

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF TENNESSEE
SOUTHERN DIVISION

In re:

No. 02-16670
Chapter 11

GEM PRODUCTS, INC.

Debtor

GEM PRODUCTS, INC.

Plaintiff

v.

Adversary Proceeding
No. 04-1220

PRESTIGE SALES CO., INC.,

Defendant

MEMORANDUM

Appearances: Richard T. Klinger and Robert Jeffrey Wolford, Kennedy, Koontz & Farinash,
Chattanooga, Tennessee, Attorneys for Plaintiff

Kyle R. Weems, Weems & Ronan, Chattanooga, Tennessee, Attorney for Defendant

HONORABLE R. THOMAS STINNETT
UNITED STATES BANKRUPTCY JUDGE

The plaintiff, Gem Products, Inc. ("Gem"), is the debtor in possession in a reorganization case under Chapter 11 of the Bankruptcy Code. As debtor in possession, Gem can assert the avoiding powers that the bankruptcy statutes grant to a bankruptcy trustee. 11 U.S.C. §§ 1101(1), 1107(a), 1106(a), 704(2), (5) & 541(a)(3). The avoiding powers allow the debtor in possession to avoid certain kinds of transfers and recover the transferred property or its value. 11 U.S.C. §§ 544-550. Gem's complaint alleges that it paid the defendant, Prestige Sales Co., Inc.

("Prestige"), \$7,000.57 shortly before bankruptcy, and the payment can be recovered from Prestige as a preferential transfer. 11 U.S.C. § 547(b). Prestige has filed a motion for summary judgment, which is the subject of this memorandum.

Prestige asserts that the payment did not *prefer* it over other creditors. 11 U.S.C. § 547(b)(5). According to Prestige, it could have and would have reclaimed the goods from Gem if it had not received the payment, *and* the reclamation would not have been an avoidable transfer in Gem's bankruptcy case. 11 U.S.C. §§ 547(b)(5) & 546(c); *Graphic Productions Corp. v. WWF Paper Corp. (In re Graphic Productions Corp.)*, 176 B.R. 65 (Bankr. S. D. Fla. 1994).

The right of a seller to reclaim goods is set out in § 2-702 of the Uniform Commercial Code (the UCC). When the seller discovers that the buyer has received goods on credit while the buyer was insolvent, then the seller may reclaim the goods by demanding their return within 10 days after the buyer received them. Tenn. Code Ann. § 47-2-702(2).

Prestige submitted the affidavit of its president, John Westbrooks, to prove that it made a written demand for return of the goods within ten days after Gem received them. Mr. Westbrooks recites the contents of a demand letter and states that he hand delivered it to an officer or manager of Gem on August 29, 2002 or shortly afterward. The demand letter states that the goods were received by Gem on August 23, 2002. Mr. Westbrooks also states that Gem paid the entire amount due for the goods instead of returning them.

Gem has not denied that it was insolvent when it received the goods because it can recover the payment as a preferential transfer only if it was insolvent about a week later when it made the payment. 11 U.S.C. § 547(b)(3), (f).

Though § 2-702(2) does not require a written demand for return of the goods, most courts have held that Bankruptcy Code § 546(c) protects a pre-bankruptcy reclamation from the trustee's avoiding powers only if the seller made a written demand. *Oakland Gin Company v. Marlow (In re Julien Co.)*, 44 F.3d 426 (6th Cir. 1995); *Zeta Consumer Products Corp. v. Equistar Chemical, LP (In re Zeta Consumer Products Corp.)*, 291 B.R. 336 (Bankr. D. N. J. 2003); *Graphic Productions Corp. v. WWF Paper Corp. (In re Graphic Productions Corp.)*, 176 B.R. 65 (Bankr. S. D. Fla. 1994). Gem has not denied that it received the written demand letter from Prestige within ten days after receiving the goods.

Gem argues that even if the facts asserted by Prestige are true, other facts may have prevented Prestige from reclaiming the goods. Summary judgment must be denied if Gem shows that there is a genuine issue of material fact with regard to Prestige's right to reclaim. Fed. R. Bankr. P. 7056; Fed. R. Civ. P. 56(c).

Gem contends that some of the goods were not returnable when Prestige demanded return because the goods had already been used to build storage racks in Gem's factory. This contention is supported by the affidavit of Jeff Walls. Mr. Walls' affidavit includes the following statements. He was employed by Gem for four years and was its controller for two years. His duties included dealing with purchaser orders. He has reviewed the file regarding the transaction in question. The file was kept in the regular course of Gem's business. His statements are based on the file and his personal knowledge. According to the description or part number on the purchase order, the goods were building materials needed to construct shelves and used to store fans and other inventory. When Gem received Prestige's demand for return of the goods, the goods were already in use to construct storage racks for inventory. In response to Prestige's demand, Gem sent Prestige a check for \$7,000.57 as payment for the goods.

Prestige contends that the goods were not consumed in construction of the storage racks, and the racks could have easily been emptied so that Prestige's goods could have been returned.

These competing statements raise a genuine issue of material fact as to whether some of the goods were returnable when Prestige demanded return. Furthermore, Prestige's contention is not supported by an affidavit from any employee of Prestige or Gem. Thus, Gem's evidence by itself raises a genuine issue of material fact as to whether some of the goods were returnable when Prestige demanded their return. See *Flav-O-Rich, Inc. v. Rawson Food Service, Inc. (In re Rawson Food Service, Inc.)*, 846 F.2d 1342, 1347-1348 (11th Cir. 1988); *Bethlehem Steel Corp. v. Wheeling-Pittsburgh Steel Corp. (In re Wheeling-Pittsburgh Steel Corp.)*, 74 B.R. 656 (Bankr. W. D. Pa. 1987).

Gem relies primarily on the argument that the security interest of Allfirst Bank would have prevented Prestige from reclaiming the goods. Gem relies again on the affidavit of Jeff Walls and attachments to the affidavit. With regard to this argument, the main point of Mr. Walls' affidavit is to introduce the attached documents – a copy of the security agreement between Gem and the bank and copies of financing statements filed by the bank.

This evidence supports the conclusion that when Gem received the goods from Prestige, the bank had a security interest in Gem's equipment and inventory, including after-acquired equipment and inventory. The security interest would have attached to the goods no later than the time that Gem received them. Tenn. Code Ann. § 9-102(33), (48)(D), § 47-9-203(a), (b) & § 47-2-401(1), (2).

When the bank's security interest attached to the goods, the bank became a purchaser, and its security interest immediately gained priority over Prestige's right to reclaim the

goods – provided the bank purchased in *good faith*. Tenn. Code Ann. § 47-1-201(19), (32), (33) & § 47-2-702(3); *In re North American Royalties, Inc.*, Civ. No. 1:03-CV-30 (E. D. Tenn. Mar. 18, 2003).

When a creditor has a security interest in the goods with priority over the seller's right to reclaim, courts generally will not allow the seller to reclaim. *Stowers v. Mahon (In re Samuels & Co.)*, 510 F.2d 139, 154 (5th Cir. 1975) (J. Godbold dissenting), *rev'd* 526 F.2d 1238 (5th Cir. 1975) (adopting Judge Godbold's dissent), *cert. den.* 429 U.S. 834, 97 S.Ct. 98, 50 L.Ed.2d 99 (1976); *Pester Refining Corp. v. Ethyl Corp. (In re Pester Refining Corp.)*, 964 F.2d 842 (8th Cir. 1992); *In re Hayward Woolen Co.*, 3 U.C.C. Rep.Serv. 1107 (Bankr. D. Mass. 1967); *Kennett-Murray & Co. v. Pawnee Nat. Bank*, 598 P.2d 274 (Okla. Ct. App. 1979).

At this point Prestige does not have the burden of proving that the bank lacked good faith. Gem has not moved for partial summary judgment as to Prestige's defense. Compare *Mitsubishi Consumer Electronics America, Inc. v. Steinberg's, Inc. (In re Steinberg's, Inc.)*, 226 B.R. 8 (Bankr. S. D. Ohio 1998); *Galey & Lord, Inc. v. Arley Corp. (In re Arley Corp.)*, 239 B.R. 261 (Bankr. S. D. N. Y. 1999). The question is whether Gem must present evidence of the bank's good faith to show that the bank's security interest apparently had priority over Prestige's right to reclaim. The court thinks not. The cases just cited hold that the seller has the burden of proving lack of good faith. Good faith is assumed unless the evidence raises the question of good faith. Nothing in the evidence with regard to summary judgment suggests the bank lacked good faith.

This brings the court to the general question of whether Gem has raised another genuine issue of material fact. The evidence shows that the bank had a security interest in the goods as soon as Gem received them, and the security interest had priority over Prestige's right to reclaim, unless Prestige can prove the bank lacked good faith. These points are sufficient to raise a genuine issue of fact as to whether Prestige could have reclaimed the goods.

Prestige might argue that it still had the right to reclaim because the bank did not need the goods in question to secure the debt; that is, Prestige would have been allowed to reclaim if the bank's other collateral was worth more than the amount of the secured debt. For the purpose of argument, the court will assume this is a correct statement of the law. Gem refers to documents filed in its bankruptcy case as evidence that the bank's collateral was worth less than the amount of the secured debt when Gem received the goods. Gem need not present such evidence in order to prevent summary judgment for Prestige. Prestige has not presented any evidence as to the value of the other collateral compared to the secured debt. If the court ignores the evidence cited by Gem, then there is no evidence either way. The argument only raises another unanswered question of fact that may or may not be relevant to whether Prestige could have reclaimed.

Prestige filed an amended motion for summary judgment. It asserts that the right to reclaim is a statutory lien that attached to the goods before Gem's bankruptcy and cannot be avoided. 11 U.S.C. §§ 545 & 547(c)(6). The right to reclaim is an equitable remedy not a statutory lien. It is not a charge against or interest in the goods to secure payment of the debt for the purchase price. 11 U.S.C. § 101(37), (53) (definitions of lien & statutory lien). The seller does not reclaim the goods and foreclose by sale or strict foreclosure to collect the sale price. Successful reclamation bars all other remedies. Tenn. Code Ann. § 47-2-702(3). The remedy is rescission of the sale for implied fraud. Tenn. Code Ann. § 47-2-702(3), Official Comment 2; *In re Federal's, Inc.*, 553 F.2d 509 (6th Cir. 1977); *Bassett Furniture Industries, Inc. v. Wear (In re PFA Farmers Market Ass'n)*, 583 F.2d 992 (8th Cir. 1978); *Lewis v. Holzman (In re Telemart Enterprises, Inc.)*, 524 F.2d 761 (9th Cir. 1975), *cert. den.* 424 U.S. 969, 96 S.Ct. 1466, 47 L.Ed.2d 736 (1976); 3 William L. Norton, Jr., *Norton Bankruptcy Law & Practice 2d* § 55:5. The court will deny the amended motion for summary judgment because it is not supported by the law.

This Memorandum constitutes findings of fact and conclusions of law as required by
Fed. R. Bankr. P. 7052.

ENTER.

R. THOMAS STINNETT
UNITED STATES BANKRUPTCY JUDGE

[Entered 12/22/2004]