

Sellers' Remedies and Strategies when Dealing with Financially-Distressed Buyers in the United States and Taiwan

The United States and Taiwan are among China's top trading partners. As Chinese companies conduct business in the US and Taiwan, they inevitably encounter buyers who cannot pay their bills. How do these Chinese companies navigate two different legal systems to recover their losses?

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China's exports to the United States, its top trading partner and export destination, have increased dramatically in the last decade with no signs of slowing down. According to the US Department of Commerce, Chinese companies exported more than US\$243 billion in goods to the US in 2005, an increase of 23.8% from the previous year.

As they conduct business in the US, Chinese companies inevitably deal with the American legal system. They encounter challenges when dealing with financially-troubled debtors who use Chapter 11 of the *US Bankruptcy Code* to rehabilitate their businesses, an alternative that does not yet exist in China's bankruptcy system.

Chinese creditors do not always know their legal rights and remedies available under US laws. They are often reluctant to consult US law firms for help because of their lack of English fluency and aversion to litigation. For these reasons, many Chinese trade creditors do not recover all of their claims against financially troubled debtors in the US.

In contrast, creditors who deal with financially-distressed debtors in Taiwan, China's third-largest trading partner, encounter fewer problems. Because there is no language barrier between Chinese sellers and Taiwanese buyers, Chinese sellers are less hesitant to consult Taiwanese law firms about their legal rights and remedies. They also take aggressive enforcement actions when necessary. In the end, Chinese sellers do not lose as much money to financially-troubled debtors in Taiwan as do their counterparts in the US.

Given the different legal systems in the US and Taiwan, how do unsecured trade creditors deal with financially-troubled debtors to whom they have sold

goods on credit? What are the remedies available to trade creditors in the US and Taiwan when they learn of a buyer's insolvency?

SELLERS' RIGHTS AND REMEDIES IN THE US

When sellers discover that a buyer to whom they sold goods on credit has become insolvent, they can seek two remedies under the *Uniform Commercial Code* (UCC), which governs commercial transactions in all 50 US states:

- i. they can stop delivery of goods in transit; and
- ii. they can reclaim goods already delivered to buyers.

To allow a carrier or warehouse to execute a stop-delivery order, sellers must present a notice that identifies goods in transit by invoice number, date, amount and container number. This notice should be accompanied by a copy of the bill of lading issued for the goods. After carriers or warehouses receive a seller's notice to stop delivery, they must follow the seller's instructions.

A seller's right to stop delivery of goods in transit is recognized even when buyers have declared bankruptcy. Typically, when debtors file for bankruptcy, they receive a protection order known as automatic stay, which protects their property from repossession actions. However, in the case of stop-delivery orders, courts do not consider them to violate automatic stay orders.

Nonetheless, a seller's right to stop delivery is no longer valid once the buyer gains tangible control of goods. Most international carriers use global tracking systems to track delivery of shipments, so it is possible for sellers to know when goods reach a buyer's designated location. However, when buyers negotiate a bill of lading, which represents the goods bought, they effectively cancel a seller's right to stop delivery.

Reclaiming goods already delivered in the US

When goods are delivered before a seller knows of a buyer's insolvency, the seller can reclaim the goods by submitting a written reclamation demand within 10 days from the day the buyer received the goods. Reclamation demands must identify goods in transit by invoice number, date, amount and container number when applicable. Because reclamation rights can only be exercised within 10 days, creditors must complete their reclamation demands and submit them early.

To determine if a reclamation demand is complete, courts review the demand's dispatch date. This is known as the dispatch rule. Most sellers send their

reclamation demands by facsimile, email or Federal Express to create a dispatch record.

Courts can annul the 10 days rule if buyers are found to have misrepresented their solvency to creditors in the three months preceding the delivery of goods. Thus, when sellers suspect that a buyer is in financial distress, they should request a written document that proves the buyer's solvency. Yet, this exception to the 10 days rule is limited since it is not valid when buyers go bankrupt.

When insolvent buyers sell goods to customers, creditors' reclaiming rights end and they can no longer claim the proceeds of goods sold. As such, creditors gain by sending representatives to buyers' premises immediately after they learn of a reclamation demand. This allows creditors to assess which goods are still available at the time of demand, which they must be able to prove in court.

Sellers' reclamation rights are recognized during bankruptcy and expanded when buyers file for bankruptcy. Previous US bankruptcy laws allowed sellers to reclaim goods up to 20 days if the 10 days period has not expired when a buyer filed for bankruptcy.

Sellers' reclamation claims under BAPCPA

In 2005, the US Congress enacted the *Bankruptcy Abuse Prevention and Consumer Protection Act* (BAPCPA) to replace the federal bankruptcy law. BAPCPA offers new reclamation rights for trade creditors when they deal with buyers who have filed for bankruptcy. It permits sellers to reclaim goods sold on credit within 45 days of a buyer's bankruptcy filing. Additionally, BAPCPA extends the UCC's 10 days rule and gives sellers the right to send reclamation demands within 20 days of buyers' bankruptcy filing.

Although BAPCPA helps sellers reclaim goods, it also ratifies court decisions made under previous bankruptcy laws, many of which considered secured creditors' rights before sellers' reclamation rights. Consequently, banks with a security interest on a buyer's existing and acquired inventory have more rights than reclaiming sellers. Because BAPCPA weakens sellers' rights to reclaim goods during bankruptcies, reclamation rights are not a practical remedy for sellers dealing with bankrupt buyers.

Nonetheless, BAPCPA protects sellers in other ways; to prevent debtors from acquiring goods when they know that bankruptcy is imminent, BAPCPA allows sellers to make administrative expense claims (AECs) for unpaid goods received by buyers in the 20 days preceding the bankruptcy filing.

Administrative expense claims

In bankruptcy cases, AECs have priority over unsecured claims. Although secured inventory lenders have priority over AECs, creditors with approved AECs receive payment before non-priority unsecured creditors.

AECs must be paid in full on the effective date of a company's confirmed plan of reorganization, unless the AEC holder agrees with a different arrangement. This means that secured lenders must reserve funds to pay AECs if they want to help debtors reorganize their business after bankruptcy.

The interpretation of receipt of goods is often contested by bankrupt buyers. The UCC defines receipt of goods as the exact moment when buyers receive goods. Reclaiming sellers like this definition because it allows them to include goods delivered long before they calculate their AECs. It also allows sellers to argue for administrative expense priority under laws that govern goods that were shipped before a bankruptcy petition was filed, but arrived at the buyer's location after the petition was filed.

Receipt of goods also describes when title of ownership is transferred to buyers, as stated in shipping documents. Thus, a bill of lading might state that the title of goods should be transferred to buyers at a seller's port. Bankrupt buyers usually prefer this definition because it gives sellers a shorter period to count back in time. As such, trade creditors must examine claims carefully before they choose an effective course of action to recover goods.

Negotiating critical vendor payments in the US

Trade creditors can also use their business relationships to negotiate for additional recovery from bankrupt debtors. Debtors are only allowed to pay their pre-petition debts via a confirmed plan of reorganization. In some US states, however, debtors can ask bankruptcy courts for permission to pay the pre-petition claims of critical suppliers whose business relationship is essential for their survival during bankruptcy.

Suppliers often unite to negotiate critical vendor payments from debtors. These collective efforts give suppliers tremendous advantages during negotiations with debtors. Yet, during collective bargaining, vendors must exercise caution to avoid violating US antitrust laws, which forbid anti-competition activities.

During payment negotiations debtors often demand that creditors waive their AECs and other rights. For this reason, creditors should consult specialized lawyers before they sign documents. Prudent creditors also compare debtors' critical vendor payments with AECs. If the two are comparable, it is best for

creditors to receive critical vendor payments first, given that it can take as long as one year to process AECs.

CREDITORS' RIGHTS AND REMEDIES IN TAIWAN

In Taiwan, creditors dealing with debtors can use two types of legal proceedings, which come with different rights and remedies. The two legal processes are:

- i. corporate reorganization under the Company Act, which governs reorganization proceedings of public companies or companies that have issued corporate bonds; and
- ii. bankruptcy proceedings under the Bankruptcy Act, which are available to all insolvent companies and individuals.

Reorganization proceedings in Taiwan

Articles 282 to 314 of the Company Act govern reorganization proceedings in Taiwan. Unlike debtors in the US, companies that have initiated reorganization proceedings in Taiwan do not receive automatic stay privileges when they file a motion for reorganization. Instead, they must apply for one, which the courts generally issue as a preliminary injunction under Article 287 of the Company Act. This injunction is useful because it restricts repossession actions against a company engaged in reorganization.

In a reorganization proceeding under the Company Act, sellers' best defence is to maintain a security interest on all goods sold on credit. Title transfer of chattels is defined under Article 761 of Taiwan's Civil Code.

Sellers can retain titles of goods, as long as purchase agreements comply with Article 5 of the *Chattel Secured Transactions Act*, which states that when sellers maintain security interests, they must state the title of goods in a written purchase agreement. According to Article 5, they must also register with relevant authorities to protect the title clause from *bona fide* buyers.

Bankruptcy proceedings in Taiwan

Reorganization under Taiwan's Company Act is restricted to publicly-traded companies or companies with public bonds. This compels most companies and individuals in financial distress to resort to bankruptcy proceedings under Taiwan's Bankruptcy Act for relief.

Bankruptcy in Taiwan is only valid when a court declares a debtor as bankrupt. Under Article 111 of Taiwan's Bankruptcy Act, sellers who have sold goods on

credit to bankrupt debtors can cancel purchase agreements and regain title of all goods sold. This is a convenient remedy for sellers, as it allows them to stop delivery of goods in transit and reclaim those already delivered to bankrupt debtors who have not paid their bill.

Unlike the reclamation rights covered by the UCC in the US, sellers in Taiwan can revoke sales and regain title of goods without time constraints. This is useful for sellers dealing with bankrupt buyers in Taiwan, particularly since under Taiwan's Bankruptcy Act trade vendors' claims are not prioritized as they are in the US.

CONCLUSION

China is the manufacturing center of the global economy. This makes Chinese vendors increasingly interact with foreign buyers, some of which might not fulfill payment obligations. This exposure teaches Chinese sellers and creditors to learn more about insolvency laws and to take precautions to avoid losses.