurance, following a demand due to insecurity under UCC § 2-609, would constitute a repudiation of the contract.[111]

107 U.C.C. § 2-611(1).

108 U.C.C. § 2-611(2).

109 U.C.C. § 2-611(3).

110 U.C.C. § 2-610, Cmt 1.

111 U.C.C. § 2-610, Cmt 2.

The announcement by a party of its intention not to perform under its contract must be positive and unequivocal.[112] Often, the basis for the repudiation is a letter, e-mail or telephone call from one party.[113] For example, an e-mail stating that "no further payments will be made" is a "manifestation of [the party]'s intention not to perform."[114] Vague and conditional language will generally not be found to be sufficient to repudiate a contract. For example, invitations to continue further dialogue could invalidate language that would otherwise constitute a repudiation.[115] Similarly, a "secret intention" by a party not to perform, or a negative attitude, will generally not rise to the level of repudiation.[116]

Asking a counterparty for more consideration than what is required by the terms of the contract is not necessarily a repudiation. Instead, a contract would be considered repudiated when the requesting party intends not to perform, unless the other party agrees to the additions to the contract. For example, a buyer repudiated a contract when the buyer required the manufacturer to perform market tests on hair dryers prior to the buyer performing under the contract, even though the contract did not require the manufacturer to perform such market tests.[117]

Further, the repudiation must impair the value of the contract.[118] A statement from the seller that it will not be able to perform a minor, immaterial portion of the contract is not a repudiation of the contract as long as it does

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112 *Carnes Co. v. Stone Creek Mech. Inc.*, 412 F.3d 845, 854 (7th Cir. 2005); *About.com Inc. v. Targetfirst Inc.*, 2003 U.S. Dist. LEXIS 3385 (S.D.N.Y. Mar. 7, 2003) (quoting *Tenavision Inc. v. Neuman*, 45 N.Y.2d 145 (N.Y. 1978)); ("In order to constitute an anticipatory repudiation of a contract, there must be a definite and unequivocal manifestation of intention on the part of the repudiator that he will not render the promised performance when the time fixed for it in the contract arrives.").

113 *Louis Dreyfus Corp. v. Brown*, 709 F.2d 898, 899 (5th Cir. 1983) (contract was repudiated by telephone call from soybean farmer informing buyer that the soybean farmer would be 20,000 bushels short of the quantity required by their contract).

114 *Carnes Co. v. Stone Creek Mech. Inc.*, 412 F.3d 845, 855 (7th Cir. 2005).

115 *Best Payphones Inc. v. Manhattan Telecomms. Corp. (In re Best Payphones Inc.)*, 432 B.R. 46 (S.D.N.Y. 2010) (repudiation was not unequivocal when a disconnect notice provided a phone number and invited the party to call about any questions about the bill).

116 *Unique Sys. Inc. v. Zotos Int'l Inc.*, 622 F.2d 373, 377 (8th Cir. 1980).

117 *Id.*

118 *Cary Oil Co. v. MG Ref. & Mktg. Inc.*, 90 F. Supp. 2d 401, 411 (S.D.N.Y. 2000).

not affect the contract's total value. The requirements for repudiation would be easily satisfied in cases of nonpayment under a contract that clearly impair the contract's value.

2. Special Considerations Involving Requirements Contracts

When a seller and buyer enter into a requirements contract with a duration of several years,[119] and the contract contains a minimum overall requirement, the buyer does not necessarily repudiate the contract by failing to order its yearly requirements. The buyer's reduction in orders during the contract's final year would not amount to a substantial impairment of the contract's value to justify repudiation where the buyer had purchased the minimum quantities required under the contract.

3. Calculation of Damages

When a buyer repudiates a contract, the seller can (1) await performance by the repudiating party for a commercially reasonable time, or (2) resort to any remedy for breach of contract.[120] In either case, the non-repudiating party may suspend its own performance under the contract.[121] If the seller or buyer seeks damages for the repudiation, the seller is entitled to the difference between the market price[122] and the contract price.[123] The market price is determined at the time of the repudiation. For example, upon learning that a seller would be unable to provide the buyer with the contracted amount of soybeans, the buyer was entitled to damages equal to

119 A requirements contract requires the buyer to purchase exclusively either the buyer's entire requirements or up to a specified amount from the seller.

120 U.C.C. § 2-610(a) and (b).

121 U.C.C. § 2-610(c); *Scapa Tapes N. Am. Inc. v. Avery Dennison Corp.*, 384 F. Supp. 2d 544, 556 (D. Conn. 2005) (applying Connecticut's applicable UCC section, Conn. Gen. Stat. § 42a-2-610).

122 *Hess Energy Inc. v. Lightning Oil Co.*, 338 F.3d 357, 365 (4th Cir. 2003) (looked to NYMEX for market price of natural gas).

123 *Louis Dreyfus Corp. v. Brown*, 709 F.2d 898, 900 (5th Cir. 1983) ("[D]amages measured by the difference between the market price when the buyer learned of the breach and the contract price.") (internal quotation omitted).

the difference between the quoted price for soybeans on the New York Mercantile Exchange at the time of the repudiation and the contract price.[124]

However, if a seller waits for performance beyond a commercially reasonable time, the seller will be unable to recover resulting damages from the buyer's nonperformance.[125] While the seller awaits the buyer's performance, the buyer may cure the repudiation and the seller will be unable to seek any damages.[126]

4. Considerations for Multiple Contracts Between the Same Parties

Sellers will often have multiple contracts with their buyers. Generally, a buyer's material breach of one contract does not justify the seller refusing to perform under another separate and distinct contract with the same buyer.[127] A seller should be careful to only suspend performance under the contracts that the buyer has actually repudiated. A seller that improperly exercises its rights under UCC § 2-610 exposes itself to damages for breach of contract. For example, where a seller had separately contracted to sell and deliver cut lumber and pine lumber to its buyer, a court held that the seller had improperly refused to deliver cut lumber, even though the buyer was past due on its invoice for the seller's prior delivery of pine lumber. The court concluded that the seller lacked the proper basis to "refuse performance because the other has breached a separate contract between them."[128] In such a situation, the seller should rely on the provisions of § 2-609 and demand adequate assurance of performance from the buyer based in part on the buyer's inability to perform under its other contract with the seller that the buyer had breached, and the repudiation of that contract.

124 *Louis Dreyfus Corp.*, 709 F.2d at 901.

125 U.C.C. § 2-610, Cmt. 1.

126 *Miller & Sons Bakery Co. v. Selikowitz*, 8 N.J. Super. 118 (N.J. App. Div. 1950).

127 *National Farmers Org. v. Bartlett and Co. Grain*, 560 F.2d 1350, 1357 (8th Cir. 1977); *Barz v. Geneva Elevator Co.*, 12 F. Supp. 2d 943, 961 (N.D. Iowa 1998); *Northwest Lumber Sales Inc. v. Continental Forest Products Inc.*, 261 Ore. 480, 495 P.2d 744 (1972).

128 *Northwest Lumber Sales Inc. v. Continental Forest Products Inc.*, 261 Ore. 480, 495 P.2d 744, 749 (1972).

F. Resale of Goods Under UCC §§ 2-703 and 2-706

1. Circumstances Under Which Goods May Be Resold

Upon the occurrence of a default by the buyer, a seller is permitted to resell the goods under the defaulted contract at a public or private sale and recover damages against the buyer for the difference between the resale price and the contract price.[129] The steps that a seller conducting a private or public sale must take in order to recover the difference between the resale price and the contract price are set forth in UCC § 2-706. Official Comment 1 to UCC § 2-706 states that "[t]he only condition precedent to the seller's right of resale … is a breach by buyer…."[130] The seller must conduct the resale in a commercially reasonable manner and must provide notice of the sale to the buyer. Even if the seller does not resell in a commercially reasonable manner and loses the ability to recover the difference between the contract price and the resale price, the purchaser of the resold goods will be able to retain the goods so long as it had acted in good faith.

2. Calculation of Damages

According to UCC § 2-706(1), when a buyer breaches its contract with a seller, the seller can recover damages in an amount equal to the difference between the resale price and the contract price, together with any incidental damages,[131] less the expenses saved as a result of the buyer's breach. Although a number of appellate courts have ruled that a seller cannot recover consequential damages arising from a buyer's breach of a sales contract, the

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129 U.C.C. §§ 2-703(d) and 2-706(1).

130 *Lugran v. J. Arrowsmith Broadway Inc.*, 1981 U.S. Dist. LEXIS 12224 at * 18 (S.D.N.Y. Mar. 27, 1981) ("[T]he only prerequisite to U.C.C. § 2-706 is wrongful rejection by the [buyer].").

131 U.C.C. § 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."

logic of this line of cases has been questioned by a leading UCC treatise. The question of what constitutes consequential damages for a seller, and whether they can be recovered as part of a breach of contract claim, remains an unsettled area of law.[132]

Any damages, however, are only awarded if the seller conducts the sale in good faith and in a commercially reasonable manner. Failure to act in such a manner prevents the seller from recovering under UCC § 2-706. For instance, "wash" sales — when a seller sells goods to a third party at an artificially low price and the third party shortly thereafter sells the goods back to the seller for a marginal profit — are not allowed.[133]

In one case, a company had resold trailers to an affiliate after trying to sell the trailers during a six-month period.[134] The sale was not commercially reasonable because the affiliate was then able to resell the trailers within eight days of purchase. The court stated that a private sale to an affiliate is "not *per se* commercially unreasonable."[135] However, the seller was unable to produce any tangible evidence of its efforts to sell the trailers during the prior six-month period. Had the seller produced a list of companies it had contacted, ads that it had placed, or other indicia of its marketing efforts, the court might have allowed the seller to recover damages provided for under UCC § 2-706.

Damages are not dependent on current market conditions. Therefore, if a seller can only locate a buyer willing to pay for the goods at well below market prices, the seller can still recover the difference between the resale price and the contract price. The market or current prices, though, will be rele-

132 *See generally* J. White and R. Summers, *Uniform Commercial Code* Sec. 7-16(b).

133 *See, e.g., Coast Trading Co. v. Cudahy Co.*, 592 F.2d 1074, 1081 (9th Cir. 1979) (seller forfeits damage claim by failing to act in a commercially reasonable manner when it had resold goods to third party, who just nine days later resold them back to seller at price of only $0.25 per ton higher, where the goods have never left seller's property).

134 *Larsen Leasing Inc. v. Thiele Inc.*, 749 F. Supp. 821 (W.D. Mich. 1990).

135 *Id.* at 823; *see also Knic Knac Agencies v. Masterpiece Apparel*, 1999 WL 156379, at *46-47 (S.D.N.Y. Mar. 17, 1999) (no evidence that resale precluded relief under U.C.C. § 2-706).

vant to "whether the seller acted in a commercially reasonable manner."[136] Accordingly, if one day after the breach a seller resells the goods to the first interested party for a *de minimis* amount, without any further marketing of the goods, it is less likely a court will conclude that the seller had acted in a commercially reasonable manner. If a seller resells the goods for an amount above the contract price, the seller is allowed to keep the difference. The seller is not liable to the buyer for any profit made on the resold goods.[137]

The timing of the resale is a key factor in determining whether a sale is commercially reasonable. For example, a seller's delay in selling heating oil more than six weeks after the buyer's breach was found to be unreasonable.[138] The seller should have quickly resold the heating oil because the heating oil market was very volatile, having greatly fluctuated during that six-week period. In another case, a court held that the resale of future contracts,[139] originally sold to a consortium of three parties, was commercially reasonable when they were resold within eight days of their breach by the first two parties and within two days of their termination by the third party.[140]

However, one court upheld a three-year delay in reselling the goods as appropriate.[141] The seller manufactured a product specifically designed for the buyer. When the buyer had breached the contract, the seller contacted every company in the industry that could potentially use the product. While the seller eventually sold the goods three years later at a price below the contract price, the court still concluded that the seller had acted in a com-

136 U.C.C. § 2-706, Cmt. 3; *see also* Cmt. 5 ("What is such a reasonable time depends upon the nature of the goods, the condition of the market and the other circumstances of the case; its length cannot be measured by any legal yardstick or divided into degrees.").

137 U.C.C. § 2-706(6).

138 *Apex Oil Co. v. Belcher Co. of New York Inc.*, 855 F.2d 997, 1007 (2d Cir. 1988) ("In view of the long delay and the apparent volatility of the market for No. 2 oil, the purported resale failed to meet the requirements of Section 2-706 as a matter of law.").

139 Resale on public exchange like NYMEX is "inherently fair to the breaching buyer and fulfills § 2-706(4)(b)." *Petroleum Traders Corp. v. Baltimore County, Maryland*, 2009 U.S. Dist. LEXIS 83458 at *28 (D. Md. Sept. 14, 2009).

140 *Petroleum Traders Corp,* 2009 U.S. Dist. LEXIS 83458 at *27.

141 *Firwood Mfg. Co. Inc. v. Gen. Tire Inc.*, 96 F.3d 163, 169 (6th Cir. 1996).

mercially reasonable manner and allowed the seller to recover the difference between the contract price and the resale price from the buyer.

3. Requirements for Private Sales and Public Sales

A seller can sell goods that are related to a breached contract through either a public or private sale. A public sale is conducted by auction. A private sale can be accomplished through solicitation and negotiation directly handled by the seller or the seller's broker.[142] The "[s]ale may be as a unit or in parcels and at any time and place and on any terms, but every aspect of the sale including the method, manner, time, place and terms must be commercially reasonable."[143]

The seller must provide notice of the sale to the buyer. Failure to provide the required notice prevents the seller's recovery of damages from the buyer.[144] If the seller conducts a private sale, the seller must provide notice to the buyer of the seller's intention to resell, but the seller is not required to provide notice of the time or place of the private sale.[145] The amount of notice of a private sale that a seller is required to provide a buyer is dependent upon the specific circumstances. If the goods at issue are perishable or at risk of rapidly declining in value, the amount of notice considered adequate will be considerably shorter than for nonperishable goods. Accordingly, a seller will likely be found to have acted reasonably if it had immediately resold fresh produce, on little or no notice to the defaulting buyer, rather than holding off any resale pending a long notice period that would have resulted in the produce rotting and becoming non-saleable.

142 U.C.C. § 2-706, Cmt. 4.

143 U.C.C. § 2-706(2).

144 *BAII Banking Corp. v. Atlantic Richfield Co.*, 1993 WL 403963, at * 19 (S.D.N.Y. Oct. 4, 1993) (failure to notify buyer of intent to resell, among other factors, barred seller from recovering damages); *In re Excello Press Inc.*, 890 F.2d 896, 903 (7th Cir. 1989) (notice of a private sale must give debtor notice of date after which collateral will be sold; debtor's general awareness that creditor was attempting to sell collateral did not constitute sufficient notice of sale); *Ford Motor Credit Co. v. Solway,* 825 F.2d 1213, 1219 (7th Cir. 1987) (notice that sale of collateral would occur on or after stated date sent by certified mail to debtor was adequate).

145 U.C.C. § 2-706(3), Cmt. 8.

What constitutes sufficient notice of a private sale will also depend on the specific circumstances. One court found sufficient notice of a private sale where the defaulting buyer had notice that the ultimate purchaser of the resold goods could not take possession of the goods without obtaining documents from the buyer's customs agent. The customs agent could not release the goods without the buyer's permission, and the defaulting buyer had sent correspondence to the seller suggesting that the seller resell some of the goods.[146]

For a public sale, the seller must give notice of the time and place of the sale. The same concept of expedited notice applies to public sales of perishable goods or goods that could rapidly decline in value if not sold quickly. The benefit of a public sale from the perspective of the seller, compared to a private sale, is that the seller is allowed to bid on the goods.[147]

4. Rights of a Good-Faith Purchaser

If a seller fails to comply with UCC § 2-706, a purchaser of the resold goods is not without protection. As long as the purchaser acted in good faith,[148] the purchaser will take the goods free of any right, claim or interest of the original buyer.[149] The policy behind this provision is that a good-faith purchaser does not have knowledge of the seller's or buyer's bad acts, or failure to comply with the UCC, and therefore should not be penalized.

146 *Lugran v. J. Arrowsmith Broadway Inc.*, 1981 U.S. Dist. LEXIS 12224 at *19 (S.D.N.Y. Mar. 27, 1981).

147 U.C.C. § 2-706(4)(d).

148 U.C.C. §§ 1-201(20) and 2-103(1)(b) define "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing."

149 U.C.C. § 2-706(5).

G. Seller's Damages for Non-Acceptance or Repudiation

UCC § 2-708 addresses a seller's damage claim where the buyer does not accept the goods it had purchased under its contract with the seller or repudiates the contract. UCC § 2-708(1) grants the seller, in such circumstances, the right to claim damages in the amount of the difference between the market price at the time and place for tender and the unpaid contract price, together with the seller's incidental damages, but less expenses saved as a result of the buyer's breach. This is similar to the calculation of a seller's damage claim arising out of its resale of goods under UCC § 2-706.

According to UCC § 2-708(2), if the court determines that the means of calculating damages under UCC § 2-708(1) fails to put the seller in the same position as it would have enjoyed in the event that the buyer had fully performed under the contract, the court may assess damages based on the profit that the seller would/could have earned from the buyer's full performance under the contract. The seller would also be entitled to incidental damages and the costs of resale reasonably incurred by the seller, less the proceeds of any resale of the goods.

H. Action for Price

Under UCC § 2-709, a seller could sue to recover the contract price, plus incidental damages, in the following three circumstances:

- The buyer had accepted the goods;
- The goods were lost or damaged within a commercially reasonable time after risk of their loss had passed to the buyer; or
- The seller is unable to resell goods identified to the contract at a reasonable price.

UCC § 2-709(2) further states that when a seller sues to recover the contract price, the buyer should be credited with the net proceeds of the seller's resale of goods identified to the contract and in the seller's control prior to the seller's collection of any money judgment against the buyer.

I. Setoff and Recoupment

1. Setoff

When a buyer fails to pay its indebtedness to a trade creditor, the trade creditor should consider whether it can exercise setoff rights. Setoff enables a creditor to reduce its exposure for amounts it owes to a financially distressed buyer by netting out the debt that the buyer owes the creditor against the debt that the trade creditor owes to the buyer. Setoff rights ensure that a creditor is not obligated to pay its buyer for a debt while there are still amounts the buyer owes to the trade creditor.

A trade creditor can exercise setoff rights when the trade creditor and its buyer sold goods and/or provided services to each other on credit terms resulting in each having indebtedness to the other. The trade creditor can reduce the balance owing on its claim by applying the amount its buyer owes the same trade creditor to reduce the amount the creditor owes to its buyer. For example, if A owes B $1,000 and B owes A $800, then A can net out, or setoff, the amounts owed so that A only pays B the net amount of $200.

Subject to certain limitations, a trade creditor can assert setoff rights even following the buyer's filing of a bankruptcy case. Exercising setoff rights against a debtor buyer avoids the risk of nonpayment by the debtor (or a significantly reduced payment as part of a bankruptcy distribution), while the trade creditor is forced to repay the full amount of its indebtedness to its buyer. The U.S. Supreme Court went as far as to say such a result would be absurd.[150]

150 *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18 (1995).

Section 553 of the Bankruptcy Code recognizes a trade creditor's setoff rights that already exist under state law or otherwise applicable nonbankruptcy law. However, § 553 and other provisions of the Bankruptcy Code place restrictions on when a creditor may exercise setoff rights. Under § 553, the exercise of setoff rights is conditioned on the existence of a mutuality of the debtor's and creditor's obligations. Mutuality requires that the same legal entities have indebtedness to each other and the debtor's and creditor's indebtedness to each other both arose either before or after the bankruptcy filing. In addition, unless a trade creditor's contract fits within the Bankruptcy Code's "safe harbor" provisions for certain securities, derivatives or commodity contracts, a creditor seeking setoff after its customer's bankruptcy filing must first obtain relief from the automatic stay that arises under Bankruptcy Code § 362. Section 553 also limits any pre-petition setoff (during that 90-day period before bankruptcy) that improved the creditor's position and certain other setoff rights that arose during the 90-day period.

2. Recoupment

A trade creditor's right of recoupment, which allows a creditor to net out its claim against its buyer against the creditor's obligations to the buyer, is similar to setoff but has certain material differences. Recoupment is only available where the debts between the creditor and buyer arose *out of the same transaction*. Various courts have interpreted "transaction" both broadly or narrowly, which impacts the availability of recoupment as a remedy depending on the relevant jurisdiction. Some courts have broadly interpreted a "transaction" to allow recoupment where the debts are related. These courts permit recoupment where the debts are sufficiently interconnected as to make it unfair to require one contract party to fulfill its obligations to the other party, but not require the other party to do the same. Other courts have narrowly interpreted "transaction" with respect to recoupment rights to require that the debts relate to the same contract or even a single transaction under a contract.

Recoupment has several advantages over setoff, particularly when a creditor's customer has filed for bankruptcy. The automatic stay imposed by Bankruptcy Code § 362 does not apply to a trade creditor exercising its recoupment rights if a creditor does not need to obtain relief from the automatic stay to exercise its right of recoupment. However, in situations where there is a question concerning whether the netting out of claims by and against a debtor would be considered the exercise of setoff rights or recoupment rights, a trade creditor should proceed cautiously and seek permission from the bankruptcy court to lift the automatic stay prior to exercising its rights.

3. Bankruptcy Prohibition of Triangular Setoff Rights

Bankruptcy law generally does not permit setoff as a remedy when there are more than two entities involved in a transaction. For instance, a company with multiple lines of business would normally operate through a group of related subsidiaries and affiliates. A trade creditor that does business with multiple entities that file for bankruptcy risks losing its setoff rights based on a lack of "mutuality" of the debts owed among the parties.

Bankruptcy Code § 553's mutuality requirement for setoff cannot be satisfied when a trade creditor seeks to set off its claim against one debtor affiliate to reduce the creditor's obligation to another debtor affiliate. Corporate law generally respects the separate legal existence of each corporate entity, absent extraordinary circumstances, and prohibits using the assets of one entity to pay the liabilities of an affiliate. Thus, if the different legal entities have indebtedness owing between them, the debts are not "mutual" and the requirements for exercising setoff rights cannot be satisfied.

Trade creditors often seek to draft around this mutuality requirement by including "triangular" setoff provisions in their agreements with their affiliated customers. Triangular setoff provisions state that, for purposes of setoff, all affiliated entities of each party to the contract will be treated as a single entity. This is often referred to as a "cross-affiliate" netting provision. The parties to such contracts agree to disregard the corporate separateness of their affiliates, for setoff purposes, and the liabilities of all affiliates are combined and netted. Whichever party is the net creditor will have the right to seek payment from the other party for the amount due following the setoff. Through such a provision, the parties agree that for setoff purposes, the debts of all affiliates of one party to the contract will be deemed to be mutual in nature to the debts of all other affiliates of the other party to the contract.

However, a number of bankruptcy courts have refused to enforce "cross-affiliate" netting provisions, or other setoff provisions that provide for triangular setoff. These courts have held that the triangular setoff provisions do not satisfy UCC § 553's mutuality requirement for setoff. For instance, a 2011 decision by the U.S. Bankruptcy Court for the Southern District of New York in *Lehman Brothers Inc.*[151] relied on the lack of mutuality to reject a creditor's attempt to set off its indebtedness to one affiliate to reduce its obligation to another debtor affiliate, notwithstanding a triangular setoff provision in the parties' agreement. The court ruled that while the contractual netting provision may give rise to enforceable setoff rights under state law, the debts did not become "mutual" by virtue of the triangular setoff provision such that they were subject to setoff in the affiliates' bankruptcy case.

The *Lehman Brothers* court relied on the 2009 decision by the U.S. Bankruptcy Court for the District of Delaware in *In re SemCrude, L.P.*, which was affirmed on appeal by the U.S. District Court in Delaware.[152] The *SemCrude* court rejected a creditor's attempt to set off claims against, and obligations to, different debtor affiliates based on the triangular setoff

151 *In re Lehman Bros. Inc.*, 458 B.R. 134, 139-140 (Bankr. S.D.N.Y. 2011).

152 *In re SemCrude L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), *aff'd*, 428 B.R. 590 (D. Del. 2010).

provision in their agreements.[153] The district court ruled that the triangular setoff provision did not create the mutuality of debts that UCC § 553 requires as a condition for a creditor exercising its setoff rights following the filing of a bankruptcy case.

4. When to Assert Setoff Rights in Bankruptcy

Special consideration should be given to how and when trade creditors raise their setoff rights against a buyer in a bankruptcy case. Courts have reached differing conclusions regarding exactly what actions or omissions will result in a creditor waiving its setoff rights. However, one consistent theme is that a creditor should be proactive in asserting its setoff rights as soon as the bankruptcy case is commenced. This means that a creditor should be diligent in reviewing pleadings, such as proposed orders approving chapter 11 financing and use of cash collateral, and be prepared to interpose an objection to any pleading that abridges or in any way abrogates a creditor's setoff rights. A creditor may also consider seeking to lift the automatic stay at the outset of a bankruptcy case in order to effectuate a setoff.

At a minimum, it is important for a trade creditor to timely file a proof of claim that articulates the facts giving rise to its setoff right and indicates that the creditor has a secured claim equal to the amount subject to setoff. Notably, there is disagreement among the courts as to whether a creditor is required to assert its setoff rights in its proof of claim. Courts following one view recognize that there is no specific bankruptcy statute or procedural rule requiring a creditor to assert setoff rights in a proof of claim.[154] According to these courts, a creditor will generally not be deemed to have waived its setoff rights when it does not assert them during the early stages

153 *SemCrude*, 428 B.R. at 594; *see also In re Orexigen Therapeutics Inc.*, 2018 Bankr. LEXIS 3579, at *15 (Bankr. D. Del. Nov. 13, 2018), *appeal docketed*, No. 18-cv-01873 (D. Del. Nov. 27, 2018) (triangular setoff provision unenforceable in bankruptcy due to lack of mutuality).

154 *See In re Denby Stores*, 86 B.R. 768, 777 (Bankr. S.D.N.Y. 1988); *U.S. v. Peterson (In re Peterson)*, 2004 WL 1397575, at *2 (Bankr. M.D. Ga. June 3, 2004); *Weems v. U.S. (In re Custom Center Inc.)*, 163 B.R. 309, 316-17 (Bankr. E.D. Tenn. 1994); *In re Northeastern Int'l Airways Inc.*, 99 B.R. 487, 489 (Bankr. S.D. Fla. 1989); *U.S. v. Krause (In re Krause)*, 261 B.R. 218, 223 (B.A.P. 8th Cir. 2001).

of a bankruptcy case. Instead, these courts will look to whether a creditor expressly waived its setoff rights through, for instance, a written statement that the creditor will not pursue its rights, statements of its counsel in court,[155] or taking actions inconsistent with an intent to exercise a setoff right (*e.g.*, making a voluntary payment to the debtor without any reservation of setoff rights).

However, other courts have adopted a strict *per se* rule that a creditor's failure to assert setoff rights in its proof of claim results in a waiver of its setoff rights.[156] For instance, the U.S. Bankruptcy Court for the Eastern District of North Carolina ruled that in chapter 11 and 12 cases, a creditor must timely file a proof of claim, assert its setoff rights, and seek to have the automatic stay lifted to allow the setoff. The court also held that the creditor could not amend its original proof of claim to assert its setoff rights because in chapter 11 and 12 cases, a debtor generally will be prejudiced by a creditor failing to assert setoff rights in its original proof of claim.

Another court adopting this view found that a creditor will generally be deemed to have waived its right of setoff if it files a proof of claim without asserting the right.[157] However, the court ruled that under the circumstances of the specific case before it, the creditor maintained its setoff rights because the creditor did *not* file a proof of claim.

As a bankruptcy case continues toward its conclusion, creditors face a substantially greater risk that they will lose their unasserted setoff rights. This risk becomes particularly acute when a debtor's plan is confirmed and/or the debtor receives a discharge. Courts are divided on the issue of whether setoff rights under § 553, or the discharge provisions of the Bankruptcy Code, should take precedence when a plan is silent on the treatment of setoff rights. The Ninth and the Tenth Circuit Courts of Appeals have ruled that a creditor's setoff right against the debtor survives a discharge,

155 *In re Calore Express Co.*, 288 F.3d 22, 38 (1st Cir. 2002).

156 *In re Lykes Bros. S.S. Co. Inc.*, 217 B.R. 304, 312 (Bankr M.D. Fla. 1997).

157 *In re Butler*, 61, B.R. 790, 791 (Bankr. S.D. Fla. 1986).

reasoning that it would not be fair to deny a creditor the right to recover an obligation while requiring the creditor to fully satisfy its debt to the debtor.[158] However, the Third Circuit Court of Appeals in *In re Continental Airlines*[159] ruled that a creditor loses its setoff rights following confirmation of a debtor's plan unless a creditor asserts its setoff rights in a proof of claim or otherwise prosecutes its rights.

There is greater consensus among the courts that a creditor's setoff rights are waived where a debtor's confirmed plan expressly abridges or abrogates setoff rights. For example, in a case where the debtor's plan expressly barred creditors from asserting setoff rights post-confirmation, the court ruled that the creditor's setoff rights were deemed waived because the creditor had failed to object to the plan.[160]

158 *Carolco Television Inc. v. Nat'l Broadcasting Co. (In re De Laurentiis Entm't Grp. Inc.)*, 963 F.2d 1269, 1276-77 (9th Cir. 1992); *see also Davidovich v. Welton (In re Davidovich)*, 901 F.2d 1533, 1539 (10th Cir. 1990).

159 *U.S. v. Cont'l Airlines (In re Continental Airlines)*, 134 F.3d 536 (3d Cir. 1998).

160 *Daewoo Int'l (America) Corp. Creditor Trust v. SSTS America Corp.*, 2003 WL 21355214, at *5 (S.D.N.Y. June 11, 2003)*; see also In re Lykes Bros. S.S. Co.*, 217 B.R. at 312; *In re Twins Inc.*, 318 B.R. 90, 96 (Bankr. D.S.C. 2004).

Chapter IV

FEDERAL BANKRUPTCY CODE RIGHTS

A. Section 503(b)(9) "20 Day" Administrative Claims

Congress added Bankruptcy Code § 503(b)(9) as part of the 2005 amendments to the Bankruptcy Code.[161] Section 503(b)(9) grants goods sellers an administrative priority claim for the value of the goods they had sold to a debtor in the ordinary course of the debtor's business and that the debtor had received within 20 days of its bankruptcy filing. This administrative claim affords unpaid goods sellers valuable leverage in bankruptcy cases. The effect of § 503(b)(9) is that it grants a qualifying claim a "step-up" in priority from a less valuable general unsecured claim to a higher ranking more valuable administrative expense claim for goods the debtor had received on credit terms shortly before the bankruptcy filing. This step-up in priority is significant because, as a general rule, an administrative claim must be paid in full prior to a general unsecured creditor receiving any distribution.

Section 503(b)(9)'s language granting trade creditors this administrative priority claim appears disarmingly simple. Creditors are entitled to an administrative priority claim for "the value of any goods received by the debtor within 20 days before the date of commencement of a case under this

161 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).

title in which the goods have been sold to the debtor in the ordinary course of such debtor's business."

However, given the brevity of § 503(b)(9) and the lack of defined terms or legislative history contained in either § 503(b)(9), or any other provision of the Bankruptcy Code related to § 503(b)(9), plus the sheer magnitude of the claims in certain bankruptcy cases, the amount of litigation over the meaning of § 503(b)(9) has been significant, and the courts have been left to develop the body of law that will determine exactly what type of transactions qualify for this administrative priority claim. Courts have already grappled with the following issues relating to § 503(b)(9) priority rights:

- Is there a deadline and manner in which a creditor must assert a § 503(b)(9) priority claim?
- What are "goods" that are protected under § 503(b)(9)?
- When are goods deemed "received"?
- Are drop-shipped goods eligible for protection under § 503(b)(9)?
- What is the "value" of the goods entitled to priority status?
- When must an allowed § 503(b)(9) claim be paid?
- What defenses can a debtor or other party assert in support of an objection to a § 503(b)(9) claim, and is a pending preference claim against the creditor one such defense?

1. Status of § 503(b)(9) Priority Claim in the Bankruptcy Hierarchy

A § 503(b)(9) claim is unique because it has all the characteristics of a general unsecured claim (*i.e.*, it arose prior to the petition date, is not secured by collateral, etc.), except that it is afforded administrative priority status under the Bankruptcy Code. Accordingly, in the bankruptcy claims hierarchy, a § 503(b)(9) claim ranks as an administrative priority claim. It enjoys the same priority status as the claims of those parties that supplied goods and services on credit to a debtor after the commencement of the bankruptcy case; lessors' post-petition claims for rent; the claims of bankruptcy estate professionals; employees' claims for post-petition wages, salaries and benefits; and claims for post-petition taxes. A § 503(b)(9) claim stands behind only secured claims. Most importantly, subject to debtors/lenders arguing otherwise, a § 503(b)(9) claim generally must be paid in full when a debtor's plan of reorganization or plan of liquidation is deemed effective.

2. Deadlines and Methods for Asserting Claims

Allowance of a § 503(b)(9) claim is not automatic or self-executing. Rather, § 503(b)(9) states that such claims will only be allowed after "notice and a hearing." This phrase generally implies that a trade creditor must file a motion for allowance of the claim and provide other parties-in-interest with the opportunity to object to the relief sought in the motion. In practice, however, courts throughout the country have approved various simplified procedures in an attempt to streamline the reconciliation process for these claims without the need for hundreds, or sometimes thousands, of trade creditors to retain counsel, file motions and appear before the court on an individualized basis.

For example, bankruptcy courts have frequently authorized the assertion of a § 503(b)(9) claim through the filing of a proof of claim. That could include filing a special proof of claim form specifically geared toward asserting a § 503(b)(9) priority claim, or including the trade creditor's § 503(b)(9) claim as part of the creditors' single proof of claim, which includes both the § 503(b)(9) priority portion and the trade creditors' remaining general unsecured claim. It all depends on the means for asserting a § 503(b)(9) priority claim that a bankruptcy court approves. Trade creditors should review the bankruptcy court docket, as well as any court order that establishes procedures for asserting § 503(b)(9) priority claims, to determine whether trade creditors can assert their § 503(b)(9) claims by filing a proof of claim or by other means.[162] These orders may provide a specific claims bar date for filing § 503(b)(9) claims, authorize a specific claim form that must be used for the filing of § 503(b)(9) proofs of claim, set a general claims bar date for filing all pre-petition claims (including § 503(b)(9) priority claims), or specify other methods for asserting claims.

Trade creditors should also be cognizant of the deadline for asserting § 503(b)(9) claims. As a general rule, this deadline is set by court order. However, trade creditors should consult both the local bankruptcy court rules in the jurisdiction in which the case is filed, as well as the bankruptcy court docket for orders entered in the case that set a bar date for asserting § 503(b)(9) claims, to confirm the deadline for filing the claims. For instance, the U.S. Bankruptcy Court for the District of Massachusetts has a local rule establishing a deadline to file a § 503(b)(9) claim of 60 days following the first date for the meeting of creditors.[163] Similarly, the U.S. Bankruptcy Court for the Eastern District of Michigan has a deadline to assert § 503(b)(9) priority claims that is 90 days after the first scheduled § 341 meeting date of creditors.[164]

Certain courts have strictly interpreted deadlines established by local rule. For example, Richfield Equities[165] and three affiliated entities filed chapter 11 petitions on September 18, 2012, in the U.S. Bankruptcy Court for the Eastern District of Michigan. Dependable Wholesale Inc. supplied the debtors with tires and related products. Dependable filed a $105,000 proof of claim against the debtors, of which $25,000 was related to goods delivered to the debtors within the 20-day § 503(b)(9) window. However, Dependable did not file a motion to assert its § 503(b)(9) claim by the January 15, 2013, deadline imposed by the court's local rule. Instead, in response to

162 *In re Pilgrim's Pride Corp.*, 421 B.R. 231, 235 (Bankr. N.D. Tex. 2009) (court entered order requiring creditors to assert their § 503(b)(9) claims by sending letter to debtors).

163 District of Massachusetts Local Bankruptcy Rule 3002-1.

164 Eastern District of Michigan Local Bankruptcy Rule 3003-1.

165 *In re Richfield Equities L.L.C.*, 556 B.R. 313 (Bankr. E.D. Mich. 2016).

an objection filed by the chapter 7 trustee to Dependable's assertion of its § 503(b)(9) claim on a proof of claim form (in contravention of the local rule), Dependable filed a motion seeking payment of the same claim more than three and a half years after the deadline.

In the motion, Dependable argued that (1) conversion of the chapter 11 case to a case under chapter 7 excused or reset the statutory deadline to file a motion; (2) the claim, including the attached invoices, contained all of the information that would have been included in the motion; and (3) cause existed to file the motion after the deadline. The bankruptcy court sustained the trustee's objection to Dependable's proof of claim and denied Dependable's late-filed motion for approval of a § 503(b)(9) claim. The court observed that the U.S. Bankruptcy Court for the Eastern District of Michigan's local rule filled a gap because neither the Bankruptcy Code nor the Bankruptcy Rules fixes a deadline by which § 503(b)(9) claims must be filed. Also, the court found no support for the argument that the conversion to a chapter 7 case reset the deadline imposed by the local rule. In addition, the court focused on how the local rule's early deadline to file § 503(b)(9) claim motions make it more likely that the documents/evidence needed for a creditor to prove, and the trustee to object to, § 503(b)(9) claims would be preserved. In addition, the court stated that it might have reached a different conclusion if Dependable — contrary to its argument — had actually attached documents to its proof of claim showing the delivery date of the goods at issue and not just Dependable's invoices. Finally, the court did not find that Dependable demonstrated the necessary cause, because the debtor and other creditors were more prejudiced by the late-filed motion than Dependable.

As of the publication of this text, neither the U.S. Bankruptcy Court for the Southern District of New York nor the U.S. Bankruptcy Court for the District of Delaware, both popular venues for large chapter 11 filings, have adopted local rules concerning the timing and method for asserting

§ 503(b)(9) claims. Thus, those deadlines must be determined on a case-by-case basis.

Numerous bankruptcy courts have approved bar dates for asserting pre-petition claims, including § 503(b)(9) administrative priority claims. Generally, a trade creditor must file only the documents necessary to show that it sold goods to the debtor in the ordinary course of the debtor's business and that the debtor received the goods within 20 days of its bankruptcy filing. In *In re Dana Corp.*, the bankruptcy court approved a claims bar date for all pre-petition claims, including § 503(b)(9) claims. The court denied the motion of a § 503(b)(9) claimant to file its claim after the claims bar date had passed, holding that the creditor's failure to timely file its claim resulted in the disallowance of administrative priority status.[166]

Importantly, asserting a § 503(b)(9) claim is not complicated by all of the requirements and limitations that make it risky and costly to pursue reclamation claims.[167] For instance, a trade creditor does not have to send a written reclamation demand, prove the debtor's insolvency, prove that the goods were in the debtor's possession at the time of the demand, or prove that the goods were not consumed, or otherwise commingled, with other like goods of the debtor as a prerequisite for asserting a valid § 503(b)(9) priority claim. Moreover, a trade creditor with a § 503(b)(9) claim will not lose its priority status where the debtor has an outstanding loan or other claim secured by a blanket and floating lien in the debtor's inventory. Although a secured creditor retains priority to its inventory collateral over a § 503(b)(9) claim, the holder of a § 503(b)(9) claim will generally still be entitled to full payment of its claim if the buyer has sufficient available unencumbered assets after satisfying its secured claim(s), and a plan cannot be confirmed without payment of all administrative claims, including § 503(b)(9) claims.

166 *In re Dana Corp., et al.*, 2007 WL 1577763, at *5 (Bankr. S.D.N.Y. May 30, 2007) (Goodyear precluded from obtaining § 503(b)(9) priority treatment because it had filed its claim after claims bar date).

167 *See infra* in Chapter III of this *Manual* concerning reclamation rights in bankruptcy.

3. § 503(b)(9) Litigation Issues

a. Meaning of "Goods"

Section 503(b)(9) only affords administrative priority treatment for the value of "goods" the debtor receives within 20 days of its bankruptcy filing. Significantly, there is no corresponding priority treatment for the value of services. Accordingly, how a court defines the term "goods" could mean the difference between a trade creditor recovering the full amount of its § 503(b)(9) priority claim, or receiving little or no recovery on its general unsecured claim.

Debtors have challenged on numerous occasions whether suppliers of water,[168] natural gas[169] and electricity[170] fall within the definition of "goods" under the statute. With no available legislative history from Congress to provide guidance on the meaning of the term "goods," the courts have applied differing tests that have resulted in non-uniform, and often conflicting, decisions on the subject. This has resulted in significant litigation over the issue.

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168 The *Pilgrim's Pride Corp.* court ruled that the debtor's water supplier was eligible for § 503(b)(9) priority status because water falls within the definition of "goods." *Pilgrim's Pride Corp.*, 421 B.R. at 242.

169 The *Plastech Engineered Prods.* and *Pilgrim's Pride Corp.* courts held that natural gas provided by a utility or other vendor falls within the definition of "goods," thereby enabling these creditors to assert § 503(b)(9) priority claims. *In re Plastech Engineered Products Inc.*, 397 B.R. 828, 839 (Bankr. E.D. Mich. 2008); *Pilgrim's Pride Corp*., 421 B.R. at 241; *accord, In re NE Opco Inc.*, 501 B.R. 233, 256-57 (Bankr. D. Del. 2013) (noting that UCC specifically includes "natural gas" as a good).

170 The *Pilgrim's Pride Corp.* court characterized electricity as a service, not a good, and therefore ineligible for § 503(b)(9) priority status; *see also In re Samaritan Alliance LLC*, 2008 WL 2520107, at *4 (Bankr. E.D. Ky. June 20, 2008); *In re NE Opco*, 501 B.R. at 256 (electricity is a service, not a good, and therefore ineligible for § 503(b)(9) priority); *In re PMC Marketing Corp.*, 517 B.R. 386, 394 (B.A.P. 1st Cir. 2014) (remanding case to bankruptcy court to determine whether electricity meets definition of a "good"); *In re Great Atlantic & Pacific Tea Co. Inc.*, 538 B.R. 666, 673-74 (S.D.N.Y. 2015); *but see In re Erving Indus. Inc.*, 432 B.R. 354 (Bankr. D. Mass. 2010) (holding that supply of electricity constituted sale of goods, entitling creditor to administrative priority treatment); *In re Grede Foundries Inc.*, 2010 Bankr. LEXIS 1823 (Bankr. W.D. Wis. 2010), *aff'd sub nom, GFI Wis. Inc v. Reedsburg Util. Comm'n.*, 2010 U.S. Dist. LEXIS 122681 (W.D. Wis. 2010); *In re Wometco de Puerto Rico Inc.*, 2016 WL 155393, at *2 (Bankr. D.P.R. Jan. 12, 2016); *In re S. Montana Elec. Generation & Transmission Co-op. Inc.*, 2013 WL 85162, at *5 (Bankr. D. Mont. Jan. 8, 2013) (finding electricity is a good based upon reasoning of *GFI Wis.*); *In re Escalera Resources Co.*, 563 B.R. 336, 373 (Bank. D. Colo. 2017).

Several courts have applied the definition of "goods" contained in UCC § 2-105: "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale…."[171] The debate over whether electricity should be considered a good or service, for purposes of § 503(b)(9), is illustrative of the differing approaches courts have taken when analyzing the issue.

The U.S. Bankruptcy Court for the Northern District of Texas ruled in *Pilgrim's Pride* that electricity is not a good. The court analogized electricity to a television show, which is not a "good" under the UCC, because it has no form, is consumed by viewing, and "can only be 'moved' physically if it is encoded in a digital or analog form."[172] According to the court, the fact that electricity is metered did not make it identifiable as a "good." The court also found that telephone calls and the internet are also metered, but are not goods, and "once electricity has been 'identified' by measurement at the meter, it has already been consumed by the end user."[173]

Other courts have rejected the *Pilgrim's Pride* holding, including the U.S. District Court for the Western District of Wisconsin, as well as the U.S. Bankruptcy Court for the District of Massachusetts.[174] These courts have held that electricity *is* a good because it is tangible and can be felt, created, measured and stored. "Electricity can be moved … it can be consumed … and there is no suggestion that electricity cannot be packaged and handled, such as in a battery."[175] These courts also distinguished the telecommunication analogy because electricity is the ultimate good that a customer purchases, while telecommunications is a means of transmitting other non-goods (*i.e.*, intellectual property, images, sounds).[176] In *GFI Wis. Inc.*

171 *In re Plastech Engineered Prods. Inc.*, 397 B.R. 828, 836 (Bankr. E.D. Mich. 2008); *In re Pilgrim's Pride Corp.*, 421 B.R. 231 (Bankr. N.D. Tex. 2009); *In re SemCrude L.P.*, 416 B.R. 399, 405 (Bankr. D. Del. 2009).

172 421 B.R. at 239.

173 *Id.*

174 *GFI Wis. Inc. v. Reedsburg Util. Comm'n.*, 440 B.R. 791 (W.D. Wis. 2010); *In re Erving Indus. Inc.*, 432 B.R. 354 (Bankr. D. Mass. 2010).

175 *GFI Wis. Inc.*, 2010 U.S. Dist. LEXIS 122681 at 22-23.

176 *See Id.* at 23 (quoting *Erving Indus. Inc.*, 432 B.R. at 354, 368: "[E]lectricity … is not merely a medium of delivery, but is the 'thing' the customer seeks to purchase").

v. Reedsburg, the main issue before the U.S. District Court for the Western District of Wisconsin was whether electricity is movable. The court, relying on expert testimony, concluded that "electricity begins flowing through power lines when a circuit is formed and continues moving at least until it is metered. The metering satisfies the identification requirement of the UCC, and the movement is sufficient to satisfy the movability requirement, even if it reaches the speed of light."[177]

The courts are also divided over the treatment of transactions that include both the sale of goods and provision of services. Both the *Plastech Engineered Products* and *Pilgrim's Pride* courts ruled that § 503(b)(9) does not exclude goods delivered under a contract the primary purpose of which is service-based.[178] According to those courts, a trade creditor is eligible for § 503(b)(9) priority status only to the extent its claim arises from the creditor's sale of goods to the debtor, and then only for the value of the goods delivered. However, other courts have reached the opposite result, holding that the predominant-purpose test determines a creditor's eligibility for § 503(b)(9) priority status.[179] Under this line of cases, if the predominant purpose of the transaction is to provide a service, a trade creditor is not entitled to any § 503(b)(9) priority treatment for the goods it had provided to the debtor.

Courts have also denied § 503(b)(9) priority treatment in situations where a trade creditor did not sell the original goods but merely inspected, ticketed, repackaged or processed the goods provided by, and then returned to,

177 *Id.* at 22.

178 Both courts rejected the predominant-purpose test — a test that numerous courts have relied upon to determine whether a transaction is for the sale of goods or the provision of services in determining the applicability of UCC Article 2 governing the sale of goods. If the predominant-purpose test applies to § 503(b)(9) claims and the contract's purpose is predominantly to provide goods, the claim would be eligible for § 503(b)(9) priority status; if it were predominantly to provide services, nothing would be recoverable under § 503(b)(9). *See also In re NE Opco Inc.*, 501 B.R. 233, 257 (Bankr. D. Del. 2013) ("[T]his Court agrees with those courts that have concluded that the apportionment test is more appropriate under [the] section 503(b)(9) context.").

179 *In re Circuit City Stores Inc.*, 416 B.R. 531 (Bankr. E.D. Va. 2009), *aff'd, Paramount Home Entm't Inc. v. Circuit City Stores Inc.*, 445 B.R. 521 (E.D. Va. 2010). Since the court had already adopted the UCC definition of goods in determining the creditor's eligibility for priority status under § 503(b)(9), the court should apply the predominant-purpose test that many other courts had previously followed in deciding whether a mixed sale of goods/provision of services transaction is a sale of goods.

other vendors for resale.[180] These courts have used a literal interpretation of § 503(b)(9) — that "it is the *goods* and not the *value* that must be received by the debtor" from the creditor.[181]

b. Meaning of "Receipt"

Another frequently litigated issue concerning § 503(b)(9) claims is when a debtor is deemed to "receive" the goods in question.[182] In a case where a supplier had delivered gasoline on consignment terms to a buyer two days prior to the 20-day period before the debtor's bankruptcy filing, the court held that the buyer had "received" the gas prior to the 20-day period, even though passage of title occurred during the 20-day period.[183] The court held that the plain language of § 503(b)(9) does not require passage of title to goods to a debtor for a § 503(b)(9) claim to arise.[184] Rather, a debtor must simply "receive" the goods within the 20 days prior to its bankruptcy filing. Because UCC § 2-103(1)(c) defines "receipt" of goods only as "taking physical possession of them," based on the factual record the debtor received the consigned goods when the gasoline went into the debtor's holding tanks, not when the debtor/consignee sold the gasoline to its customers.

In *In re World Imports Ltd.*, the U.S. Court of Appeals for the Third Circuit became the first U.S. Circuit Court of Appeals to address the definition of

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180 *In re Goody's Family Clothing Inc.*, 401 B.R. 131 (Bankr. D. Del. 2009); *see also In re Modern Metal Products Co.,* 2009 WL 2969762 (Bankr. N.D. Ill. Sept. 16, 2009) (debtor provided raw steel to creditor who processed it into finished parts and returned them to debtor; this constituted a service, not provision of goods).

181 *Id.*

182 As in the case of reclamation, a creditor asserting a § 503(b)(9) priority claim should obtain proof of the debtor's receipt of the goods as soon as practicable after the commencement of the bankruptcy case.

183 *In re Pridgen*, 2008 WL 1836950, at *4 (Bankr. E.D.N.C. April 22, 2008). *see also In re Circuit City Stores Inc.*, 432 B.R. 225 (Bankr. E.D. Va. 2010) (holding that debtor receives goods in consignment transaction when debtor takes actual physical possession of goods, rather than when title to goods passes to debtor at later date).

184 *In re Wezbra Dairy*, 493 B.R 768, 771 (Bankr. N.D. Ind. 2013) ("receipt" of corn silage occurred when it was placed on debtor's property for consumption by debtor's dairy herd, because debtor had control over the silage, was responsible for its care and protection, and debtor bore risk of loss, regardless of fact that seller retained title until silage was removed from storage bunker to be fed to herd).

the term "receipt" under § 503(b)(9).[185] The court applied the definition of "receipt" contained in Article 2 of the UCC and required that the debtor or its agent take physical possession of the goods, regardless of passage of title or assumption of the risk of loss.

Courts are also beginning to address whether a seller that drop-ships its goods to the ultimate customer is entitled to a § 503(b)(9) priority claim.[186] A seller that drop-ships goods delivers them, at the debtor's instruction, to the debtor's customers or other third parties. As a result, the debtor/buyer never takes physical possession of the goods. It remains an open question as to whether a seller in a drop-ship transaction can ever satisfy § 503(b)(9)'s requirement that the debtor "receive" the goods within the 20 days prior to bankruptcy.

The court in *In re Plastech Engineered Products* held that the debtor must actually physically receive the goods in order for § 503(b)(9) to apply. The court recognized that a debtor can take constructive possession of goods through a third party's actual physical possession of the goods as an agent, designee, bailee, or in some other representative capacity for the debtor. However, the court could not decide whether the debtor had constructively received drop-shipped goods because there were unresolved factual issues. The parties reached a settlement of the trade creditor's § 503(b)(9) claim before the court had an opportunity to rule on the issue.

Debtors and trustees have argued that a creditor's drop-shipment of goods does not constitute "receipt" under § 503(b)(9) because UCC § 2-103 defines "receipt of goods" as "taking physical possession of goods."[187] Accordingly, since it is only the debtor's customer, and not the debtor, that actually takes physical possession of the goods in a drop-ship arrangement, the debtor did not "receive" the goods within the meaning of § 503(b)(9).

185 *In re World Imports Ltd.*, 862 F.3d 338 (3d Cir. 2017).

186 *In re Plastech Engineered Prods. Inc.*, 2008 WL 5233014 (Bankr. E.D. Mich. Oct. 7, 2008).

187 U.C.C. § 2-103(l)(c).

Section 503(b)(9) claimants have countered that the courts should look to the stoppage of delivery provisions of UCC § 2-705(2)(c),[188] and that a trade creditor may stop delivery of goods until it loses its stoppage of delivery rights, when, among other circumstances, the carrier acknowledges that it is holding the goods for the buyer by either reshipping the goods according to the buyer's instructions, or holding the goods as the buyer's warehouseman. The claimants also argue that once the goods are drop-shipped, the trade creditor can no longer stop shipment of the goods and the buyer must be deemed to have received the goods.

Specifically, UCC § 2-705(2)(b), (c) and (d) provide for a buyer obtaining constructive possession of goods through receipt by a designee or another representative of the buyer. This is accomplished through either "(b) acknowledgment to the buyer by any bailee of the goods except a carrier that the bailee holds the goods for the buyer; (c) *such acknowledgment to the buyer by a carrier by reshipment* or as warehouseman; or (d) negotiating to the buyer of any negotiable document of title covering the goods." Arguably, the drop-shipment of goods subject to a trade creditor's § 503(b)(9) priority claim should fall within the scope of UCC § 2-705(2)(c). The comments to UCC § 2-705 even suggest that a buyer could be deemed to have received goods through receipt by a subpurchaser, such as the debtor's customer in a drop-shipment situation. Official Uniform Comment 2 to UCC § 2-705 states, in pertinent part:

> "Receipt by the buyer" includes receipt by the buyer's designated representative, the subpurchaser, when shipment is made direct to him and the buyer himself never receives the goods.[189]

In fact, the Third Circuit Court of Appeals upheld a buyer's constructive receipt of goods through possession by a third-party bailee based on UCC § 2-705(2)(b).[190] The *Marin* court recognized that receipt occurs when a

188 Discussed *supra* at Chapter II of this *Manual*.

189 U.C.C. § 2-705, Cmt. 2.

190 *In re Marin Motor Oil Inc.*, 740 F.2d 220, 225 (3d Cir. 1984) (pre-BAPCPA); *In re Bill's Dollar Stores Inc.*, 164 B.R. 471, 474 (Bankr. D. Del. 1994) (citing *Marin*).

seller cannot stop delivery of its goods. It would seem this would include a buyer's constructive receipt of goods under § 2-705(2)(c) through a carrier's reshipment of goods in the context of drop-shipment.

In *Ningbo Chenglu Paper Products Mfg. Co. Ltd. v. Momenta Inc.,*[191] the U.S. District Court for the District of New Hampshire, affirming the lower bankruptcy court's decision, held that a buyer "receives" goods qualifying for § 503(b)(9) priority status if it obtains either physical or constructive possession of the goods.[192] The court denied the trade creditor's administrative claim and instead held that, for purposes of § 503(b)(9), the phrase "received by the debtor" means to be possessed by a debtor, either actually or constructively, and that delivery to, or possession by, a debtor's customer under a drop-ship arrangement does not constitute the requisite constructive possession by the debtor under § 503(b)(9). Similarly, in *In re SRC Liquidation, LLC,*[193] the U.S. Bankruptcy Court for the District of Delaware, relying on the Third Circuit's holding in *World Imports*, denied priority status to a trade creditor with a drop-ship § 503(b)(9) claim because the debtor had not "received" the drop-shipped goods where neither the debtor nor its agent had actually obtained physical possession of the goods. The debtor did not receive the drop-shipped goods when title to, or risk of loss of, the goods had passed to the debtor upon their transfer to the carrier, nor had the debtor constructively received the goods upon their delivery to the carrier because the carrier was not the debtor's agent. In addition, the court determined that the word "received" should have the same meaning — obtaining physical possession — for reclamation rights under § 546(c) and administrative priority claims under § 503(b)(9).

191 *Ningbo Chenglu Paper Prods. Mfg. Co. Ltd. v. Momenta Inc.*, 2012 WL 3765171, at *7 (D. N.H. Aug. 29, 2012); *see also In re World Imports*, 516 B.R. 296, 300 (E.D. Pa. 2014) (goods that are delivered under a drop-ship arrangement are not "received" by the debtor for purposes of § 503(b)(9)); *In re ADI Liquidation Inc.*, 572 B.R. 543, 550 (Bankr. D. Del. 2017) (same).

192 *In re VPH Pharmacy Inc.*, 578 B.R. 776, 781 (Bankr. E.D. Mich. 2017) (§ 503(b)(9) does not require that goods be delivered directly by seller to debtor, but rather goods may be received by either employee of debtor or by debtor's agent).

193 *In re SRC Liquidation LLC*, 2017 WL 2992718 (Bankr. D. Del. July 3, 2017).

c. Determining "Value" of the Goods

While § 503(b)(9) states that a seller of goods is entitled to an administrative priority claim for the value of goods that a debtor receives in the ordinary course within 20 days of its bankruptcy filing, § 503(b)(9) does not state the manner in which to calculate the value of the goods. The bankruptcy court in *In re SemCrude* ruled that there is a presumption that the value of the goods, for purposes of § 503(b)(9), should be based on the purchase or invoice price of the goods.[194] However, a debtor can rebut this presumption by presenting evidence that, under the circumstances of a particular transaction, it would be inappropriate to use the purchase price as an indicator of the value of the goods.[195]

The bankruptcy court in *In re Pilgrim's Pride* held that a § 503(b)(9) claimant can prove the value of the goods for which it is seeking allowance of priority status based on what it would have cost the debtor to acquire similar goods.[196] The court noted that the "contract price for the goods delivered would provide a good starting place" for determining their value.[197] In other circumstances, such as when the goods are commodities, the court suggested that it would be appropriate to determine value, for § 503(b)(9) purposes, based on prices in the commodity markets, which are indicative of how much it would have cost the debtor to acquire the goods.[198]

194 *In re SemCrude L.P.*, 416 B.R. 399, 405 (Bankr. D. Del. 2009).

195 *Id.*

196 *In re Pilgrim's Pride Corp.*, 421 B.R. 231, 243 (Bankr. N.D. Tex. 2009).

197 *Id.* at 243, n.13.

198 *Id.* at 243-44.

d. Timing of Payment

The timing of payment of § 503(b)(9) administrative priority claims, like all other administrative claims, is generally left to the bankruptcy court's discretion, provided that all administrative claims generally must be paid in full by, or shortly after, the effective date of any confirmed chapter 11 plan. All the courts that have considered § 503(b)(9) creditors' applications for immediate payment of their allowed priority claims, over the debtor's objection, have uniformly held that a trade creditor does not have a right to immediate payment of its allowed § 503(b)(9) priority claim.[199] The courts have consistently followed the approach of the bankruptcy court in *In re Bookbinder's Restaurant* that there is "nothing in the language of § 503(b)(9) that support[s] the creditor's suggestion that it is entitled to immediate payment of its allowed expense in derogation of the accepted principle that the timing of payment of an allowed administrative expense is within the court's discretion."[200]

In some bankruptcy cases, trade creditors have quickly moved in the bankruptcy court for allowance and payment of their § 503(b)(9) administrative claims. This has sometimes led to a court-approved agreement between the debtor and the trade creditor for allowance and payment of the claim, contingent upon the creditor's agreement to extend favorable credit and other terms to the debtor. In other cases, the debtor obtained a court order that authorizes, but does not direct, the debtor's payment of allowed § 503(b)(9) priority claims during the chapter 11 case in exchange for the trade creditors' agreement to extend credit and other favorable terms acceptable to the debtor. Trade creditors with § 503(b)(9) claims should carefully review such orders and any agreement they are asked to review and execute to confirm the terms that will bind them, and to determine whether they can negotiate more favorable alternative terms.

199 *In re Arts Dairy LLC*, 2009 WL 1758760 (Bankr. N.D. Ohio June 19, 2009); *In re Global Home Prods. LLC*, 2006 WL 3791955 (Bankr. D. Del. Dec. 21, 2006); *In re Bookbinders' Restaurant Inc.*, 2006 Bankr. LEXIS 3749; 2006 WL 3858020 (Bankr. E.D. Pa. Dec. 28, 2006).

200 *Bookbinders*, 2006 WL 3858020 at *4.

4. Debtor's Defenses

Debtors have often invoked § 502(d) of the Bankruptcy Code to disallow a § 503(b)(9) claim based on a pending preference claim against the trade creditor.[201] Some courts have rejected this argument. The U.S. Bankruptcy Court for the Eastern District of Michigan, in the *Plastech Engineered Products* case,[202] held that § 502(d) of the Bankruptcy Code is not a basis for disallowing a § 503(b)(9) priority claim based on the assertion of a preference claim against the trade creditor. While § 502(d) provides for the disallowance of a claim based on the existence of a preference claim against the trade creditor asserting such claim, the court ruled that § 502(d) does not apply to administrative claims, including claims arising under § 503(b)(9) in favor of goods suppliers, but instead applies only to pre-petition general unsecured claims.

The U.S. Bankruptcy Court for the Northern District of Georgia in the *TI Acquisition* case[203] reached the same conclusion. Although the *TI Acquisition* court did not disallow a trade creditor's § 503(b)(9) priority claim based on a pending preference action against the trade creditor, the court refused to order the immediate payment of the trade creditor's allowed § 503(b)(9) claim, deferring payment until the adjudication of the lawsuit. The court concluded that directing the immediate payment of the trade creditor's § 503(b)(9) claim would have prejudiced the debtor's other creditors in the event that the trade creditor was unable to pay any judgment on the preference claim that the debtor obtained. However, the court required full payment of the trade creditor's allowed § 503(b)(9) claim upon confirmation of the debtor's plan, even if the

201 11 U.S.C. § 502(d) states as follows:

> Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.

202 *In re Plastech Engineered Prods. Inc.*, 394 B.R. 147 (Bankr. E.D. Mich. 2008); *see also In re Momenta Inc.,* 455 B.R. 353, (Bankr. D.N.H. 2011).

203 *In re TI Acquisition LLC*, 410 B.R. 742 (Bankr. N.D. Ga. 2009).

preference action against the trade creditor was pending at that time, because the Bankruptcy Code requires the payment of all allowed administrative claims upon the effective date of an approved chapter 11 plan.

Using a slightly different rationale to reach the same result, the U.S. Bankruptcy Court for the Eastern District of Virginia, in the *In re Circuit City* case, allowed the debtor to rely on § 502(d) to temporarily disallow creditors' § 503(b)(9) priority claims,[204] holding them in abeyance pending resolution of all f uture preference litigations against the affected creditors. The court ruled that this would avoid the risk of § 503(b)(9) claimants receiving a windfall through the immediate payment of their § 503(b)(9) claims at the expense of other creditors. The *Circuit City* court also relied on § 502(d) as a basis for temporarily disallowing creditors' § 503(b)(9) claims because these claims are pre-petition and not post-petition claims.

5. Can a Creditor Include Its § 503(b)(9) Claim as Part of Its New Value Defense to a Preference Claim?

The court in *In re Circuit City*[205] considered whether an allowed § 503(b)(9) claim could be included as part of a creditor's new value defense to a preference claim under Bankruptcy Code § 547(c)(4).[206] The court held that a creditor whose § 503(b)(9) claim was fully funded by the establishment of an escrow account pursuant to a court order could not include the claim as part of its new value defense because the new value was paid by an "otherwise unavoidable transfer."

204 *In re Circuit City Stores Inc.*, 426 B.R. 560, 579 (Bankr. E.D. Va. 2010).

205 *In re Circuit City Stores Inc.*, 2010 WL 4956022 (Bankr. E.D. Va. Dec. 1, 2010).

206 The trustee may not avoid under this section a transfer—

> …
>
> 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 —
>
> not secured by an otherwise unavoidable security interest; and
>
>> on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

The *Circuit City* court's ruling is consistent with the logic and result of the U.S. Bankruptcy Court for the Northern District of Georgia's holding in *TI Acquisition*.[207] Both courts concluded that the dual policy considerations of encouraging creditors to extend credit to troubled companies and promoting equal treatment of creditors are satisfied by *either* (1) allowing and paying a § 503(b)(9) claim *or* (2) including the value of the goods that comprise a § 503(b)(9) claim in a new value defense to reduce a creditor's preference liability, but not both.[208]

In *In re Commissary Operations Inc.,*[209] the U.S. Bankruptcy Court for the Middle District of Tennessee also considered whether creditors can assert their fully paid § 503(b)(9) claims as part of their subsequent new value, pursuant to § 547(c)(4) of the Bankruptcy Code, to reduce their preference liability. The *Commissary* court held that the § 503(b)(9) claimants could both obtain relief on their § 503(b)(9) claims and include these priority claims as part of their new value defense to reduce their preference liability. The court found that the § 503(b)(9) claimants had provided the requisite new value to Commissary and its bankruptcy estate prior to the bankruptcy filing date to qualify for the new value defense. The court also stated that new value should be determined when a bankruptcy case commences and should not be impacted by post-petition circumstances, such as the debtor's payment of the new value. In addition, creditors asserting their § 503(b)(9) claims as new value to reduce their preference exposure should be treated no differently than creditors whose pre-petition claims were paid post-petition pursuant to a critical vendor or other first-day order, and who were also permitted to include their claims as new value to reduce their preference liability. Finally, allowing a creditor to assert its § 503(b)(9) claim as part of its new value defense is also consistent with the intent of §§ 503(b)(9) and 547(c)(4): to encourage creditors to continue selling goods on credit terms to distressed companies.

207 *In re TI Acquisition LLC*, 429 B.R. 377 (Bankr. N.D. Ga. 2010).

208 *Circuit City*, 2010 WL 4956022 at *9.

209 *In re Commissary Operations Inc.*, 421 B.R. 873 (Bankr. M.D. Tenn. 2010); *see In re Phoenix Rest. Group Inc.*, 317 B.R. 491, 496 (Bankr. M.D. Tenn. 2004).

6. Other Defenses

Debtors have also attempted to set off their pre-petition claims against a creditor's § 503(b)(9) priority claim, with mixed results. The Ninth Circuit Bankruptcy Appellate Panel in *Brown & Cole Stores*[210] held that the debtor could set off its pre-petition breach of contract claim against the creditor to reduce the creditor's § 503(b)(9) claim. However, the *TI Acquisition*[211] court rejected the debtor's attempt to set off its payments to the creditor during the 20-day period prior to bankruptcy on invoices unrelated to the creditor's § 503(b)(9) priority claim, in reduction of the creditor's priority claim.

The *Circuit City* court[212] allowed the debtor to invoke its setoff rights to apply its pre-petition credit claims, on account of a variety of items, against creditors to reduce the creditors' § 503(b)(9) claims. The court relied on Bankruptcy Code § 558[213] and found sufficient mutuality to allow Circuit City to exercise its right of setoff to reduce creditors' more valuable higher priority § 503(b)(9) claims, rather than reduce their less valuable and lower priority general unsecured claims.

Likewise, relying on the *Circuit City* decision and its focus on Bankruptcy Code § 558, the U.S. Bankruptcy Court for the District of Delaware in *In re ADI Liquidation*[214] held that it is proper for a debtor to set off credits and other similar claims owing by its vendors to reduce the vendors' § 503(b)(9) claims. The *ADI* court also took the analysis one step further and held that a debtor could set off or recoup credits and other similar claims against secured and administrative priority claims, in addition to § 503(b)(9) claims.

210 *Brown & Cole Stores LLC*, 375 B.R. 873 (B.A.P. 9th Cir. 2007).

211 *In re TI Acquisition LLC*, 410 B.R. 742 (Bankr. N.D. Ga. 2009).

212 *In re Circuit City Stores Inc.*, 2009 WL 4755253 (Bankr. E.D. Va. Dec. 3, 2009).

213 Bankruptcy Code § 558 provides: "The estate shall have the benefit of any defense available to the debtor as against any entity other than the estate, including statutes of limitation, statutes of frauds, usury, and other personal defenses. A waiver of any such defense by the debtor after the commencement of the case does not bind the estate."

214 *In re ADI Liquidation Inc.*, 2015 WL 4638605, at *6 (Bankr. D. Del. May 5, 2015).

ADI Liquidation, f/k/a AWI Delaware Inc., was a cooperative food distributor that provided distribution and retail services to numerous retail members. Similar to the *Circuit City* case, numerous creditors asserted § 503(b)(9) claims against the debtors. Prior to the petition date, the debtors' vendors earned numerous categories of credits and other related claims.

After the sale of substantially all of the debtors' assets, the debtors and the creditors' committee filed a joint motion seeking the authority to set off or recoup the credits first, against secured and administrative claims (including § 503(b)(9) claims) of their vendors, and then against the vendors' general unsecured claims. The *ADI* court, following the reasoning of the *Circuit City* decision, held that the debtors had the right to first set off the credits against the secured and administrative claims and then against general unsecured claims.[215]

One issue addressed by the *ADI* court that was not addressed by the *Circuit City* court was whether the debtors' setoff or recoupment rights could be limited by the parties' contracts or prior courses of dealings by ADI and its various suppliers. The *ADI* court established a rebuttable presumption that a creditor's prior course of dealing, industry practice and contract terms (*e.g.*, waiver of setoff and recoupment rights included in a contract) do not operate as a waiver of a debtor's equitable remedies under Bankruptcy Code § 558. Accordingly, a creditor would, however, be given an opportunity to argue that ADI waived its equitable remedies, including setoff and recoupment rights under contract, through the course of its dealings, or through industry practice. This issue has yet to be litigated, so it is unclear how future courts will interpret this aspect of the decision.

215 *Id.* at *2.

B. Reclamation Under Bankruptcy Code § 546(c)

Bankruptcy Code § 546(c)(1) recognizes state law reclamation rights in bankruptcy cases. Specifically, § 546(c)(1) states that a trade creditor satisfying § 546(c)(1)'s requirements for reclamation has a valid reclamation claim.[216] The automatic stay arising under § 362 of the Bankruptcy Code does not prevent a creditor from pursuing or enforcing a reclamation claim.

1. Bankruptcy Code Reclamation Deadlines and Prerequisites

A reclamation claimant under § 546(c)(1) has the ability to reclaim goods sold on credit that an insolvent debtor received during the 45-day period prior to the date of the bankruptcy filing, so long as the trade creditor sends the debtor a written notice demanding reclamation of the goods (1) within 45 days after the goods are received or (2) within 20 days after the bankruptcy filing if the 45-day period expires after the bankruptcy filing date.[217]

Sales in the Ordinary Course: § 546(c)(1) is limited to sales in the ordinary course of the trade creditor's business.

Insolvency: In bankruptcy, the reclaiming creditor must prove the debtor/buyer's insolvency relying on the balance sheet test. This may make it more difficult for a trade creditor to prove its reclamation claim, since value is difficult and often expensive to prove in the bankruptcy context. However, papers that the debtor files in its bankruptcy case, particularly the Schedules and Statement of Financial Affairs required by the Bankruptcy Code, may aid the trade creditor's satisfaction of its burden of proof. In any event, a trade creditor should not be deterred from preserving its reclamation rights by sending a written reclamation demand because of the apparent

216 11 U.S.C. § 546(c)(1).

217 11 U.S.C. § 546(c)(1).

difficulty of proving the debtor's insolvency. In fact, most debtors in bankruptcy are insolvent, and insolvency is often not disputed.

Written Demand: § 546(c)(1) requires that a trade creditor send a written reclamation demand to the debtor or trustee, if one was appointed. The trade creditor should also send a copy of the demand to the debtor's or the trustee's counsel.

Time of Reclamation: Similar to the UCC, the Bankruptcy Code does not provide a definition as to when a reclamation demand is deemed made. A trade creditor should, therefore, send its written demand by a mode of delivery that ensures receipt of the demand the same day (*e.g.,* by hand delivery, facsimile or email or more than one of these methods).

Return of Goods: Under § 546(c)(1), when a trade creditor takes all the necessary steps to enforce its reclamation claim, its sole remedy is the return of the goods. The alternative remedies previously available to a successful reclaiming trade creditor under the prior version of § 546(c) (a replacement lien in the debtor's assets and/or an allowed administrative priority claim in the amount of the reclamation claim) were eliminated as part of the 2005 BAPCPA amendments to the Bankruptcy Code.

Immediately after learning of a buyer's bankruptcy filing, a trade creditor should verify whether the bankruptcy court has entered an order that establishes procedures to address reclamation claims. Otherwise, the trade creditor might consider quickly, and preferably before the buyer's anticipated disposition of the goods, filing a lawsuit for reclamation of its goods in the bankruptcy court. The lawsuit could include a request for a temporary restraining order that prohibits the debtor from disposing of, or altering, the goods, or, at a minimum, grants the creditor access to the goods and to the debtor's records. The trade creditor should also communicate with other reclamation creditors to coordinate their reclamation efforts.

By quickly filing its reclamation lawsuit, a trade creditor might force the debtor to immediately address the trade creditor's reclamation claim and avoid the argument that the trade creditor waived its claim by sitting on its rights. Some bankruptcy courts have denied a trade creditor's reclamation claim when the trade creditor had failed to act diligently to enforce its claim — in particular, where the goods were sold or altered, or an intervening lender was granted a security interest in the goods following the reclamation demand.

For example, in the *Circuit City* case,[218] a trade creditor timely sent a reclamation demand for the return of approximately $11.6 million in goods shipped to a debtor within 45 days prior to its bankruptcy filing. Thereafter, the trade creditor did not take any further action to enforce its claim. Approximately seven months later, the debtor objected to the reclamation claim and sought to reclassify it as a general unsecured claim. The bankruptcy court granted the debtor's motion due to the trade creditor's failure to diligently pursue its reclamation rights. On appeal, the district court agreed with the bankruptcy court that the trade creditor's failure to diligently pursue its reclamation rights was fatal to its reclamation claim. Specifically, the district court relied on the following facts:

- The trade creditor never filed a complaint against the debtor or sought relief from the automatic stay to pursue its reclamation rights;
- The trade creditor did not object to the debtor's motion for approval of post-petition financing, which provided the debtor's lender with a first-priority security interest in all of the estate's assets, including the goods supplied by the creditor subject to its reclamation claim; and
- The trade creditor did not object to the sale of the debtor's inventory, including the goods in question, at the hearing to authorize going-out-of-business sales of the debtor's assets.

218 *Paramount Home Entertainment Inc. v. Circuit City Stores Inc.*, 445 B.R. 521 (E.D. Va. 2010).

The U.S. Bankruptcy Court for the District of Nebraska in *In re Professional Veterinary Products Ltd., et al.*[219] reached a different conclusion. Boeringer Ingelheim Vetmedica, Inc. (BIV) asserted a reclamation claim in Professional Veterinary Products, Ltd.'s (PVP) bankruptcy case related to certain veterinary pharmaceutical products valued at more than $1 million that BIV had sold to PVP within 45 days before PVP's August 20, 2010, bankruptcy filing. Shortly after the bankruptcy filing, on August 25, BIV made a written demand on PVP to reclaim its goods. On August 30, PVP responded to BIV's demand by asserting that BIV did not have a valid reclamation claim, and it refused to return the goods. On September 8, BIV filed an adversary proceeding in the bankruptcy court seeking reclamation of the goods, an accounting of the sale of any of the goods, or, alternatively, the imposition of a lien or allowance of an administrative expense claim equal to the amount of the goods, and an injunction prohibiting the sale of the goods. On September 14, the bankruptcy court approved the sale of substantially all of the debtor's inventory to a third party, to which BIV did not object. On September 16, PVP filed a motion to establish exclusive and global procedures (including a stay of BIV's pending adversary proceeding) for determining reclamation claims and § 503(b)(9) claims, which was granted on September 29.

The sale order entered by the bankruptcy court provided that the sale was free and clear of all "Interests" in PVP's assets, and that any such Interests would attach to the proceeds of the sale. On November 8, 2010, PVP filed a notice of proposed treatment of reclamation claims, seeking to deny all reclamation claims for three reasons: (1) the inventory was sold and the proceeds were already paid to PVP's senior secured lender; (2) the reclamation claimants, including BIV, had failed to protect their interests in their respective inventory; and (3) PVP was not insolvent on the petition date. BIV filed a response to the notice of proposed treatment on the issue of whether BIV had any remedy on account of its reclamation claim following the sale of the goods.

219 *In re Prof'l Veterinary Prods. Ltd.*, 454 B.R. 479 (Bankr. D. Neb. 2011).

The bankruptcy court rejected PVP's argument that BIV was not entitled to a reclamation claim because BIV had purportedly failed to zealously pursue the claim by (1) filing a stay-relief motion, (2) objecting to the sale of the inventory, and/or (3) seeking a temporary restraining order. Instead, the court concluded that BIV did protect its reclamation rights in an appropriate manner, under the circumstances, where the court-approved reclamation procedures stayed BIV's adversary proceeding and expressly barred BIV from taking steps to protect its interests in its goods. The bankruptcy court distinguished the *Circuit City* court's holding because the reclamation procedures in the *Circuit City* case did not explicitly "preclude reclamation claimants from exercising any of their rights." The procedures in the *Circuit City* case also differed from the reclamation procedures in the PVP case because these procedures "explicitly prohibit[] reclamation claimants from taking steps to protect their interest and stays BIV's adversary proceeding."

Another interesting aspect of the PVP case concerns the potential remedies available to reclamation claimants. Following BAPCPA and the enactment of § 546(c)(1) of the Bankruptcy Code, the nearly universally held view among commentators was that reclamation claimants' sole remedy was to recover their goods. This view was premised on the fact that BAPCPA removed the prior wording of § 546(c) that provided for the granting of a lien on the proceeds of the goods sold, or an administrative claim, as alternate remedies on account of an allowed reclamation claim. However, the court held that notwithstanding the BAPCPA amendments, BIV might still be able to successfully argue that it is entitled to a lien on the proceeds of the goods, based on the debtor's conduct and the application of the doctrine of estoppel. The court ruled that the definition of "Interests" contained in the PVP sale order was broad enough to include reclamation claims, and it was possible that such interests attached to the sale proceeds, allowing BIV to assert that its reclamation claim should enjoy a higher priority than those of general unsecured creditors. A form of reclamation demand to send to a debtor or bankruptcy trustee is included as Form 7 in the Appendix.

2. Pre-Petition Floating Inventory Security Interest Defense

Bankruptcy Code § 546(c)(1) subordinates reclamation claimants to the rights of a pre-petition secured lender with a blanket, or floating, lien on the debtor's inventory. As a result, reclamation claimants are susceptible to having their claims subordinated to the secured lender. This Bankruptcy Code section, amended by BAPCPA in 2005, ratifies the consensus view of the courts that have similarly held that reclamation rights are subject to the prior rights of a secured creditor with a floating security interest in the debtor's inventory.

Court decisions interpreting § 546(c)(1) have resulted in harsh results for reclamation creditors. In *In re Advanced Marketing Services Inc.,*[220] publisher Simon & Schuster (S&S) delivered more than $5.1 million worth of goods to the debtors within the 45-day reclamation period. S&S timely sought to reclaim the goods shortly after the debtors filed their bankruptcy petition. The bankruptcy court denied S&S's request for a temporary restraining order against the debtors that would have barred the debtors' sale of S&S's goods subject to its reclamation claim, holding that S&S had failed to prove that it was likely to succeed on the merits of its reclamation claim because the debtors' senior lenders held a security interest in substantially all of the debtors' assets, including all inventory. The debtors' pre-petition lenders agreed to provide post-petition debtor-in-possession (DIP) financing, with the pre- and post-petition financing being cross-collateralized. The bankruptcy court held that "the Senior Lenders' pre-petition and post-petition liens on the Debtors' inventory are superior to S&S's reclamation claim."[221] Until the senior lenders' liens were satisfied through the sale of inventory, S&S's reclamation claim would likely be valueless.

220 360 B.R. 421 (Bankr. D. Del. 2007).

221 *Id.* at 426.

Likewise, in *In re Dana Corp.*,[222] the debtors challenged the reclamation claims filed by hundreds of creditors, arguing that they were "subject to" the pre-existing liens of the debtors' secured lenders in the goods subject to reclamation claims. The court ruled in favor of the debtors. The goods sought to be reclaimed were subject to the secured lenders' pre-petition floating blanket inventory security interest. Also, under the court-approved DIP financing agreement, the debtors were authorized to use the lenders' pre-petition collateral, including the reclamation goods, with a replacement lien in all pre- and post-petition collateral and proceeds. The pre-petition indebtedness was refinanced and paid off using the proceeds of the new DIP financing loan. The court held that the goods subject to reclamation claims were either liquidated in satisfaction of the pre-petition indebtedness, or were pledged as collateral for the DIP loan. In either event, the reclamation goods were effectively disposed of, rendering reclamation rights valueless.

Finally, in *In re Circuit City Stores Inc.,*[223] the bankruptcy court noted that the creditor was not entitled to a junior lien or administrative claim expense priority status on account of its reclamation claims. The court adopted the reasoning in *Dana Corp.* and held that an administrative expense claim could be granted only if the creditor demonstrated a benefit to the debtor's estate, which it had failed to do.

Despite all of these decisions, the 2016 decision by the U.S. Bankruptcy Court for the District of Delaware in *In re Reichhold Holdings US Inc.*[224] might breathe some life into the reclamation remedy in limited circumstances. At the time of Reichhold's bankruptcy filing, Reichhold's pre-pe-

222 367 B.R. 409 (Bankr. S.D.N.Y. 2007); *see also In re First Magnus Fin. Corp.*, 2008 WL 5046596 (Bankr. D. Ariz. Oct. 16, 2008) (creditor lost its reclamation rights where debtor ignored reclamation request and surrendered goods subject to reclamation demand to senior secured lender); *cf. Phar-Mor Inc. v. McKesson Corp.*, 534 F.3d 502 (6th Cir. 2008) (rejected *Dana Corp.* and upheld the reclaiming creditor's right to recovery, despite the floating lien on inventory. However, the Sixth Circuit's decision is of questionable validity because it is based on the pre-BAPCPA version of § 546(c), which provided for an allowed administrative claim as one form of relief in favor of a successful reclaiming creditor. The current version of § 546(c)(1) does not grant administrative priority status for valid reclamation claims).

223 2010 Bankr. LEXIS 697 (Bankr. E.D. Va. Mar. 4, 2010), *aff'd*, 445 B.R. 521 (E.D. Va. Sept. 3, 2010).

224 556 B.R. 107 (Bankr. D. Del. 2016).

tition lender had a security interest in substantially all of Reichhold's assets, including inventory. After the petition date, Reichhold received the bankruptcy court's approval to obtain post-petition DIP financing, which included granting the lenders a first-priority security interest in all of Reichhold's assets, including inventory. Significantly, the pre-petition loan was not satisfied by the proceeds from the sale of any vendor's goods, but instead was satisfied from the proceeds of the post-petition DIP loan. The goods were merely pledged to secure the post-petition loan.

Covestro LLC (Covestro) filed a reclamation claim shortly after the petition date. The bankruptcy court held that Covestro's reclamation claim had priority over, and was not extinguished by, the chapter 11 secured DIP loan. The court held that creditors' reclamation rights have priority where a pre-petition secured loan was satisfied, and that the reclamation rights arose before the chapter 11 DIP lenders' security interest attached to the goods to be reclaimed. In other words, it was a situation where there were two different loans with two different lenders instead of a single integrated transaction. Accordingly, the court rejected the *Dana Corporation* holding that there was a single integrated transaction, describing that court's reasoning as "too much of a stretch."

Despite this potentially positive development for holders of reclamation claims, the next court addressing this issue reverted back to the majority approach in analyzing this issue. In a 2017 decision by the U.S. Bankruptcy Court for the Southern District of Indiana, *In re hhgregg Inc.*, the court relied on the *Dana Corporation* decision to grant a motion to dismiss filed by Wells Fargo Bank challenging Whirlpool Corp.'s (Whirlpool) purported reclamation claim.[225] In the *hhgregg* case, Whirlpool sold goods to the debtors within the 45-day period prior to the petition date and timely made a reclamation demand. In addition, during the pre-petition period, Wells Fargo and the debtors were parties to a pre-petition credit agreement pursuant to which Wells Fargo was granted a lien on, and security interest in,

225 *Whirlpool Corp. v. hhgregg Inc., et. al. (In re hhgregg Inc., et al.),* 578 B.R. 814 (Bankr. S.D. Ind. 2017), *aff'd.,Whirlpool Corp. v. Wells Fargo Bank, N.A.*, 2018 WL 4853568 (S.D. Ind. Oct. 5, 2018), *appeal docketed*, No. 18-3363 (7th Cir. Nov. 2, 2018).

substantially all of the debtors' assets, including inventory, both existing and after-acquired, and all proceeds thereof. After the petition date, the bankruptcy court also approved the debtors' entry into a DIP financing facility of up to $80 million, secured by a first priming lien on substantially all of the debtors' assets, again including inventory and the proceeds thereof. Certain proceeds of the DIP facility were used to repay, in full, the amounts owed (more than $66 million) under the pre-petition credit agreement. Significantly, the bankruptcy court observed that the liens granted to Wells Fargo were effective as of the petition date and that there was an explicit provision in the final DIP order stating that the DIP liens related back to the petition date. This resulted in reclamation claims being subordinated to DIP claims.

Unlike certain other courts, the *hhgregg* bankruptcy court did not hold that the relevant inquiry was whether the pre-petition and post-petition DIP loans were an "integrated transaction," but instead found that the relevant question was "whether one or more secured creditors had liens in the reclaimed goods that were prior in time to the reclamation demand." The court observed that Whirlpool's goods were at no time free from a floating lien because Wells Fargo's liens were perfected under the pre-petition credit agreement through the petition date and, after the petition date, were perfected under the DIP credit agreement, which the court had approved on an interim basis on the petition date. In addition, the court distinguished the *Reichhold* decision, in which both the pre-petition and post-petition liens were satisfied in full, leaving the debtor's inventory and other collateral free and clear of liens and security interests. Under these circumstances, in contrast to the *hhgregg* case, reclamation claims in *Reichhold* had the next highest priority. Accordingly, the *hhgregg* court held that Whirlpool's reclamation claim was subordinate to Wells Fargo's pre-petition liens and the DIP liens in the inventory provided by Whirlpool.

While floating-inventory liens may defeat reclamation claims, they should not deter a trade creditor from attempting to enforce its reclamation rights.

The debtor/buyer and the lender may, for example, agree to waive the existence of a floating blanket inventory security interest as a defense to reclamation claims in order to maintain the goodwill of the debtor's vendors. In any event, a reclaiming trade creditor or group of reclaiming trade creditors that assert their reclamation claims may have the necessary leverage to obtain relief.

3. State Law Reclamation Defenses in Bankruptcy Cases

When Bankruptcy Code § 546(c) was modified by the BAPCPA amendments in 2005, some trade creditors questioned whether the changes created a new federal right of reclamation that would make the state law defenses to reclamation inapplicable. Previously, § 546(c) stated that the avoidance powers were "subject to any statutory or common law right of a seller of goods." However, the 2005 BAPCPA amendments modified the section to state that the avoidance powers are "subject to the right of a seller of goods." Reclaiming trade creditors have argued that the deletion of the reference to "statutory or common law" and the omission of UCC § 2-702(3)'s requirement that reclamation rights are subject to the rights of a buyer in the ordinary course or good-faith purchaser meant that reclaiming trade creditors had superior rights to buyers in the ordinary course and good-faith purchasers, and are subordinate to only holders of prior security interests specifically mentioned in § 546(c)(1).

This argument was summarily dismissed by *In re Dana Corp.*,[226] which has been followed by all other courts that considered the issue.[227] That court held that "[i]f amended [§] 546(c) created an independent federal reclamation right that replaced state law, then in bankruptcy a reclaiming seller would conceivably have broad rights superior to those of buyers in the ordinary course of business, lien creditors or good faith purchasers, other

226 367 B.R. 409 (Bankr. S.D.N.Y. 2007).

227 *In re Circuit City Stores Inc.*, 2010 Bankr. LEXIS 697, at *22 (Bankr. E.D. Va. 2010) ("This Court finds the *In re Dana Corporation* analysis persuasive and concludes that there still exists no federal right to reclamation post-BAPCPA."); *In re Magwood*, 2008 Bankr. LEXIS 479, at *4 (Bankr. M.D. Ala. 2008) ("The statute does not create a substantive federal right of reclamation.").

than a holder of a prior security interest. Clearly, Congress could not have intended to permit reclamation of goods that have been sold to consumers or other good faith purchasers."[228] Therefore, state law defenses that a buyer in the ordinary course and a good-faith purchaser take free of reclamation rights should still apply in bankruptcy cases.

4. Global Reclamation Reconciliation Programs in Chapter 11 Cases

Debtors, often urged to do so by their creditors' committees, may implement global reclamation reconciliation programs in their chapter 11 cases. These programs are approved by bankruptcy courts on a case-by-case basis. Global reclamation programs are designed to establish expeditious and less expensive procedures to reconcile and resolve reclamation claims, ensure a more uniform treatment of allowed reclamation claims, encourage trade creditors to extend credit during the debtor's chapter 11 case, avoid litigation costs, avoid disruption of the debtor's operations, and address the rights of the debtor's secured lender.

Many programs relieve a trade creditor from having to immediately file a reclamation lawsuit in bankruptcy court and instead provide a mechanism for resolving disputed reclamation claims. Reclaiming trade creditors should confirm this and avoid the fate of reclaiming trade creditors in the *Circuit City* case, where the global reclamation program that was approved did not bar creditors from enforcing their reclamation claims. The court relied on this fact in holding that a creditor that did not diligently enforce its reclamation rights forfeited those rights.[229]

These programs frequently allow the debtor to provide each trade creditor with the proposed allowed amount of its reclamation claim based on the debtor's records. If a trade creditor disputes the debtor's proposed allowed reclamation claim amount, a fixed period of time is established for the par-

228 *Dana*, 367 B.R. at 417.

229 *See Paramount Home Entertainment Inc. v. Circuit City Stores Inc.*, 445 B.R. 521 (E.D. Va. 2010).

ties to exchange documentation and try to negotiate a settlement. The program might also establish a dispute-resolution mechanism that allows the bankruptcy court to decide any objection that the reclaiming trade creditor and debtor are unable to resolve, as well as the treatment and payment of allowed reclamation claims. However, given the numerous defenses available to debtors to impair the ability of a trade creditor to enforce its reclamation rights, the ultimate utility of these programs remains questionable.

C. Trade Creditor's Obligation to Perform Under Executory Contracts with Chapter 11 Debtors

Bankruptcy Code § 365 generally allows a debtor, subject to bankruptcy court approval, to "assume" or "reject" and/or assign executory contracts and unexpired leases.[230] The rationale behind this section is to afford a debtor the right to reaffirm (*i.e.*, assume) a profitable agreement with a third party, or possibly monetize the value of the contract by assigning it to another party, for cash or other consideration. Similarly, § 365 allows a debtor to "reject" (*i.e.*, breach) an executory contract with a third party that is no longer profitable or otherwise beneficial to the debtor's estate. A critically important, but surprisingly unsettled, area of bankruptcy law concerns the rights and obligations of a party to an executory contract with a debtor on the bankruptcy filing date that continues from the filing date until the debtor decides whether to assume or reject the contract.

230 11 U.S.C. § 365(a) ("Except as provided in … subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the Debtor."); 11 U.S.C. § 365(f)(1) ("The trustee may assign an executory contract or unexpired lease of the debtor only if — (A) the trustee assumes such contract or lease in accordance with the provisions of this section; and (B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.").

1. Definition of Executory Contract

The Bankruptcy Code does not define the term "executory contract."[231] The legislative history of § 365 suggests that an executory contract is a contract "on which performance remains due to some extent on both sides."[232] Another definition of executory contracts that has been adopted by many courts is the one put forth by Prof. Vern Countryman:

> A contract [is executory if it is one] under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.[233]

Essentially, an "executory contract" is one that is ongoing when the debtor's bankruptcy case commences with continuing obligations on both sides.[234] If one party has completely or substantially performed its obligations under the contract prior to the date of the bankruptcy filing, the contract is no longer executory and the nondebtor party only holds a claim against the debtor's estate for breach of contract.[235] Examples of executory contracts include supply agreements, purchase orders in effect on the bankruptcy filing

231 Section 365 also applies to "unexpired" leases. If the lease has expired by its own terms, or has been irreversibly terminated under applicable law prior to the bankruptcy filing date, it is not an unexpired lease. *In re Great Feeling Spas Inc.*, 275 B.R. 476 (Bankr. D.N.J. 2002). The determination of whether a lease has been irreversibly terminated prior to the bankruptcy filing date is a matter of state law.

232 S. Rep. No. 989, 95th Cong., 2d Sess. 58 (1978).

233 Countryman, *Executory Contracts in Bankruptcy*, 57 Minn. L. Rev. 439, 446 (1973); s*ee, e.g., In re U.S. Wireless Data Inc.*, 547 F.3d 484, 488 n.1 (2d Cir. 2008).

234 *In re C & S Grain Co.*, 47 F.3d 233, 237 (7th Cir. 1995) ("For purposes of the Bankruptcy Code, an executory contract is one in which the obligations of each party remain substantially unperformed. Consequently, when the debtor … has breached the contract pre-petition with the result that the other party has no further duty to perform … the contract is no longer executory for purposes of section 365.").

235 *In re Spectrum Info. Tech.*, 190 B.R. 741, 747 (Bankr. E.D.N.Y. 1996); *In re Norwood Chevrolet Co.*, 143 B.R. 804 (Bankr. D.R.I. 1992) (substantial performance by both parties precludes rejection of contract); *In re Columbia Gas Sys.*, 146 B.R. 106, 106 (D. Del. 1992), *aff'd, Enterprise Energy Corp. v. United States,* 50 F.3d 233 (3d Cir. 1995) (court-approved settlement that required only "perfunctory act utilizing preapproved terms and conditions" is not an executory contract).

date, consignment agreements and service contracts (such as advertising agreements).

The Bankruptcy Code prohibits certain special categories of executory contracts from being assumed and/or assigned. Bankruptcy Code § 365(c)(1) prohibits the assumption or assignment of any executory contract to which the debtor is a party if applicable nonbankruptcy law excuses the nondebtor party to the contract from accepting performance from, or rendering performance to, an entity other than the debtor, absent the nondebtor's consent. This provision serves to protect the common law principle that contracts made to obtain the personal services of a particular individual should not be freely assignable, over the objection of a counterparty, to someone else to perform the service.

Similarly, Bankruptcy Code § 365(c)(2) prohibits a debtor from assuming or assigning contracts to provide loans, extend debt financing, or give other financial accommodations to another party. The purpose of this provision is to prevent a nondebtor party from being forced to make loans and advances to a borrower in bankruptcy that likely has a much different risk profile than the borrower had when the loan commitment was originally made. Another exception exists for certain securities, commodities and financial contracts that are protected under the "safe harbor" provisions of the Bankruptcy Code, which allow the counterparties to such contracts to immediately liquidate these contracts upon a bankruptcy filing.

Finally, a debtor cannot assume or assign (1) a contract that has been properly terminated pursuant to applicable law prior to the bankruptcy filing date, or (2) a contract that has already expired post-petition by its own terms. As part of proper due diligence in analyzing a party's rights against, and obligations to, a debtor under an executory contract, each of these circumstances should be carefully reviewed. If the contract expired by its terms prior to the date of the bankruptcy filing, then the bankruptcy estate has no legal interest in the contract, and it can be neither assumed nor assigned. Similarly, if the contract expired by its own terms during the course of the bankruptcy case, and the debtor did not have an option to extend the term of the agreement, the debtor lacks the ability to maintain the contract in place. A debtor cannot obtain greater rights under its pending contracts when it filed its bankruptcy case than the rights it had prior to the bankruptcy filing.

2. Debtor's Right to Assume or Reject Executory Contracts and Unexpired Leases

Executory contracts and unexpired leases may be assumed, assigned or rejected by a debtor upon approval by the bankruptcy court through motion practice, or as part of the confirmation of a debtor's chapter 11 plan.[236] Because Bankruptcy Code § 365 requires court approval of the assumption of an executory contract or lease, courts generally hold that a debtor cannot assume an executory contract or lease by its conduct alone.[237] A debtor's right to assume or reject a particular contract or lease also cannot be waived by the debtor through a pre-petition agreement.[238] Finally, a core principle relating to executory contracts and leases is that unitary, integrated contracts cannot be assumed in part and rejected in part; rather, they must be either accepted or rejected in their entirety.[239]

The Bankruptcy Code does not set out standards that a court must apply to determine whether to approve a debtor's decision to assume or reject an executory contract or lease. However, most courts that have considered the issue employ some form of the "business judgment test."[240] Under this test, a debtor need only show that its decision to assume or reject the contract

236 11 U.S.C. §§ 365(a) and 1123(b)(2); *In re Univ. Medical Ctr.*, 973 F.2d 1065 (3d Cir. 1992); *In re Wallace*, 122 B.R. 222 (Bankr. D.N.J. 1990); *In re 1 Potato 2*, 182 B.R. 540 (Bankr. D. Minn. 1995); *In re Speed Fab-Crete of Nevada*, 57 B.R. 720 (Bankr. D. Nev. 1986).

237 *In re A.H. Robbins Co.*, 68 B.R. 705, 708-09 (Bankr. E.D. Va. 1986); *In re University Medical Center*, 973 F.2d 1065 (3d Cir. 1992).

238 *In re Trans World Airlines Inc.*, 261 B.R. 103, 117 (Bankr. D. Del. 2001).

239 *City of Covington v. Covington Landing Ltd. Partnership*, 71 F.3d 1221, 1226-27 (6th Cir. 1995).

240 *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984); *Sharon Steel Corp. v. National Fuel Gas Distribution Corp.*, 872 F.2d 36 (3d Cir. 1989); *Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.)*, 4 F.3d 1095 (2d Cir. 1993); *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc. (In re Richmond Metal Finishers Inc.)*, 756 F.2d 1043 (4th Cir. 1985).

or lease is an exercise of its sound business judgment.[241] A court will not substitute its own business judgment for that of the debtor unless there is a showing of bad faith or an abuse of discretion by the debtor.[242] In practice, this makes opposing a debtor's motion to assume or reject an executory contract or lease very difficult, except in extraordinary circumstances.

3. Assumption

The Bankruptcy Code contains three prerequisites for the assumption of an executory contract or lease.[243] First, if the contract is in default at the time it is to be assumed (other than as a result of a breach of an insolvency or bankruptcy-related clause), the debtor must promptly cure all defaults, or at least provide "adequate assurance" that it will promptly cure the defaults. The Bankruptcy Code provides a broad right to cure defaults, regardless of whether the terms of the contract would permit such cure.[244] The majority of courts that have addressed the issue have held that when a debtor seeks to assume an executory contract or lease under § 365, the debtor must cure both pre-petition and post-petition defaults. If the debtor is able to provide a remedy that offers the nondebtor party the substantial equivalent of its economic rights under the contract or lease, it satisfies the cure requirement.[245]

Second, the debtor must compensate or provide adequate assurance of prompt compensation for "actual pecuniary loss" to the nondebtor party resulting from the debtor's default under the contract. Attorneys' fees incurred in connection with a party's enforcement of its contractual rights against the debtor, if properly provided for in the contract, are included

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241 *In re III Enterprises Inc. V*, 163 B.R. 453, 469 (Bankr. E.D. Pa. 1994), *aff'd, Pueblo Chemical v. III Enterprises V Inc.,* 169 B.R. 551 (E.D. Pa. 1994).

242 *In re G Survivor Corp.*, 171 B.R. 755, 757 (Bankr. S.D.N.Y. 1994), *aff'd, John Forsyth Co. v. G Licensing,* 187 B.R. 111 (S.D.N.Y. 1995).

243 11 U.S.C. § 365(b).

244 *In re Sigel & Co. Ltd.,* 923 F.2d 142, 144-45 (9th Cir. 1991).

245 *In re Circle K Corp.*, 190 B.R. 370, 375-76 (B.A.P. 9th Cir. 1995), *aff'd,* 127 F.3d 904 (9th Cir. 1997).

in the types of claims that comprise a pecuniary loss.[246] In addition, any interest charges that accrue pursuant to the terms of the contract are considered an actual pecuniary loss flowing from a debtor's default and are also compensable.[247] Trade creditors should be mindful that attorneys' fees and interest charges are only recoverable if they are expressly provided for in the contract or are otherwise collectable under applicable law.[248]

Third, the debtor must demonstrate that it can provide adequate assurance of future performance under the contract. The Bankruptcy Code does not define "adequate assurance of future performance" or provide examples of what types of assurances will suffice. The legislative history of § 365 suggests that the bankruptcy court must satisfy itself that the debtor's performance under the contract provide the nondebtor party the full benefit of the bargain of the contract.[249] Generally, courts interpreting the "adequate assurance of future performance" requirement have adopted a pragmatic approach, with a focus on whether the assuming party will be reasonably able to meet the financial obligations imposed by the contract.[250] Among other things, a debtor can provide adequate assurance by introducing evidence of the debtor's financial health.[251]

A debtor's general obligation to cure defaults under an executory contract or lease to be assumed is not applicable to all contractual provisions. The most significant exception to this rule is the so-called "*ipso facto*" clause that is often found in many commercial contracts. [252] An *ipso facto* clause is a contractual provision that terminates the contract upon the filing of a bankruptcy petition or similar insolvency proceeding, or upon the insol-

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246 *In re F & N Acquisition Corp.,* 152 B.R. 304, 308 (Bankr. W.D. Wash. 1993); *In re Westworld Community Healthcare Inc.*, 95 B.R. 730 (Bankr. C.D. Cal. 1989).

247 *In re Hillsborough Holdings Corp.*, 126 B.R. 895, 898 (Bankr. M.D. Fla. 1991).

248 *In re Ryan's Subs Inc.*, 165 B.R. 465, 468-69 (Bankr. W.D. Mo. 1994); *In re Eagle Bus Mfg. Inc.*, 148 B.R. 481, 483 (Bankr. S.D. Tex. 1992).

249 S. Rep. No. 95-989 at 59 (1978).

250 *In re Carlisle Homes Inc.*, 103 B.R. 524, 538 (Bankr. D.N.J. 1988).

251 *In re Bygaph Inc.*, 56 B.R. 595, 605-06 (Bankr. S.D.N.Y. 1986).

252 Section 365(e)(2) identifies certain exceptions to the general rule that *ipso facto* clauses are unenforceable.

vency of one of the parties to the contract. The Bankruptcy Code generally invalidates *ipso facto* clauses.[253] The policy behind invalidating *ipso facto* clauses is that a debtor attempting to reorganize could never cure the default of an *ipso facto* provision (*i.e.*, the debtor could never revoke its bankruptcy petition or insolvency).

4. Rejection

Bankruptcy Code § 365(g) governs the effect of a debtor's rejection of an executory contract or lease.[254] A debtor's rejection of a contract is considered a breach of the contract that gives the nondebtor party a claim against the debtor's estate.[255] Rejection does not result in the termination of the contract. The classification of a rejection damages claim depends in large part on the timing of rejection of the contract. In the typical case, a debtor will reject a contract following the bankruptcy filing date. A trade creditor's damage claim against the debtor resulting from the rejection (frequently referred to as a "rejection damages claim") is a pre-petition general unsecured claim because it is deemed to have arisen immediately prior to the bankruptcy filing.[256] If a debtor breaches or rejects an executory contract or lease following assumption of the contract, the trade creditor's damage claim arises on the date of the breach and the creditor would be entitled to an administrative priority claim.[257]

5. Deadlines

The deadline to assume or reject an executory contract or lease depends on the chapter of the Bankruptcy Code under which the debtor filed its bankruptcy case. In chapter 7 cases, a trustee has 60 days from the bankruptcy

253 11 U.S.C. § 365(e)(1) ("[A]n executory contract or unexpired lease of the debtor may not be terminated or modified ... at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on — (B) the commencement of a case under this title.").

254 *In re Wright*, 256 B.R. 858 (Bankr. W.D.N.C. 2001).

255 Damages resulting from the rejection "must be administered through bankruptcy and receive the priority provided general unsecured creditors." *NLRB v. Bildisco*, 465 U.S. 513, 531 (1984).

256 11 U.S.C. §§ 365(g)(1) and 502(g).

257 11 U.S.C. § 365(g)(2); *In re Klein Sleep Prods. Inc.*, 78 F.3d 18, 30 (2d Cir. 1996).

filing date to assume or reject an executory contract or lease.[258] Courts, however, are permitted to grant additional time upon a showing of cause. If the trustee fails to act within the 60-day period, or within any court-granted extension, the contract is deemed rejected.[259]

In chapter 11 cases, a debtor may assume or reject an executory contract or lease at any time prior to confirmation of a chapter 11 plan.[260] A chapter 11 plan may provide for the assumption or rejection of executory contracts and leases that have not been previously assumed or rejected.[261] The nondebtor party to an executory contract or lease may file a motion at any time during the chapter 11 case to compel the debtor to assume or reject the contract within a specified period of time. However, a trade creditor must satisfy a very high burden of proof to obtain this relief prior to approval of any chapter 11 plan. Typically, the nondebtor party must show compelling circumstances, such as where the nondebtor party will be forced to begin a significant undertaking and/or a long-term commitment of capital without any assurance that the debtor will ultimately assume the contract at issue. As a result, courts frequently deny these motions.

The 2005 BAPCPA amendments to the Bankruptcy Code significantly enhanced the rights of nondebtor commercial lessors concerning when a chapter 11 debtor must assume or reject an unexpired nonresidential real property lease. A debtor must generally assume or reject such lease by the earlier of (1) 120 days after the bankruptcy filing date or (2) the date that a plan is confirmed.[262] The court may grant an extension for up to an additional 90 days after the initial 120-day period for cause shown.[263] However, the court may *not* grant any subsequent extensions of the debtor's time to assume or reject the lease without the lessor's written consent.[264] Accordingly, absent

258 11 U.S.C. § 365(d)(1).

259 When a case is converted from another chapter to chapter 7, the 60-day period will run from the date of conversion. *In re Tompkins*, 95 B.R. 722, 724 (B.A.P. 9th Cir. 1989).

260 11 U.S.C. § 365(d)(2).

261 11 U.S.C. § 1123(b)(2).

262 11 U.S.C. § 365(d)(4)(A).

263 11 U.S.C. § 365(d)(4)(B)(i).

264 11 U.S.C. § 365(d)(4)(B)(ii).

the lessor's written consent, a court cannot grant a debtor more than 210 days from the debtor's bankruptcy filing date to assume or reject nonresidential real property leases.

6. Assignment of Contracts

In addition to a straightforward assumption or rejection of executory contracts and leases, a debtor also has the right under the Bankruptcy Code to assume an executory contract or lease (by fulfilling all of the requirements for assumption discussed above) and assign it to a third party. This right of assignment of executory contracts and leases enables debtors and trustees to sell and recoup profit from their profitable contracts.

Generally, any anti-assignment provisions contained in a contract or lease will not prohibit a debtor from receiving bankruptcy court authorization for the assignment.[265] In addition to satisfying the first two requirements of assumption (*e.g.*, curing defaults and compensating for pecuniary loss), the debtor must also provide adequate assurance that the proposed assignee will be able to perform the obligations required by the contract.[266] What qualifies as "adequate assurance of future performance" under Bankruptcy Code § 365(f)(2) is very similar to the adequate-assurance showing for assumption required under § 365(b)(1). Once a bankruptcy court authorizes the debtor to assume and assign a contract or lease, the estate has no further

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265 11 U.S.C. § 365(f)(1) ("[N]otwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.").

266 11 U.S.C. § 365(f)(2) states:

> The trustee may assign an executory contract or unexpired lease of the debtor only if —
>
> > (A) the trustee assumes such contract or lease in accordance with the provisions of this section; and
> >
> > (B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

liability for any breach of the contract or lease that may occur following the date of the assignment.[267]

7. Obligations During the Limbo Period Before Assumption or Rejection

The Bankruptcy Code is silent on the rights and obligations of the parties to an executory contract during the period between the filing of the bankruptcy case and when the debtor decides whether to assume or reject the contract. This time period is often referred to as the "limbo" period. However, courts have uniformly held that an executory contract generally remains in effect pending the debtor's assumption or rejection of the contract.

8. Automatic Stay

A debtor that files for bankruptcy benefits from the automatic stay arising under § 362(a) of the Bankruptcy Code. This stay (*i.e.*, injunction) generally bars a trade creditor from modifying or terminating contracts and leases with the debtor that were in effect on the bankruptcy filing date, unless the creditor obtains relief from the court to "lift the stay" to permit the creditor to take action against the debtor with respect to the contract or lease.[268]

Courts have generally found that executory contracts, such as supply and service agreements, are property of the debtor's estate that are entitled to the protection of the automatic stay. As a result, a creditor cannot terminate the contract without first obtaining court approval for relief from the stay.[269] A majority of courts have ruled that a creditor also cannot stop per-

267 11 U.S.C. § 365(k) ("Assignment by the trustee to an entity of a contract or lease assumed under this section relieves the trustee and the estate from any liability for any breach of such contract or lease occurring after such assignment.").

268 For example, the automatic stay provisions of § 362(a)(3) prohibit a vendor that has a pre-petition claim against the debtor from taking action to obtain possession of property of a debtor's estate or property from the debtor's estate. Similarly, § 362(a)(6) prevents a creditor from taking action to collect or recover its pre-petition claim against the debtor.

269 *In re Computer Commc'ns.*, 824 F.2d 725, 731 (9th Cir. 1987) (relying, in part, on legislative history of § 362 that stay should be broad in scope and that "[j]udicial toleration of an alternative procedure of self-help and *post hoc* justification would defeat the purpose of the automatic stay"); *see also In re West Electronics Inc.*, 852 F.2d 79, 82 (3d Cir. 1988).

forming under the contract. This is true even if the debtor owes significant sums to the creditor on account of goods supplied, or services provided, pre-petition or has otherwise materially breached the contract. These courts consider the creditor's refusal to perform to be a willful violation of the automatic stay, which could lead to actual and punitive damages assessed against the party, as well as the recovery of the debtor's attorneys' fees. However, a trade creditor's obligation to extend credit in connection with fulfilling a contract post-petition is a much less settled area of law.

9. Nondebtor Party's Obligation to Perform

a. Majority View

Most courts have held that during the period between the filing of a bankruptcy case and a debtor's decision to assume or reject an executory contract, the debtor can compel the nondebtor to continue performing under the contract. However, the nondebtor party cannot enforce the contract against the debtor to the extent that the debtor has the right to reject the contract at any time, subject to bankruptcy court approval, leaving the nondebtor with an unsecured claim based on its unpaid pre-petition claim under the contract and its damages arising from the debtor's rejection of the contract.[270] Where the nondebtor provides goods and/or services to the debtor subsequent to a bankruptcy filing, the debtor has an obligation to pay for the reasonable value of these goods and/or services that is generally afforded an administrative priority status pursuant to § 503(b).[271] The trade creditor could also move in the bankruptcy court to compel the debtor's immediate payment of the trade creditor's administrative claim.

270 *See NLRB v. Bildisco and Bildisco*, 465 U.S. at 531; *United States ex rel. United States Postal Service v. Dewey Freight Systems*, 31 F.3d 620, 624-25 (8th Cir. 1994); *In re Public Service Co. of New Hampshire*, 884 F.2d 11, 14 (1st Cir. 1989); *In re Rhodes Inc.*, 321 B.R. 80, 91 (Bankr. N.D. Ga. 2005) ("As a general proposition, the non-debtor party to an unexpired lease or other executory contract is obliged to perform it until it is assumed or rejected."); *In re Nat'l Steel Corp.*, 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004); *In re Pittsburgh-Canfield Corp.*, 283 B.R. 231, 238 (Bankr. N.D. Ohio 2002); *In re El Paso Refinery LP*, 196 B.R. 58, 72 (Bankr. W.D. Tex. 1996).

271 *Bildisco and Bildisco*, 465 U.S. at 531; *In re Nat'l Steel Corp.,* 316 B.R. at 305.

b. Minority (In re Lucre) *View*

A contrary view adopted by the U.S. Bankruptcy Court for the Western District of Michigan, *In re Lucre*, states that nothing in the Bankruptcy Code requires the nondebtor party to perform its obligations under an executory contract where the debtor had materially breached the contract prior to the bankruptcy filing.[272] The court concluded that the automatic stay did not prevent the nondebtor party from ceasing performance under a contract that has been materially breached. The *Lucre* court focused on state contract law to determine whether the nondebtor party could stop performing under its contract with a party upon default of its terms. The court found it illogical that a debtor should be able to compel performance from the counterparty after the bankruptcy filing when the debtor could not otherwise compel the nondebtor party's performance, under applicable state law, prior to bankruptcy because of the debtor's material breach of the contract.

Accordingly, there is at least some judicial authority for the proposition that a debtor cannot enforce a contract that has been materially breached prior to a bankruptcy. However, parties to contracts with debtor entities should be very cautious of relying upon the minority view espoused by *Lucre*, especially in light of the significant risks associated with a court following the majority view and finding that the nondebtor party violated the automatic stay by refusing to perform under an executory contract. A more prudent course would be for such a party to first seek declaratory relief from the bankruptcy court that the nondebtor has the right to stop performing under the contract and treat the contract as terminated.

10. Trade Creditor's Obligation to Extend Credit to a Chapter 11 Debtor

Many supply and service agreements contain provisions requiring a vendor to extend unsecured credit to its customers so that payment is not due until after the goods are delivered or services are performed. A buyer's risk

272 *In re Lucre Inc.*, 339 B.R. 648, 662 (Bankr. W.D. Mich. 2006), *appeal dismissed as moot*, 471 F. Supp. 2d 845 (W.D. Mich. 2007).

profile, and a trade creditor's reasonable belief that it will be compensated by the buyer, are usually materially different at the inception of their agreement compared with after a buyer has filed for chapter 11, particularly where the buyer has a large outstanding pre-petition debt owed to the trade creditor. A trade creditor with a significant unpaid pre-petition claim against a debtor that is doubtful of a debtor's ability to reorganize may understandably be concerned about continuing to extend credit to its buyer (now a chapter 11 debtor).

Typically, in such a situation the debtor will assert that the trade creditor is protected by (1) the liquidity provided by the debtor's court-approved financing arrangement with its secured lender, and (2) the § 503(b) administrative priority claim the vendor is afforded on account of the post-petition goods and/or services that the trade creditor provides to the debtor on credit terms. Unfortunately, chapter 11 cases frequently fail, and the debtor is forced to liquidate its assets either in the chapter 11 case (*e.g.*, Toys "R" Us) or through a chapter 7 case. Depending on the amount of the debtor's secured debt and other administrative claims, a trade creditor may have substantial grounds to be concerned that the debtor will have insufficient assets to fully and timely pay all administrative claims. A debtor that lacks sufficient cash to fully pay all administrative claims (after paying secured claims) is administratively insolvent. Trade creditors routinely argue that it is inequitable for them to be forced to extend post-petition credit when there is a significant risk of nonpayment due to the debtor's administrative insolvency. However, it is significant to note that there are no reported decisions requiring a trade creditor to extend credit to a debtor based on the terms of a pre-petition executory contract.

Frequently, a debtor will threaten to sue its trade creditor for breach of contract, violation of the automatic stay and/or injunctive relief in circumstances where the trade creditor refuses to continue to sell goods, or provide services on credit, to the debtor, notwithstanding the credit terms contained in its supply or services agreement. The debtor might argue that the trade creditor is precluded by the automatic stay from altering the terms of its agreement with the debtor, including modifying credit terms, such as switching to cash-in-advance terms, because the contract is an executory contract that is property of the debtor's estate. The trade creditor might face the risk of being sued for willfully violating the automatic stay. In any such lawsuit, the debtor could claim actual and punitive damages, sanctions and costs associated with the trade creditor's refusal to extend credit.

In response to, or in anticipation of, such threats by a debtor, a trade creditor might consider making a demand for adequate protection of the trade creditor's interest in the debtor's property (*i.e.*, the supply or service contract that constitutes property of the estate) to secure the trade creditor's continued performance under the contract and, if necessary, move for this relief in the bankruptcy court. Bankruptcy Code § 363(e) allows a party with an interest in, among other things, the property that a debtor uses, sells or leases to request that such use, sale or lease be conditioned upon the debtor providing "adequate protection" of the requesting party's property interest. A trade creditor may move to compel the debtor to assume the contract or, alternatively, have the automatic stay lifted to allow the trade creditor to terminate the contract to the extent that the debtor refuses to furnish adequate protection. Bankruptcy Code § 361 states that when a court concludes that adequate protection is warranted, the debtor must provide the trade creditor with a cash payment, a letter of credit, a replacement lien, or other consideration that provides the "indubitable equivalent" of the trade creditor's interest in the debtor's property. However, a debtor cannot furnish adequate protection by just providing the trade creditor with an administrative claim, which the creditor is already entitled to assert under Bankruptcy Code § 503(b) on account of its post-petition extensions of credit.

Prior to bankruptcy, a trade creditor that has a commercially valid reason to be concerned about a debtor's ability to perform under a contract often has the right to demand adequate assurance of future performance from its counterparty pursuant to UCC § 2-609.[273] However, after a counterparty

273 *See* Chapter II of this *Manual*.

files for bankruptcy, it is unsettled whether relief from a bankruptcy court (*i.e.*, in the form of relief from the automatic stay or seeking adequate protection) is a prerequisite for a trade creditor to exercise its state law remedies. As such, the safest approach for a trade creditor is to seek declaratory relief from the bankruptcy court prior to taking any action that is materially different from the terms of its contract with the debtor.

Another approach, perhaps to be used in combination with the other strategies discussed above, is for the trade creditor to file a motion with the bankruptcy court to compel the debtor to immediately decide to assume or reject its executory contract with the trade creditor.[274] Because Bankruptcy Code § 365(d)(2) does not include a standard by which a court determines whether to compel assumption or rejection prior to plan confirmation, the bankruptcy court must balance the interests of the debtor against those of the trade creditor.[275] This inquiry is an equitable one in which the bankruptcy court considers the potential harm to the estate in being forced to make an accelerated decision on assumption or rejection of the contract against the potential harm to the trade creditor in delaying the decision to assume or reject the contract until the end of the bankruptcy case.[276]

Courts are reluctant to force a debtor into assuming or rejecting a contract during the bankruptcy case, prior to confirmation of the plan, absent unique circumstances.[277] The reason for this reluctance is that the "interests of the creditors collectively and the bankrupt estate as a whole will not yield easily to the convenience or advantage of one creditor out of many."[278] Even with this uphill battle, a trade creditor might choose to file such a motion in order to add an element of uncertainty for the debtor as to whether the court would grant the motion. This may create the necessary leverage to allow for meaningful negotiations between the trade creditor and debtor to

274 11 U.S.C. § 365(d)(2); *In re Physician Health Corp.*, 262 B.R. 290 (Bankr. D. Del. 2001).

275 *In re Mayer Pollock Steel Corp.*, 157 B.R. 952, 964-65 (Bankr. E.D. Pa. 1993); *In re Dunes Casino Hotel*, 63 B.R. 939, 949-50 (D.N.J. 1986); *In re GHR Energy Corp.*, 41 B.R. 668, 670 (Bankr. D. Mass. 1984).

276 *In re Kmart Corp.*, 290 B.R. 614, 619-20 (Bankr. N.D. Ill. 2003).

277 *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1215 (7th Cir. 1984).

278 *In re Public Service Co.*, 884 F.2d 11, 15 (1st Cir. 1989).

reach agreements on modified credit and other terms between the parties during the pendency of the bankruptcy case.

Perhaps the best recent illustration of the tension between the rights of a debtor and a trade creditor under an executory contract occurred in the chapter 11 case of *Visteon Corp.* in the U.S. Bankruptcy Court for the District of Delaware.[279] Visteon had threatened to sue trade creditors that would not continue to sell to Visteon on a post-petition basis under the open credit terms contained in their respective pre-petition contracts. One of the trade creditors, Panasonic, sought declaratory relief in the bankruptcy court that it did not have any post-petition obligation to continue to provide to Visteon the pre-petition credit terms required by their contract. Panasonic sought an order from the court that stated that it would only be required to continue its post-petition performance under its contract if Visteon paid Panasonic on cash-in-advance terms or otherwise provided Panasonic with credit protections, such as a letter of credit, to ensure payment. Among the various reasons that Panasonic relied upon in support of its application was that Visteon was facing administrative insolvency and its post-petition secured financing was inadequate to reasonably ensure that Panasonic's post-petition administrative claim would be fully and timely paid. Ultimately, Panasonic and Visteon reached a settlement prior to the hearing to consider the motion.

The moving trade creditors in the *Visteon* case also invoked their stoppage of delivery rights with respect to future sales to further justify their right to switch to cash-in-advance terms. They relied on several bankruptcy court decisions that denied relief to a debtor seeking to compel a trade creditor's delivery of goods on credit terms pursuant to an existing pre-petition contract. For instance, in *In re Kellstrom Indus. Inc.*,[280] a trade creditor had sold goods to the debtor but retained possession of the goods prior to the debtor's bankruptcy filing. Following the filing, the debtor sought to sell all of its assets, including the goods that the trade creditor was holding. The trade

279 *In re Visteon Corp.* (Bankr. D. Del.) (Case No. 09-11786 (CSS)).

280 282 B.R. 787 (Bankr. D. Del. 2002).

creditor opposed the sale, invoking its adequate-protection rights based on its UCC right to stop delivery of the goods it was holding. The bankruptcy court held that the trade creditor was entitled to adequate protection on account of its stoppage of delivery rights due to the debtor's prior cash payment for the goods in the trade creditor's possession.[281]

Trade creditors often couple the argument of a debtor's potential administrative insolvency and an unreasonable risk of nonpayment with the companion argument that the trade creditor should not be compelled to extend credit under an executory contract because Bankruptcy Code § 365(c)(2) prohibits a debtor from assuming an executory contract if "such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor...." Although the text of § 365(c)(2) suggests that a supply or services contract with open credit terms falls within this statutory provision, the courts that have considered this argument have narrowly construed § 365(c)(2) to apply only to contracts whose *principal* purpose was to lend money or provide a financial accommodation.[282] These courts have held that § 365(c)(2) cannot be extended to a contract with a primary purpose of supplying goods or services, with the trade creditor's incidental obligation to extend credit or other financial accommodations to the debtor.[283]

281 *Id.* at 790-91; *see also In re Sportfame of Ohio Inc.*, 40 B.R. 47, 53 (Bankr. N.D. Ohio 1984); *In re Ike Kempner & Bros. Inc.*, 4 B.R. 31 (Bankr. E.D. Ark. 1980); *In re Blackwelder Furniture Co. Inc.*, 7 B.R. 328, 337-38 (Bankr. W.D.N.C. 1980).

282 In fact, this interpretation appears to be consistent with the legislative history of § 365(c)(2) ("Characterization of contracts to make a loan, or extend other debt financing or financial accommodations, is limited to the extension of cash or a line of credit and is not intended to embrace ordinary leases or contracts to provide goods and services with payments to be made over time." 124 Cong. Rec. H11089 (Daily Ed. Sept. 28, 1978) (Statement of Rep. Edwards)); *see In re Thomas B. Hamilton Co. Inc.*, 969 F.2d 1013, 1018-19 (11th Cir. 1992).

283 *In re Neuhoff Farms Inc.*, 258 B.R. 343, 347-48 (Bankr. E.D.N.C. 2000); *In re UAL Corp.*, 293 B.R. 183, 189 (N.D. Ill. 2003); *but see In re Cole Bros. Inc.*, 154 B.R. 689, 692 (W.D. Mich. 1992) (finding that extension of credit was integral part of dealership agreement where manufacturer provided inventory and floor plan financing); *see also In re Sun Runner Marine Inc.*, 945 F.2d 1089, 1092 (9th Cir. 1991) (same).

CONCLUSION

Unsecured trade creditors risk realizing a small or no recovery on their claims against a financially troubled buyer, particularly if the buyer files a bankruptcy petition. Trade creditors should watch for the warning signs of a financially troubled buyer, then act quickly to take the steps discussed in this *Manual* to increase the likelihood of obtaining a quicker and substantially larger recovery from their financially troubled buyer.

Trade creditors should also consider the various risk-mitigation tools they could obtain from the buyer or purchase from a third party. In addition, trade creditors have pre-bankruptcy UCC remedies, such as their right to seek adequate assurance, stoppage of delivery or reclamation of goods, anticipatory repudiation, and damages for breach of contract. They could also avail themselves of post-bankruptcy remedies, such as their § 503(b)(9) priority claims, stoppage of delivery rights, bankruptcy reclamation rights and rights with respect to pending executory contracts.

APPENDIX

Form 1: Letter of Credit

[ISSUING BANK LETTERHEAD]

Date:
IRREVOCABLE STANDBY LETTER OF CREDIT NUMBER: __________________
ISSUING BANK: ____________________ [CONFIRMING BANK:] _____________
BENEFICIARY: _____________________ APPLICANT: __________________
AMOUNT:
Not exceeding USD$___________________ (___________________US Dollars)

EXPIRATION: _____________________, at our counters

Ladies and Gentlemen:

At the request of and for the account of ____________ (the "Account Party"), we ____________ (the "Issuing Bank") hereby issue this Irrevocable Standby Letter of Credit No. _____________ (the "Letter of Credit") in your favor in the aggregate amount of (US$________________).

This Letter of Credit is effective immediately and shall subject to renewal as provided below, expire at 5:00 o'clock pm eastern time local time in ____________, ("Eastern Time"), on ____________, [one year from the date of LC] as the same may be automatically extended in accordance with the terms hereof (the "Termination Date").

Notwithstanding anything contained herein to the contrary, this Letter of Credit shall be automatically renewed annually for a period of one (1) year unless, sixty (60) days prior to the Termination Date, we notify the Beneficiary by registered United States mail (return receipt requested) addressed to [INSERT COMPLETE BENEFICIARY CONTACT INFORMATION], and not by any other means, that we will not renew this Letter of Credit. Upon receipt of such a notice not to renew, Beneficiary shall have the unconditional right to make a Drawing (as defined below) under this Letter of Credit by delivering the Required Documents (defined below) in the manner set forth.

Demand for payment under this Letter of Credit may be made by you in a single, multiple or partial drawings (each a "Drawing"). A Drawing may be made by you on any Business Day (as defined below) prior to 5:00 o'clock pm (Eastern Time) by presentation to [Issuing Bank] [Confirming Bank] at its office at ______________, telephone no. _____________ (or at our office located at _______________ or via facsimile at Telecopier No_____________, of the following documentation (collectively, the "Required Documents"):

(I) Your duly completed and signed draft in the form of Annex A -1 hereto (the "Draft") drawn on the Issuing Bank; and

(II) A Drawing Certificate in the form of Annex B -1 hereto duly signed by your authorized officer.

Payment against the Required Documents properly presented under this Letter of Credit prior to 5:00 p.m. (Eastern Time) on any Business Day, on or prior to the Termination Date, shall be made by the [Issuing Bank] [Confirming Bank], with its own funds in United States Dollars, by wire transfer in immediately available funds, to the account specified by you in your draft, on the same Business Day. Payment against Required Documents properly presented under this Letter of Credit on or after 5:00 p.m. (Eastern Time) on any Business Day, on or prior to the Termination Date, shall be made by the [Issuing Bank][Confirming Bank], with its own funds in United States Dollars, by wire transfer in immediately available funds, to the account specified by you in your draft, on the following Business Day. If the Required Documents presented in connection with the Drawing do not, in any instance, conform to the terms and conditions of this Letter of Credit, the Issuing Bank promptly shall give you notice that the purported presentment of the documents was not effected in conformity with this Letter of Credit, stating in reasonable detail the reasons therefor and that the Issuing Bank is holding any documents so presented at your disposal or is returning same to you, as you may elect. Upon being notified that the purported presentment was not effect in conformity with this Letter of Credit, you may, prior to the Termination Date, attempt to correct any such nonconforming demand for payment or documentation. For purposes hereof, "Business Day" means any day other than Saturday or Sunday or a day on which commercial banks are required or authorized to be, closed in the State of New York.

All other communications and notices to the Issuing Bank with respect to this Letter of Credit shall be in writing and delivered or sent by facsimile or e-mail to the Issuing Bank at the address, facsimile number, or e-mail address set forth in the third paragraph of this Letter of Credit, and shall specifically refer to the Issuing Bank by name and to this Letter of Credit by the Irrevocable Standby Letter of Credit No.__.

This Letter of Credit sets forth in full the Issuing Bank's undertaking and such undertaking shall not in any way be modified, amended, amplified or limited by any document, instrument or agreement referred to in this Letter of Credit, or in any certificate presented by you under this Letter of Credit, and any such reference shall not be deemed to incorporate herein by reference any document, instrument or agreement.

This Letter of Credit is freely transferable by you.

All banking charges including, without limitation, charges to transfer this Letter of Credit are for the account of the Account Party.

All inquiries regarding the Letter of Credit should be directed to us at our phone number(s) and/or e-mail addresses [TELEPHONE NUMBER(S) AND E-MAIL ADDRESSES].

Kindly direct all correspondence regarding this Letter of Credit to [NAME, ADDRESS OF ISSUING BANK AND E-MAIL ADDRESS], Attention Standby Letter of Credit Department, making reference to our Letter of Credit number.

This Letter of Credit is subject to the International Standby Practices 1998, International Chamber of Commerce Publication No. 590 (the "ISP98"). As to matters not covered by the ISP98, this Letter of Credit shall be governed by the laws of the State of [New York].

[Name of Confirming Bank] is requested to add its confirmation to this Letter of Credit.]

Very truly yours,

[NAME OF ISSUING BANK]

By:_______________________
Name:_____________________
Title:______________________

[Name of Confirming Bank] hereby undertakes to honor any drafts presented to it when drawn under and in strict conformity with this credit.

[NAME OF CONFIRMING BANK]

By:______________________
Name:____________________
Title:_____________________

THIS IS AN INTEGRAL PART OF LETTER OF CREDIT NUMBER:_______

IRREVOCABLE STANDBY LETTEROF CREDIT NO. ___

ANNEX A-1

DRAFT

TO: [ISSUING BANK]

Pay at sight to the order of [Name of Beneficiary] ("Beneficiary") the sum of __________ United States Dollars (US$_________), drawn under Irrevocable Standby Letter of Credit No._______ dated ________, 20__.

The aforementioned payment shall be made to the Beneficiary in accordance with the following wire transactions:

[Name of Beneficiary]
ABA Number:_____________________
Account Name:____________________
Account Number:__________________
Attention:_________________________
Reference:________________________

Dated:____________________________

[Name of Beneficiary]

By:________________
Title:_______________

THIS IS AN INTEGRAL PART OF LETTER OF CREDIT NUMBER:______________

IRREVOCABLE STANDBY LETTER OF CREDIT NO.________________________

ANNEX B-1

DRAWING CERTIFICATE

The undersigned, [Name of Beneficiary] ("Beneficiary") certifies as follows to _________ as issuer of the above-referenced Standby Letter of Credit: ANY ONE OR MORE OF THE FOLLOWING:

[IF DRAWING IS FOR AMOUNTS DUE] The amount of the attached draft represents the amount owing by _______________ ("_______________") to Beneficiary, as reflected on Beneficiary's books and records, (a) for goods that Beneficiary sold to _______________ (i) which goods _______________ has failed and/or refused to accept, and/or (ii) which goods are the subject of an order that has been cancelled or repudiated by, or on behalf of, _______________; and/or (iii) which goods have been delivered to _______________, and/or (b) based on other indebtedness or liabilities owing by _______________ to Beneficiary.]; AND/OR

[IF DRAWING IS FOR BANKRUPTCY PREFERENCE EXPOSURE] The amount of the draft represents a payment or payments by Applicant [APPLICANT SHOULD BE DEBTOR] to Beneficiary within ninety (90) days of a petition filed by or against Applicant under the Bankruptcy Code (the "Bankruptcy"), all or a portion of which is required to be repaid by Beneficiary to Applicant, a trustee or other fiduciary in connection with the Bankruptcy]; AND/OR

[IF DRAWIN IS FOR RECEIPT OF NOTICE OF NON RENEWAL] The Beneficiary has received from Issuing Bank a notice stating that the Issuing Bank will not renew the Letter of Credit and the amount of the draft represents the total undrawn amount of the Letter of Credit.]

Dated:______________

[Name of Beneficiary]

By_________________

Title:_______________

Form 2: Purchase Money Security Agreement

PURCHASE MONEY SECURITY AGREEMENT

The Purchase Money Security Agreement ("Security Agreement") made and entered into as of this [__] day of [__________], __________ between [__________], having a principal place of business at [__________] (the "Debtor"), and [Name of entity], a [__________] corporation having a place of business at [__________] (the "Secured Party").

WITNESSETH:

WHEREAS, the Debtor has purchased and may hereafter purchase from the Secured Party on credit, [describe goods], related products and other goods sold by Secured Party; and

WHEREAS, the Secured Party requires as a condition precedent to the extension of credit to the Debtor that all of the Debtor's obligations to be incurred to the Secured Party hereafter are secured to the extent, and upon the terms and subject to the conditions provided for, herein.

NOW, THEREFORE, in consideration of the foregoing, and the mutual covenants herein contained, IT IS AGREED by and between Debtor and the Secured Party as follows:

1. Security Interest Granted. The Debtor hereby pledges, assigns, transfers, sets over and grants to the Secured Party a continuing general lien upon, and purchase money security interest in, the "Collateral" hereinafter defined to secure the payment and performance of all of the "Obligations," as hereinafter defined, of the Debtor to the Secured Party.

2. Definitions. As used herein the following terms shall mean:

a. "Collateral" - all Inventory Collateral and Non-Inventory Collateral.

b. "Inventory Collateral" - all right, title and interest of the Debtor in and to all the inventory of goods now existing or hereafter acquired by Debtor from Secured Party or its agents, representatives or distributors, and/or heretofore and hereafter sold, furnished or supplied, directly or indirectly, by the Secured Party or its agents, representatives or distributors to the Debtor (collectively the "Goods"), and all finished goods and other inventory made in whole or in part with any of the Goods, wherever located, and all products and cash and non-cash proceeds of, and supporting obligations with respect to, the foregoing, including without limitation all insurance proceeds with respect thereto.

c. "Non-Inventory Collateral" - all documents, instruments, promissory notes, investment property, financial assets, general intangibles, chattel paper, accounts, letter of credit rights, contract rights, and all other rights to payment of money and deposit accounts (such terms having the meanings ascribed by the Uniform Commercial Code) of Debtor now existing and/or heretofore or hereafter created, arising out of or relating to the sale, transfer or disposition of the

Inventory Collateral, all returned and repossessed goods, and all books and records of the Debtor relating to any of the foregoing and/or the Inventory Collateral, wherever located, and all supporting obligations with respect thereto, and all products and cash and non-cash proceeds of, the foregoing.

d. "Obligations" - the performance, including the full, prompt and unconditional payment to the Secured Party, upon the terms and as and when due, of any and all obligations, liabilities or indebtedness of the Debtor to the Secured Party, of whatever nature, whether direct or indirect, absolute or contingent, matured or unmatured, monetary or non-monetary, liquidated or unliquidated, now existing and/or which may heretofore or hereafter become due, arising under any instrument, agreement, promissory note, contract, guaranty, indemnity, loan or otherwise, including, without limitation, the costs and fees of Secured Party, including the costs and expenses (including attorneys' fees) in preparing, administering and enforcing this Security Agreement and of retaking, storing, preparing and selling the Collateral upon default, if any.

3. Representations and Warranties. The Debtor represents and warrants that:

a. The Debtor is duly organized and operates a business under the laws of the State of ______ and is duly qualified and in good standing in every other state in which the conduct of its business requires such qualification;

b. The execution, delivery and performance of this Security Agreement are within the Debtor's powers, have been duly authorized by all necessary corporate action, and are not in contravention of any law or of any indenture, agreement or undertaking to which Debtor is a party or by which it is bound;

c. The Debtor is and shall be the lawful owner of the Collateral, which is and shall remain free and clear of any liens, encumbrances, security interests, adverse claims, charges, taxes, levies or assessments, except for the security interests listed on Schedule A attached hereto (the "Permitted Liens");

d. The security interest in the Collateral granted hereunder will, when perfected in accordance with the Uniform Commercial Code, constitute and remain a valid and perfected first priority lien and security interest in the Collateral;

e. There is no litigation, investigation or administrative proceeding, by any governmental or public body or authority pending or, to the best of the Debtor's knowledge threatened or any basis therefor, involving the Debtor or any of its assets which, if adversely determined, would, or is likely to, materially and adversely affect the performance by the Debtor of the Obligations;

f. The Inventory Collateral is now, and/or shall hereafter be, stored or maintained at the Debtor's place of business at ______________________;

g. The Debtor's chief executive office is located at ______________; and

h. The Debtor's books and records are located at ________________.

4. Covenants of the Debtor. The Debtor covenants that so long as any of the Obligations remain outstanding and unpaid:

a. The Debtor shall defend its right, title and interest to the Collateral against all persons and against all claims or demands of any kind whatsoever;

b. The Debtor shall pay, when due, all charges, taxes, assessments and fees which may now or hereafter be imposed on the ownership, sale, purchase or possession of the Collateral, and the Secured Party may, but is under no duty to, pay said items and charge the cost for same to the Debtor;

c. Except for the sale in the ordinary course of business, the Debtor shall retain possession and control of, and keep and store the Collateral at all times, at the Debtor's risk of loss, only at the Debtor's place of business set forth in Section 3(f) above;

d. The Inventory Collateral shall at all times be segregated from all of the Debtor's other inventory and shall be marked as subject to the Secured Party's security interest;

e. The Debtor shall not, without prior written authorization by the Secured Party, cause or permit any of the Collateral, whether now owned or hereafter acquired, to be subject to a lien except:

(i) liens granted to the Secured Party;

(ii) the Permitted Liens; and

(iii) liens securing taxes, assessments, or governmental charges or levies, or the claims or demands of materialmen, mechanics, carriers, warehousemen, landlords and other like persons, where such liens are being contested in good faith and adequate reserves have been established therefor;

f. Immediately upon becoming aware that the holder of any obligation, or of any other evidence of indebtedness or other security of the Debtor has given notice or taken any other action with respect to a claimed default or event of default, the Debtor shall give the Secured Party a written notice specifying the notice given, or action taken by such holder, and the nature of the claimed default or event of default and what action the Debtor is taking, or proposes to take, with respect thereto;

g. Immediately upon becoming aware of any developments or other information which may materially and adversely affect the assets of the Debtor, or the value of the Collateral (resulting from sales other than in the ordinary course of business), its business, prospects, profits or condition (financial or otherwise), or the ability to pay or perform its Obligations under this Agreement, the Debtor shall notify the Secured Party, in writing, specifying the nature of such development or information and such anticipated effect to the Secured Party, and will execute and deliver, or will cause to be duly executed and delivered, such further instruments and documents, and do or use its best efforts to cause to be done such further acts as may be necessary or proper, in the opinion of the Secured Party, to effectuate the provisions or purposes of this Security Agreement;

h. The Debtor shall not sell, consign, lend, rent, license, lease or otherwise dispose of the Collateral or any interest therein except in the ordinary course of the Debtor's business or as otherwise may be authorized by the Secured Party in writing (for the purpose hereof, sales by Debtor to any of its subsidiaries or affiliates shall not be deemed to be sales in the ordinary course of business);

i. The Debtor shall immediately notify the Secured Party in writing of any change in Debtor's name, type of organization, jurisdiction of organization or registration or other legal jurisdiction, place or places of business or of the discontinuance of any such place or places of business, or in the location of the Debtor's books and records;

j. The Debtor shall, promptly, at the request of the Secured Party, take whatever action is necessary or appropriate to obtain from any person possessing a lien upon, or security interest in, any assets of the Debtor, such written assurance, including, without limitation, a written subordination agreement by said lienor, or statement clarifying the nature of such lien, as is sufficient to assure the Secured Party that its lien on, and security interest in, the Collateral is a first priority, senior lien thereon and security interest therein.

5. Preservation of Inventory Collateral; Insurance.

a. The Debtor shall at all times, at its own cost and expense, keep the Inventory Collateral in good condition and shall not misuse, abuse, waste or allow the Inventory Collateral to deteriorate, except for normal wear and tear, and shall not use the Inventory Collateral in violation of any statute, ordinance or policy of insurance relating thereto;

b. The Debtor shall, at the Debtor's expense, at all times keep the Inventory Collateral insured against loss or damage by fire (including extended coverage), theft and such other casualties as the Secured Party may require, all in such amounts, under such forms of policies, upon such terms, for such periods and written by such companies or underwriters as the Secured Party may designate or approve. The Debtor has furnished to the Secured Party a copy of the insurance policy or policies currently in effect covering the Inventory Collateral and the Secured Party shall be named as an additional insured and loss payee on all such policies. Upon the Debtor's failure to obtain insurance or to keep same in force, the Secured Party may, but is under no duty to, obtain insurance or pay any premium and charge the cost of same to the Debtor, which shall be automatically included as part of the Obligations. The Debtor shall provide immediate written notice to the Secured Party and to any insurers of any loss or damage to the Inventory Collateral and shall promptly file proofs of loss with all of the relevant insurers. The Secured Party may act as attorney in fact for the Debtor in making, adjusting or settling any claims under such insurance policy.

6. Books and Records; Inspection.

a. The Debtor shall at all reasonable times, and from time to time, without the necessity of any prior notice or demand, allow the Secured Party by any of its officers, agents, attorneys, accountants or other representative, to examine or inspect the Collateral wherever the same may be located, and to examine, inspect and make extracts from, or copies of, the Debtor's books and records relating to any or all of the Collateral;

b. The Debtor will, at any time at the Secured Party's request, deliver to the Secured Party a schedule specifically identifying all of the Inventory Collateral, and shall from time to time deliver to the Secured Party such additional schedules and such certificates and reports respecting any or all of the Collateral as the Secured Party may request. Any such schedule, certificate or report shall be executed by a duly authorized officer or representative of the Debtor and shall be in such form as the Secured Party may specify.

7. Financial Statements.

So long as any of the Obligations remain outstanding and unpaid, the Debtor will deliver to the Secured Party, as soon as practicable after the end of each fiscal year of the Debtor, and in any event, within ninety (90) days thereafter:

a. a balance sheet of the Debtor as at the end of such year and statements of income and of surplus of the Debtor for such year and in each case in comparative form the figures for the corresponding periods of the previous fiscal year (audited by Debtor's certified public accountants, or if such audited statements are not available, a certificate from the Debtor's chief financial officer indicating that the statements have been prepared in accordance with generally accepted accounting principles, consistently applied); and

b. all such other financial information as the Secured Party shall from time to time reasonably request.

8. Events of Default. The Debtor shall be in default hereunder upon the occurrence of any of the following (collectively, the "Events of Default"):

a. Failure by the Debtor at any time to pay in full, and as and when due, any Obligation of the Debtor to the Secured Party, or failure to perform any of the covenants or provisions contained or referred to herein, or in any instrument or agreement evidencing any of the Obligations of the Debtor to the Secured Party, or any breach thereof;

b. The Debtor or any of the Collateral becoming subject to a judgment, execution or other judicial process, or the loss, theft, substantial damage, destruction, transfer or the encumbrance of any of the Collateral except as permitted in this Security Agreement;

c. Any reduction in the value of the Collateral, or any act or omission to act on the part of the Debtor which imperils the prospect of full performance or satisfaction of the Debtor's Obligations to the Secured Party;

d. Dissolution, termination of existence, insolvency, business failure, the filing of a petition for relief under Title 11 of the United States Code by or against the Debtor; the consent, acquiescence or taking of any action by the Debtor, or the filing by or against the Debtor of any petition or action, looking to or seeking any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any other present or future state or Federal statute, law or regulation; the appointment, with or without the consent of the Debtor, of any trustee, custodian, receiver or liquidator of the Debtor or any property or assets of the Debtor; or if the Debtor shall make an assignment for the benefit of creditors; or shall be unable to pay its debts as they become due;

e. A breach by the Debtor of any representation, warranty, covenant or default of this, or any other agreement, between the Debtor and the Secured Party, or between the Debtor and its lender, or between the Debtor and any third party who has been granted a security interest by the Debtor, and their successors and assigns; or

f. Such change in the financial or other condition of the Debtor, as in the opinion of Secured Party, unreasonably impairs the Secured Party's security or increases its risk hereunder.

9. Rights and Remedies Upon Default. Upon the occurrence of any Event of Default, and at any time thereafter, the Secured Party shall have all of the rights and remedies of a secured party under the Uniform Commercial Code, and all other rights and remedies under applicable law, including, without limitation, any and all of the following:

a. To declare all Obligations of the Debtor to the Secured Party immediately due and payable;

b. To take immediate and exclusive possession of the Inventory Collateral or any part thereof, and for that purpose, the Secured Party may, so far as the Debtor can give authority therefor, without judicial process, enter upon any premises on which the Inventory Collateral or any part thereof may be situated and remove the same therefrom;

c. To hold, maintain, preserve and prepare the Inventory Collateral for public or private sale at the Secured Party's sole discretion, until disposed of, or to retain the Inventory Collateral subject to the Debtor's right of redemption, in satisfaction of the Obligations to the Secured Party as provided in the Uniform Commercial Code. The Secured Party may require the

Debtor to assemble the Collateral and make it available to the Secured Party for possession at a place to be designated by the Secured Party, which is reasonably convenient to both parties. Unless the Collateral is perishable, threatens to decline speedily in value, or is of a type customarily sold on a recognized market, the Secured Party will give the Debtor reasonable notice of the time and place of any public sale of the Collateral. The Debtor agrees that the requirements of reasonable notice shall be met if such notice is given at least ten (10) days before the time of sale or other disposition of the Collateral. The Secured Party shall have the right to conduct such sales on the Debtor's premises and to use the Debtor's premises for such purposes and for such time as the Secured Party may see fit, without charge. The Secured Party reserves the right to purchase any or all of the Collateral at such sale. The Secured Party shall not be liable or responsible for the safeguard of the Inventory Collateral. The proceeds of any such public or private sale, or other disposition, shall first be applied to the expenses of retaking, storing, preparation and the sale of the Inventory Collateral, including reasonable attorneys' fees and legal expenses and disbursements, and the remainder, if any, shall be credited against the Obligations of the Debtor to the Secured Party;

d. To require the Debtor to deliver to the Secured Party a schedule specifically identifying all of the Inventory Collateral and such additional schedules, certificates and reports relating to any or all of the Collateral as the Secured Party may request. Any such schedule, certificate or report shall be executed by a duly authorized officer or representative of Debtor and shall be in such form as the Secured Party may specify. Any schedule identifying Collateral shall, if the Secured Party so requests, be accompanied by a true and correct copy of the invoice and shipping documents evidencing sale and shipment of any inventory of the Debtor, including the Inventory Collateral, and the original shipping documents, notes, instruments, chattel paper, or other items relating to the Collateral. The Debtor's failure to give the schedules or certificates and/or reports set forth herein shall in no way limit the security interest of the Secured Party in the Collateral.

e. To (a) notify account debtors of the Debtor, as to the Secured Party's security interest in the Debtor's accounts receivable and to assert claims, and sue account debtors of the Debtor, in respect of accounts which are part of the Collateral in the name of the Debtor or the Secured Party, and to endorse the name of the Debtor on any notes, acceptances, checks, drafts, money orders or other evidences of payment relating to the Collateral; (b) sign the Debtor's name on any invoices or bills of lading relating to the Collateral or drafts against customers, assignments and verifications of accounts and notices to customers, and to send requests for verification of accounts comprising the Collateral to any customer; and (c) do all other acts and things necessary to carry out this Security Agreement for which purposes the Debtor hereby constitutes the Secured Party or any person designated by the Secured Party as attorney-in-fact for the Debtor with power to receive and open all mail addressed to the Debtor and to notify the U.S. Post Office authorities to change the address as may be designated by the Secured Party. In addition to the foregoing, the Debtor hereby authorizes the Secured Party to compromise and settle any claim or suit by the Debtor or the Secured Party against account debtors of the Debtor on any terms deemed reasonable by the Secured Party without the consent or agreement of the Debtor.

f. The Secured Party shall have no obligation to cleanup or otherwise prepare the Inventory Collateral for sale.

g. The Secured Party may sell the Inventory Collateral without giving any warranties as to the Inventory Collateral and may disclaim any warranties of title or the like.

h. If the Secured Party sells any of the Inventory Collateral on credit terms, the Obligor shall be credited only with payments that the Secured Party actually receives from the purchaser. In the event the purchaser fails to deliver full payment of the purchase price for the Inventory Collateral, the Secured Party may resell the Inventory Collateral without any further notice to the Debtor.

i. To the extent that applicable law imposes duties on the Secured Party to exercise remedies in a commercially reasonable manner, the Debtor acknowledges and agrees that it is not commercially unreasonable for the Secured Party to: (a) fail to incur expenses deemed significant by the Secured Party to prepare Inventory Collateral for disposition or otherwise to complete raw material or work in process into finished goods or other finished products for disposition, (b) fail to obtain third party consents for access to Inventory Collateral to be disposed of, or to obtain or, if not required by other law, to fail to obtain governmental or third party consents for the collection or disposition of Inventory Collateral to be collected or disposed of, (c) fail to exercise collection remedies against account debtors or other persons obligated on Collateral, or to remove liens or encumbrances on, or any adverse claims against, Collateral, (d) exercise collection remedies against account debtors and other persons obligated on Collateral directly or through the use of collection agencies and other collection specialists, (e) advertise dispositions of Inventory Collateral through publications or media of general circulation, whether or not the Inventory Collateral is of a specialized nature, (f) contact other persons, whether or not in the same business as the Debtor, for expressions of interest in acquiring all or any portion of the Inventory Collateral, (g) hire one or more professional auctioneers to assist in the disposition of Inventory Collateral, whether or not the collateral is of a specialized nature, (h) dispose of Inventory Collateral by utilizing internet sites that provide for the auction of assets of the types included in the Inventory Collateral or that have the reasonable capability of doing so, or that match buyers and sellers of assets, (i) dispose of assets in wholesale rather than retail markets, (j) disclaim disposition warranties, (k) purchase insurance or credit enhancements to insure the Secured Party against risks of loss, collection or disposition of Inventory Collateral, or to provide to the Secured Party a guaranteed return from the collection or disposition of Inventory Collateral, or (l) the extent deemed appropriate by the Secured Party, to obtain the services of other brokers, investment bankers, consultants and other professionals to assist the Secured Party in the collection or disposition of any of the Inventory Collateral. The Debtor acknowledges that the purpose of this Paragraph 9 is to provide a non-exhaustive list of what actions or omissions by the Secured Party would not be commercially unreasonable in the Secured Party's exercise of remedies against the Inventory Collateral and that other actions or omissions by the Secured Party shall not be deemed commercially unreasonable solely on account of such actions or omissions not being included in this Paragraph 9. Without limitation upon the foregoing, nothing contained in this Paragraph 9 shall be construed to grant any rights to the Debtor, or to impose any duties on the Secured Party, that would not have been granted or imposed by this Security Agreement or by applicable law in the absence of this Paragraph 9.

10. Proceeds of Dispositions of the Collateral; Expenses. The Debtor shall pay to the Secured Party on demand, any and all expenses, including reasonable attorneys' fees and disbursements, incurred or paid by the Secured Party in preparing, negotiating and/or closing with respect to this Security Agreement and all related agreements, and/or in protecting, preserving or enforcing the Secured Party's rights under, or in respect of, any of the Obligations or any of the Collateral, or defending any of its rights to any amounts received hereunder. Without limiting the foregoing, the Debtor agrees that whenever any attorney is used by the Secured Party to obtain payment hereunder, to advise it as to its rights, to adjudicate the rights of the parties hereunder, or for the defense of any of its rights to amounts secured, received or to be received hereunder, or any claims against Secured Party, the Secured Party shall be entitled to recover all reasonable attorneys' fees and distributions, court costs and all other expenses attributable thereto. After deducting all of said expenses, the residue of any proceeds of collection or sale of the Obligations or Collateral shall, to the extent actually received in cash, be applied to the payment of the Obligations in such order or preference as the Secured Party may determine proper allowance and provision being made for any Obligations, not then due. Upon the final payment and satisfaction in full of all of the Obligations, and after making any payments required by UCC §§9-608(a)(1)(C) or 9-615(a)(3), any excess shall be returned to the Debtor, and the Debtor shall remain liable for any deficiency in the payment of the Obligations.

11. Waiver of Jury Trial. THE DEBTOR WAIVES ITS RIGHT TO A JURY TRIAL WITH RESPECT TO ANY ACTION OR CLAIM ARISING OUT OF ANY DISPUTE IN CONNECTION WITH THIS SECURITY AGREEMENT, ANY RIGHTS OR OBLIGATIONS HEREUNDER, OR THE PERFORMANCE OF ANY SUCH RIGHTS OR OBLIGATIONS.

Except as prohibited by law, the Debtor waives any right which it may have to claim or recover in any litigation referred to in the preceding sentence, including any special, exemplary, punitive or consequential damages, or any damages other than, or in addition to, actual damages. The Debtor: (i) certifies that neither the Secured Party nor any representative, agent or attorney of the Secured Party has represented, expressly or otherwise, that the Secured Party would not, in the event of litigation, seek to enforce the foregoing waivers; and (ii) acknowledges that, in entering into this Security Agreement and all other agreements with Debtor, the Secured Party is relying upon, among other things, the waivers and certifications contained in this Paragraph 11.

12. Alterations or Amendments. The terms of this Security Agreement may not be changed, varied, modified or altered except by a writing signed by both parties and specifically referring to this Security Agreement.

13. Non-Waiver of Rights. No delay or omission on the part of the Secured Party in exercising any of its rights hereunder, or the acquiescence in or waiver by the Secured Party of a breach of any term, covenant or condition of this Security Agreement shall be deemed or construed to operate as a waiver of such rights of acquiescence thereto except, in the specific instance for which given.

14. Notices. Notices to either party shall be in writing and shall be delivered personally or by registered or certified mail, return receipt requested, postage prepaid, and by e-mail to the Debtor and the Secured Party at the address as first set forth herein, or to such other physical and e-mail addresses and persons as may be designated by either party to the other by notice given in conformity with this paragraph.

15. Assignment. The Secured Party may assign this Security Agreement and the Collateral and, if so assigned, the assignee shall be entitled, upon notifying the Debtor, to full performance by the Debtor of all the Debtor's warranties, covenants and agreements hereunder, and the assignee shall be entitled to all the rights and remedies of the Secured Party hereunder. To the extent not previously waived or relinquished herein, the Debtor will not assert and hereby waives and relinquishes any claims, defenses or offsets as against such assignee that it may have against the Secured Party.

16. Financing Statement. The Debtor authorizes the Secured Party to file financing statements at any time with respect to any of the Collateral. The Debtor will pay all costs and fees for filing any financing statement wherever the Secured Party deems it necessary or desirable to file same, which shall be included as part of the Obligations. The Debtor also ratifies its authorization for the Secured Party to have filed any financing statement if filed prior to the date of this Agreement.

17. Termination. This Agreement shall be a continuing agreement in every respect until such time as the Debtor has paid and/or performed all of the Obligations to Secured Party and has notified Secured Party of its election to terminate this Security Agreement.

18. Governing Law. The substantive internal law of the State of [New York] shall govern the rights, duties and remedies of the parties, and the enforcement, interpretation, and construction hereof.

IN WITNESS WHEREOF, the parties hereto have signed this Security Agreement the day and year first above written.

[NAME OF DEBTOR]

By:______________________

Title:____________________

E-mail Address:________________________

[NAME OF SECURED PARTY]

By:______________________

Title:____________________

E-mail Address:________________________

[ATTACH CORPORATE/LLC/PARTNERSHIP RESOLUTIONS-AUTHORIZATION]

SCHEDULE A

PERMITTED LIENS

SECURED PARTY NOTICE AND ACKNOWLEDGMENT

Regular Mail and Certified Mail-Return Receipt Requested

Date: ________________

[Name and Address of Secured Inventory Lender] use lienholder's address in its UCC-1 or other address that is reasonable under the circumstances

Re: Notice of Ownership Interest and/or Purchase Money Security Interest as to ABC Corporation ("ABC"), having an office at ________________________.

Ladies and Gentlemen:

ABC has delivered, and/or expects to deliver in the future, the inventory described on Schedule A annexed hereto (the "Inventory") to ___________________ ("Company"), pursuant to that certain Inventory Consignment Agreement by and between ABC and Company, dated as of [DATE] (as may be amended, restated, replaced or otherwise modified from time to time, the "Agreement").

Certain of ABC's secured lenders have requested that ABC take certain actions to clarify its continuing interest in the Inventory until purchased by Company pursuant to the Agreement. Therefore, we are providing notice in accordance with the provisions of Section 9-324 of the applicable state Uniform Commercial Code, that to the extent it has not already done so, ABC expects to deliver the Inventory on consignment to Company and/or acquire a purchase money security interest in the Inventory.

[In addition, we are requesting that you sign below to acknowledge and agree to ABC's ownership interest and/or purchase money security interest in the Inventory (regardless of whether such goods were delivered to Company prior to or following the date hereof), in either case until such time as the Inventory is purchased by Company in accordance with the Agreement.][Can be deleted if prior secured party refuses to execute]]

Any questions relevant to the foregoing should be directed to ______________ of ABC at the address set forth above. _________________'s telephone number is _________________. Please execute the below acknowledgment and return to ABC at your earliest convenience.

(Signature Page Immediately Follows)

Very truly yours,

ABC CORPORATION

By:______________________

Name:____________________

Title:_____________________

[ACKNOWLEDGED:

[Lender]

By:______________________

Name:____________________

Title:_____________________] [Can be deleted if acknowledgement is refused]

Schedule A to Secured Party Notice and Acknowledgment

DESCRIPTION OF INVENTORY

UCC-1 FINANCING STATEMENT

[redacted]

UCC FINANCING STATEMENT

Follow instructions (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]

B. SEND ACKNOWLEDGMENT TO: (Name and Address)

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1. DEBTOR'S EXACT FULL LEGAL NAME - insert only one debtor name (1a or 1b) - do not abbreviate or combine names

	1a. ORGANIZATION'S NAME **[CONSIGNEE NAME]**					
	1b . INDIVIDUAL'S LAST NAME		FIRST NAME	MIDDLE NAME		SUFFIX
1c.	MAILING ADDRESS **[CONSIGNEE ADDRESS]**		CITY **[CITY]**	STATE **[__]**	POSTAL CODE **[ZIP]**	COUNTRY **[USA]**
1d. TAX ID # SNN OR EIN	ADD'NL INFO RE ORGANIZATION DEBTOR	1e. TYPE OF ORGANIZATION **[ENTITY TYPE]**	1f. JURISDICTION OF ORGANIZATION **[STATE OF ORGANIZATION]**	1g. ORGANIZATION ID #, if any **[CONSIGNEE ORG ID]** ☐ NONE		

2. **ADDITIONAL DEBTOR'S EXACT FULL NAME -** insert only one debtor name (2a or 2b) - do not abbreviate or combine names

	2a. ORGANIZATION'S NAME					
OR	2b . INDIVIDUAL'S LAST NAME		FIRST NAME	MIDDLE NAME		SUFFIX
2c.	MAILING ADDRESS		CITY	STATE	POSTAL CODE	COUNTRY
2d. TAX ID # SNN OR EIN	ADD'NL INFO RE ORGANIZATION DEBTOR	2e. TYPE OF ORGANIZATION	2f. JURISDICTION OF ORGANIZATION	2g. ORGANIZATION ID #, if any ☐ NONE		

3. **SECURED PARTY'S NAME** (or NAME of TOTAL ASSIGNEE of ASSIGNOR S/P) - insert only one secured party name (3a or 3b)

	3a. ORGANIZATION'S NAME **[Name of Consignor]**				
OR	3b . INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME		SUFFIX
3c.	MAILING ADDRESS **[CONSIGNOR ADDRESS]**	CITY ______________________	STATE __	POSTAL CODE _________	COUNTRY ______

4. This FINANCING STATEMENT covers the following collateral:

All Product (as defined In Schedule A attached hereto) supplied by Secured Party (Consignor) to Debtor (Consignee) from time to time pursuant to that certain Consignment Agreement by and between Consignor and Consignee, dated as of [DATE] as may be amended, restated, replaced or otherwise modified from time to time.

5. ALTERNATIVE DESIGNATION if applicable ☐LESSEE/LESSOR ☒CONSIGNEE/CONSIGNOR ☐BAILEE/BAILOR ☐SELLER/BUYER ☐AG LIEN ☐NON-UCC FILING

6. ☐I This FINANCING STATEMENT is to be filed (for record) (or records) IN THE REAL ESTATE RECORDS Attach Addendum (if applicable)	7. Check to REQUEST SEARCH REPORT(S) on Debtor(s [ADDITIONAL FEE] (optional)	☐All Debtors ☐Debtor 1 ☐Debtor 2

8. OPTIONAL FILER REFERENCE DATA

SCHEDULE A TO UCC-1 FINANCING STATEMENT

CONSIGNEE/DEBTOR:	CONSIGNOR/SECURED PARTY:
[CONSIGNEE NAME] [CONSIGNEE ADDRESS]	[Name of Consignor] [CONSIGNOR ADDRESS]

Reference is hereby made to that certain Consignment Agreement dated as of [DATE] (as said agreement may be amended, supplemented or restated from time to time, the "*Consignment Agreement*") among the above-named Consignee/Debtor ("*Consignee*") and the above-named Consignor/Secured Party ("*Consignor*"). Each capitalized term used herein has the meaning ascribed to that term in the Consignment Agreement unless otherwise defined below.

For purposes of the Financing Statement to which this Schedule is attached, the "*Product*" shall mean [DESCRIPTION].

Form 3: Guaranty

GUARANTY

TO: [Name and Address of Creditor]

Date: ________________

Re: Name of Customer ___________________________ ("Customer")

State of Incorporation or Organization ______________________

Address _________________

____

As an inducement to you in your sole discretion to sell goods and/or provide services from time to time to the Customer on such terms of credit as you shall, in your sole discretion, grant and in consideration of such sales or credit as may be so extended by you, the undersigned ("Guarantor") agrees to be primarily liable for and to pay you forthwith when due, or upon demand thereafter, with interest, and without deduction for, any claim of setoff or counterclaim of the Customer or the Guarantor, or loss of contribution from any co-guarantor hereunder, the full amount of any and all obligations and indebtedness of the Customer now or hereafter owing to you, however arising, together with all interest, costs and expenses and attorneys' fees incurred by you because of the Customer's default or because of any default hereunder (the "Obligations").

The Guarantor waives notice of acceptance hereof, of orders, sales, and deliveries to the Customer, of the amounts and terms thereof, and of all defaults, disputes or controversies with the Customer and of the settlement, compromise or adjustment thereof. The Guarantor consents to, and waives notice of all changes of terms, the withdrawal or extension of credit or time to pay, the release of the whole or any part of the Obligations, the settlement or compromise of disputes or differences, the acceptance or release of security, or the failure to perfect any security interest in any collateral, the acceptance of notes, trade acceptances or any other form of obligation for the Obligations, and of demand, protest and notice of protest and notice of dishonor of such instruments or their endorsements, and anything whatsoever, whether or not herein specified, which may be done or waived by or between you and the Customer.

This Guaranty is a guarantee of payment and is a primary, direct, immediate and unconditional obligation of the Guarantor and shall be enforceable by you before or after proceeding against the Customer, any other person, or any security held by you. You shall be under no obligation at any time to first resort to, make demand on, or file a claim against or exhaust your remedies against Customer, any co-guarantor or other persons or corporations, their properties, or estates, or to resort to or exhaust your remedies against any collateral. As security for this Guaranty, the Guarantor hereby assigns, transfers and sets over unto you all its right, title and interest in, and to any and all amounts now or hereafter owing by the Customer to the Guarantor, and any property of the Guarantor now or hereafter in your possession or under your control.

THE GUARANTOR WAIVES ALL RIGHTS OF SUBROGATION, CONTRIBUTION, REIMBURSEMENT OR INDEMNIFICATION, AND ANY OTHER CLAIMS AGAINST THE CUSTOMER ARISING BY CONTRACT OR OPERATION OF LAW, AND THE GUARANTOR SHALL HAVE NO RIGHT OF RECOURSE TO, OR ANY CLAIM AGAINST, ANY ASSETS OR PROPERTY OF THE CUSTOMER, WHETHER OR NOT THE OBLIGATIONS HAVE BEEN SATISFIED. If there is more than one Guarantor, each Guarantor agrees not to seek contribution from any other Guarantor until all the Obligations shall have been paid in full. If any amount shall nevertheless be paid to a Guarantor by the Customer or another Guarantor, such amount shall be held in trust for your benefit and shall forthwith be paid to you to be credited to and applied to the Obligations, whether matured or unmatured. The provisions of this paragraph shall survive the termination of this Guaranty, and any satisfaction and discharge of the Customer by virtue of any payment, court order or any federal or state law.

All liabilities of the Customer and of the Guarantor, if not otherwise payable on demand, shall mature immediately without notice upon the default by the Customer or the Guarantor in the performance of the Obligations; or upon the death of any individual Guarantor; the insolvency of the Customer or the Guarantor; the appointment of a receiver or trustee for the Customer or Guarantor or for any property of either of them; the filing of a voluntary or involuntary petition for relief under the Bankruptcy Code by or against the Customer or the Guarantor; the making by the Customer or Guarantor of an assignment for the benefit of creditors; the calling of a meeting of Creditors by the Customer or the Guarantor; the issuance of any writ of attachment against any of the property of the Customer or the Guarantor; or the suspension of business of the Customer. This Guaranty shall be enforceable by you, your successors and assigns and shall bind the successors and assigns of the Guarantor.

In the event you retain attorneys for the purpose of effecting collection of the Obligations or of the liabilities of the Guarantor hereunder, the Guarantor shall pay all collection costs and expenses of every kind, including attorneys' fees, whether or not suit is filed.

Your records showing the account between you and the Customer shall be admissible in evidence in any action or proceeding hereon as prima facie proof of the items therein set forth, and your monthly statements rendered to the Customer to the extent to which no written objection is made within thirty (30) days after the date thereof, shall constitute an account stated between the Customer and you and shall be binding on the Guarantor. This Guaranty and its performance shall for all purposes be deemed to be made in, and governed by, the laws of the State of [New York].

EACH OF US HEREBY WAIVES TRIAL BY JURY AND CONSENTS TO THE JURISDICTION OF THE SUPREME COURT OF THE STATE OF NEW YORK, NEW YORK COUNTY, AND THE UNITED STATES DISTRICT COURT, SOUTHERN DISTRICT OF NEW YORK IN ANY ACTION OR PROCEEDING COMMENCED IN ENFORCEMENT HEREOF. In the event that you commence any action or suit to enforce this Guaranty, service of process may be made on the Guarantor by mailing a copy thereof to the Guarantor at the address and e-mail address set forth below or at the last known address and e-mail address of the Guarantor appearing on your records.

It is intended by the Guarantor that all payments to you in reduction of the Obligations shall be valid, indefeasible and unassailable. If after receipt of any payment of, or proceeds of any collateral applied (or intended to be applied) to the payment of, all or any part of the Obligations, you are for any reason compelled to surrender or voluntarily surrender, such payment or proceeds to any person, (a) because such payment or application of proceeds is or may be avoided, invalidated, declared fraudulent, set aside, determined to be void or voidable as a preference, fraudulent conveyance, impermissible setoff or a diversion of trust funds; or (b) for any other reason, including without limitation (i) any judgment, decree or order of any Court or administrative body having jurisdiction over you or any of your property, or (ii) any settlement or compromise of any such claim effected by you with any such claimant (including the Customer), then the Obligations or part thereof intended to be satisfied shall be reinstated and continue and this Guaranty shall continue in full force as if such payment or proceeds had not been received by you, notwithstanding any revocation thereof or the cancellation of any note or other instrument evidencing any Obligation or otherwise; and the Guarantor shall be liable to pay to you and hereby does indemnify you and hold you harmless for, the amount of such payment or proceeds so surrendered and all expenses (including all attorneys' fees, court costs and expenses attributable thereto) incurred by you in the defense of any claim made against you that any payment or proceeds received by you in respect of all or any part of the Obligations must be surrendered. The provisions of this paragraph shall survive the termination of this Guaranty, and any satisfaction and discharge of the Customer by virtue of any payment, court order or any federal or state law.

This Guaranty may be revoked only on actual receipt by your general credit manager at the above office address of written notice of revocation from the Guarantor or written notice of the death of any individual Guarantor. No revocation or termination of this Guaranty shall affect in any manner rights arising under this Guaranty with respect to (a) all Obligations which shall have been created, contracted, assumed or incurred prior to receipt by you of written notice of such revocation or termination, and (b) Obligations which shall have been created, contracted, assumed or incurred after receipt by you of such written notice pursuant to any contract entered into by you prior to receipt of such notice.

If two or more persons have executed this Guaranty, then each shall be jointly and severally liable hereunder for all Obligations, and the term Guarantor shall include any and all such persons. This is a continuing Guaranty and shall be unaffected by the death of any individual Guarantor or the termination hereof by any Guarantor, or by the fact that for certain periods of time there may be no Obligations owing to you by the Customer. The termination of this Guaranty with respect to any Guarantor shall not affect or diminish the liability of any other Guarantor.

Guarantor hereby authorizes you and/or any of your agents to conduct such credit, financial or other appropriate investigation of the Guarantor as you shall deem necessary and the Guarantor hereby consents to your receipt and use of any credit report from third parties in connection herewith.

Name of Non-Individual Guarantor:

____

By: ________________________

Print Name

Title: _______________________

Address:_____________________

____

E-mail Address:_______________________

FEIN No.: ____________________

Name of Individual Guarantor

____

____

Address:_____________________

____

E-mail Address:_______________________

Social Security No.: _____________

[Individual Acknowledgment(s)]

STATE OF _______________

COUNTY OF _____________

On this _______day of __________, before me personally appeared _____________, and _________ , to me known, and known to me to be the individual(s) described in and who executed the foregoing instrument and (t)(s)he(y) duly acknowledged to me that (t)(s)he(y) executed the same.

____
Notary Public

[Partnership Acknowledgment]

STATE OF ______________

COUNTY OF ____________

On this ___________ day of ____________, ___________, before me personally appeared _______________, and _______________, to me known and known to me to be the members of ________________________ partnership mentioned and described in and which executed the foregoing instrument, and the said members duly acknowledged to me that they executed said instrument for and on behalf of, and with the authority, of the said partnership for the uses and purposes therein mentioned.

____
Notary Public

[Limited Liability Company or Partnership Acknowledgment]

STATE OF ______________

COUNTY OF ____________

On this day of ___________________, __________________, before me personally came ____________________, and ____________________, to me known who, being duly sworn, deposes and says that (t)(s)he(y) is/are the ___________________________ and the _______________ of ________________, the limited liability company/partnership described in and which executed the foregoing instrument; and that (t)(s)he(y) executed said instrument for and on behalf of, and with the authority of, the said limited liability company/partnership pursuant to and under the authority given to them under the articles of organization and operating agreement of said company.

____
Notary Public

[Corporate Acknowledgment]

STATE OF ______________

COUNTY OF ____________

On this day of ___________________, ____, before me personally came ___________________, and ___________________ , to me known who, being duly sworn, deposes and says that (t)(s)he(y) is/are the ___________________ and the ________________________________of _________________________, the corporation described in and which executed the above instrument; that (t)(s)he(y) know(s) the seal of the corporation; that the seal affixed to said instrument is such corporate seal;

that it was so affixed by order of the Board of Directors of said corporation and (t)(s)he(y) signed his (her) (their) name(s) by like order.

____

Notary Public

Form 4: Adequate Assurance Demand

[On Creditor's Letterhead]

Via Email, Fax, Federal Express and Certified Mail, R.R.R.

XYZ Company

Re: Purchase and Supply Agreement dated October 1, 20XX between XYZ Company and [Creditor] (the "Agreement")

Dear _____________________:

Following your meeting with our Comptroller and Director of Credit on June 1, 20XX, [Creditor] believes that grounds for insecurity exist under Official Code of [Georgia] [(O.C.G.A.)] § 11-2-609 and other applicable law with respect to XYZ's ability to pay for goods hereafter sold and delivered based on the 30-day credit terms previously provided to XYZ ("Credit Terms") pursuant to the Agreement. Such grounds for insecurity are based on:

XYZ's decision to close its mill in Birmingham, Alabama.

Non-renewal in March of this year of XYZ's bank line of credit.

XYZ's inability to pay the interest due on its bond debt on August 1, 20XX.

Articles in the press regarding the financial condition of XYZ, Inc., including the *Debtwire* May 11, 20XX, report regarding the prospective XYZ debt restructuring, which may include issuance of second-lien debt, due in part to XYZ's "disastrous operating conditions."

XYZ's most recent financial statements provided to Creditor that show a lack of liquidity and continuing losses.

> Discussions with you regarding the possibility of XYZ filing Chapter 11.

In light of the foregoing, pursuant to [O.C.G.A.] § 11-2-609 and other applicable law, [Creditor] demands adequate assurance of XYZ's ability to timely and fully pay for goods that [Creditor] shall sell and deliver to XYZ and to otherwise fully satisfy XYZ's obligations to [Creditor], including full payment of all invoices for goods previously sold and delivered to XYZ on Credit Terms. In addition, [Creditor] is immediately suspending the Credit Terms on all sales to XYZ on and after the date of this letter and will sell to XYZ only on a cash-in-advance basis, until [Creditor] receives such assurances of payment. [Creditor] reserves all of its other rights and remedies, including, without limitation, the right to refuse and/or stop delivery under [O.C.G.A.] §§ 11-2-702, 11-2-703 and 11-2-705.

Very truly yours,

____

Form 5: Stoppage of Delivery Demand

[Date]

Via Email, Fax, Federal Express and Certified Mail, R.R.R.

[Carrier/warehouse]

Re: Stoppage of Delivery Demand: [name of customer]

Dear [insert]:

Demand is hereby made on you to stop delivery of all of the goods of the above customer in your possession, including, without limitation, all of the goods identified in the Schedule annexed hereto, pursuant to §§ 2-702, 2-703 and 2-705 of the Uniform Commercial Code.

Please contact the undersigned for instructions in connection with the return of the goods. We make this demand for stoppage of delivery without prejudice to all other rights and remedies available to us, at law or in equity.

Very truly yours,

[Name Of Creditor]

By:___________________________

Title: _________________________

cc: [Name and Address of Debtor]

Schedule To Stoppage Of Delivery Demand

Invoice No.______________________Invoice Date___________________Invoice Ar

Form 6: State Law—Pre-Bankruptcy Reclamation Demand

[Creditor Letterhead]

___________, 20XX

Via Email, Fax, Federal Express and Certified Mail, R.R.R.

[Name and address of debtor(s)/recipient(s) of goods]

Re: Reclamation Demand by [Name of Creditor]

Dear _________:

Demand is hereby made upon you, pursuant to § 2-702 of the Uniform Commercial Code, for the return of all goods that the undersigned had sold to you and you had received within ten (10) days of the date of this letter. This demand specifically includes, but is not limited to, goods identified in the Schedule annexed hereto.

Please contact the undersigned for instructions in connection with the return of the goods.

You are further notified that all goods subject to our right of reclamation must be protected and segregated by you and shall not be used for any purpose whatsoever except those purposes specifically authorized following notice and a hearing by a court having the appropriate jurisdiction.

We make this demand for reclamation without prejudice to all other rights and remedies available to us, at law or in equity.

Very truly yours,

[Name Of Creditor]

By:___________________________

Title: _________________________

SCHEDULE TO RECLAMATION DEMAND

Invoice No.________ Invoice Date________ Invoice Amount________

Form 7: Bankruptcy Reclamation Demand

[Creditor Letterhead]

___________, 20XX

Via Email, Fax, Federal Express and Certified Mail, R.R.R.

[Name and address of debtor(s)/recipient(s) of goods]

Re: Reclamation Demand by [Name of Creditor]

Dear __________:

Demand is hereby made upon you, pursuant to § 2-702 of the Uniform Commercial Code, and/or § 546(c)(1) of the United States Bankruptcy Code, for the return of all goods that the undersigned had sold to you and you had received within forty-five (45) days before your bankruptcy filing date of [fill in the date of the bankruptcy petition]. This demand specifically includes, but is not limited to, goods identified in the Schedule annexed hereto.

Please contact the undersigned for instructions in connection with the return of the goods.

You are further notified that all goods subject to our right of reclamation must be protected and segregated by you and shall not be used for any purpose whatsoever except those purposes specifically authorized following notice and a hearing by the Bankruptcy Court or other court.

We make this demand for reclamation without prejudice to all other rights and remedies available to us, at law or in equity, including but not limited to, our right to an allowed administrative expense claim under § 503(b)(9) of the Bankruptcy Code for all goods received by you within twenty (20) days before the date of commencement of your bankruptcy case.

Very truly yours,

[Name Of Creditor]

By:___________________________

Title: _________________________

SCHEDULE TO RECLAMATION DEMAND

Invoice No.________ Invoice Date________ Invoice Amount________

ABI Membership Enrollment Form

Name ____

Firm/Company____

Title/Profession ____

Address____

City, State, Zip + 4 ____

Phone/Fax ____

E-mail Address ____

Annual Dues (please check one)

❒	General Membership	US $350
❒	Government/Academic (nonprofit)	US $150
❒	Student (full-time)	US $20

Additional/Optional

❒	INSOL International	US $150
❒	ABI Endowment Contribution	US $45

Payable by Check or Credit Card

❒ Enclosed is my check payable to the American Bankruptcy Institute.

❒ Please charge to my credit card: ❒ Visa ❒ Amex ❒ MC

Account No. ____

Exp. Date____________________ Signature ____

Return to:

American Bankruptcy Institute
P.O. Box 7403
Merrifield, VA 22116-7403
Fax: (866) 921-1027

Membership is on an individual basis and is valid for one year from the enrollment date. Dues are not deductible as charitable contributions for tax purposes, but may be considered ordinary and necessary business expenses. Memberships are nontransferable.

Join ABI online at join.abi.org!

TRADE CREDITOR'S RISK-MITIGATION TOOLS AND REMEDIES MANUAL

Trade creditors dealing with financially troubled customers often have difficulty collecting on their claims. Unpaid sellers and service providers must refrain from collection efforts against a buyer that files for bankruptcy unless specifically authorized to take action by the bankruptcy court or the Bankruptcy Code. Instead, they frequently have a general unsecured claim against the buyer in bankruptcy, with the right to file a proof of claim with the bankruptcy court. Trade creditors usually obtain little or no recovery on their unsecured claims because the value of the debtor's assets is frequently significantly reduced when they are liquidated in bankruptcy. The *Trade Creditor's Risk-Mitigation Tools and Remedies Manual* is designed to provide trade creditors with a single resource that they can reference to help them obtain payment of their claims against their financially distressed customers, both prior to and after the customer's bankruptcy filing. The *Manual* discusses various risk-mitigation tools that trade creditors can request from their buyers, or purchase from third parties, to secure payment of their claims prior to the filing of their buyer's bankruptcy. The *Manual* also assists trade creditors by helping them determine and enforce their rights against a financially distressed buyer under the Uniform Commercial Code (UCC) and the Bankruptcy Code.

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