

Bruce Nathan, Esq.



# The Continuing Conflict Between Secured Lender and Reclamation Rights

The courts have reached conflicting decisions over whether a debtor's Chapter 11 lender trumps a trade creditor's reclamation rights where the lender is secured by the debtor's inventory and its loan is used to pay off a pre-petition loan also secured by the debtor's inventory. The United States Bankruptcy Court for the Southern District of Indiana, in *In re h Gregg, Inc.*, recently denied relief on a reclamation claim based on it being subordinate to, and rendered valueless by, the debtors' Chapter 11 loan secured by the debtors' inventory. The *h Gregg* court relied on the rulings of the United States Bankruptcy Court for the Southern District of New York, in the *Dairy Mart* and *Dana Corporation* cases, that denied relief on reclamation claims because the debtors' Chapter 11 lenders' security interest in the goods subject to reclamation trumped the rights of the reclaiming creditors in the goods. Both courts relied on the debtors' use of the proceeds of the Chapter 11 loans secured by the debtors' inventory to repay the debtors' pre-petition loans also secured by the debtors' inventory. The courts regarded the debtors' pre-petition and Chapter 11 secured loans as one transaction that related back to the inception of the pre-petition secured loan when there were no reclamation claims.

The courts concluded that the creditors' reclamation rights arose prior to, and therefore, trumped the Chapter 11 lenders' security interest in the debtors' inventory.

The *h Gregg* court rejected the holdings of the United States Court of Appeals for the Sixth Circuit, in *In re Phar-Mor Inc.*, and the United States Bankruptcy Court in Delaware, in *In re Reichhold Holdings U.S., Inc.* Both courts had granted reclamation claims priority over the debtors' Chapter 11 lenders' claims secured by the debtor's inventory and whose loans had paid off pre-petition loans also secured by the debtors' inventory. The courts concluded that the creditors' reclamation rights arose prior to, and therefore, trumped the Chapter 11 lenders' security interest in the debtors' inventory. The courts also rejected the holdings of the *Dairy Mart* and *Dana Corporation* courts that viewed the pre-petition and Chapter 11 secured loans as an integrated transaction.

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## State Law Reclamation Rights

Reclamation rights are governed by Section 2-702 of the Uniform Commercial Code (the "UCC"), the state uniform commercial law enacted in all 50 states. According to UCC Section 2-702(2), a trade creditor can reclaim goods delivered to a buyer if the creditor proves that the goods were sold to the debtor on credit terms; the debtor was insolvent when it had received the goods; and the creditor demanded return of the goods within 10 days of their receipt by the debtor.

According to UCC Section 2-702(3), a creditor's state law reclamation rights are subject to the rights of a buyer in the ordinary course of business or other "good faith purchaser." A "good faith purchaser" includes the debtor's secured creditor with a prior blanket security interest in the debtor's inventory.

## Reclamation Rights Under Bankruptcy Code Section 546(c)

Bankruptcy Code Section 546(c) recognizes a creditor's reclamation rights under state law. It provides as follows:

(1) ... [S]ubject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under sections 544(a), 545, 547 and 549 are subject to the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days before the commencement of a case under this title, but such a seller may not reclaim such goods unless such seller demands in writing reclamation of such goods: (A) not later than 45 days after the date of receipt of such goods by the debtor; or (B) not later than 20 days after the date of the commencement of the case, if the 45-day period expires after the commencement of the case.

According to Section 546(c)(1), a creditor can reclaim goods sold on credit terms to the debtor in the ordinary course of the creditor's business that the debtor had received within 45 days prior to bankruptcy. A creditor must send a written reclamation demand to the debtor identifying the goods subject to reclamation not later than 45 days after the debtor's receipt of the goods. If the 45-day period expires after the bankruptcy filing, the creditor has up to 20 days after the filing to send a reclamation demand. The creditor must also prove the debtor was insolvent when the debtor received the goods and that the goods were identifiable and on hand when the demand was made.

Section 546(c) also states that a reclaiming creditor's rights are subject to the prior rights of a creditor with a security interest in the debtor's inventory. That should be clear where the competing secured creditor is the debtor's pre-petition lender with a security interest in all of the debtor's inventory, including the reclamation goods. It is less clear when the debtor's Chapter 11 lender, also secured by the debtor's inventory, had paid off the pre-petition secured loan and claims priority status over creditors asserting reclamation rights.

Section 546(c)(1) also provides that reclaiming goods is the sole remedy for a creditor that has satisfied the requirements for reclamation. This is in contrast to the prior version of Section 546(c)(1), which granted creditors alternative remedies of an allowed administrative priority claim or a replacement security interest in lieu of return of the goods.

### **Dana Corporation and Dairy Mart vs. the Phar-Mor Lines of Cases**

Many practitioners have viewed reclamation rights as an ineffective remedy in bankruptcy cases, due in large part to the many adverse court holdings that denied relief to reclamation creditors. These courts relied on the *Dairy Mart* decision in 2003 and the *Dana Corporation* decision in 2007.

In both *Dairy Mart* and *Dana Corporation*, the debtors' pre-petition lenders had security interests in substantially all of the debtors' assets, including inventory. Following their bankruptcy filings, the debtors obtained financing from their Chapter 11 lenders and granted them a security interest in substantially all of the debtors' assets, including inventory.

The debtors used part of the proceeds of their Chapter 11 loans to repay their pre-petition secured loans.

The *Dairy Mart* court denied relief to the reclamation creditors, holding that the debtors' Chapter 11 secured lenders had trumped reclamation claims and rendered them valueless. The court found that the debtor had used the reclamation goods and their cash proceeds to repay the pre-petition lenders' secured debt. The court also treated the pre-petition and Chapter 11 secured loans as an "integrated transaction." The Chapter 11 lenders' security interest in the debtor's inventory was, therefore, deemed to have related back to the pre-petition lenders' security interest in inventory, which had arisen prior to reclamation rights.

The *Dana Corporation* court also denied relief to the reclamation creditors, treating their reclamation rights as valueless. The court had similarly relied on an unbroken chain between the pre-petition lenders' and the Chapter 11 lenders' security interests in the debtor's inventory, notwithstanding the debtor's use of the proceeds of its Chapter 11 secured loan to fully repay its pre-petition secured loan. The court ruled that reclamation rights were subject to the Chapter 11 lenders' security interest in the debtor's inventory because the Chapter 11 lenders' security interest had related back to the pre-petition lenders' security interest in the debtor's inventory, which, in turn, preceded the creditors' assertion of reclamation rights.

Many practitioners have viewed reclamation rights as an ineffective remedy in bankruptcy cases, due in large part to the many adverse court holdings that denied relief to reclamation creditors.

However, in its 2008 decision in the *Phar-Mor* case, the United States Court of Appeals for the Sixth Circuit upheld creditors' reclamation rights, explicitly rejecting the holdings of *Dairy Mart* and *Dana Corporation*. The Sixth Court relied on the fact that the debtor's pre-petition secured loan was fully paid from the proceeds of the Chapter 11 financing, and not from the disposition of reclamation goods. In addition, the pre-petition lenders had released their security interest in the debtor's inventory and the Chapter 11 lenders were granted a new security interest in inventory that was unrelated to the pre-petition lenders' security interest and arose after creditors had asserted their reclamation rights. As a result, the pre-petition and Chapter 11 secured loans were considered separate transactions and creditors' reclamation rights were not subject to the Chapter 11 lenders' security interest in the debtor's inventory because the secured lenders did not have a prior lien in the reclamation goods that trumped reclamation rights.

And more recently, in 2016, the United States Bankruptcy Court in Delaware, in *In re Reichhold Holdings U.S., Inc.*, similarly ruled that creditors' reclamation rights had priority

over the debtor's Chapter 11 secured lender where the debtor had satisfied its pre-petition loan, secured by the debtor's inventory, with the proceeds of the debtor's Chapter 11 financing also secured by inventory. The court agreed with the Sixth Circuit's holding in *Phar-Mor* that the creditor's reclamation rights had arisen prior to the subsequently granted security interest in the debtor's inventory held by the debtor's Chapter 11 lender.

The *Reichhold* court also rejected the *Dairy Mart* and *Dana Corporation* holdings in refusing to treat the pre-petition and Chapter 11 secured loans as an "integrated transaction." There were "two different loans by two different lenders at two different times." The Chapter 11 lenders had no prior rights in the reclamation goods under Section 546(c) of the Bankruptcy Code and, therefore, did not trump trade creditors' reclamation rights, which had arisen before the Chapter 11 lenders were granted any rights in the goods.

### The Facts of the *hhgregg* Case

The debtor *hhgregg*, Inc. and affiliated entities (the "debtors") operated 220 brick-and-mortar retail stores in 20 states and sold appliances, electronics and related services. The debtors filed their Chapter 11 case on March 6, 2017, (the "Petition Date") with the United States Bankruptcy Court for the Southern District of Indiana. Prior to the Petition Date, the debtors had entered into a revolving credit facility with Wells

"Whirlpool Reclamation Goods"). On March 10, 2017, Whirlpool had sent a written demand to the debtors for the return of the Whirlpool Reclamation Goods. Following the debtors' rejection of Whirlpool's reclamation demand, Whirlpool commenced a lawsuit against the debtors and the Pre-Petition Secured Lenders and DIP Lenders (collectively the "Secured Lenders") seeking return of the Whirlpool Reclamation Goods or payment of the proceeds from any post-petition sale of the Whirlpool Reclamation Goods.

Unfortunately, the debtors were unable to successfully reorganize or sell their business and ended up selling their inventory, including the Whirlpool Reclamation Goods, as part of a going-out-of-business sale process. The Secured Lenders moved to dismiss Whirlpool's complaint, relying on the *Dairy Mart* and *Dana Corporation* holdings that the pre-petition and post-petition secured loans were an integrated transaction. The Secured Lenders argued that their security interest in the debtors' inventory, including the Whirlpool Reclamation Goods, had priority over Whirlpool's rights in the Whirlpool Reclamation Goods. The DIP Lenders' security interest related back to when the Pre-Petition Secured Lenders' security interest in the Whirlpool Reclamation Goods had arisen, which occurred prior to Whirlpool's assertion of reclamation rights.

Whirlpool, in turn, relied on the *Phar-Mor* and *Reichhold* holdings that its reclamation rights had priority over the DIP Lenders' security interest in the debtors' inventory. The debtors had used the Chapter 11 loan proceeds, and not the Whirlpool Reclamation Goods, to repay the pre-petition secured loan. In addition, the DIP Lenders had obtained their security interest in the debtors' inventory, including the Whirlpool Reclamation Goods, after Whirlpool's reclamation rights had arisen.

### The Bankruptcy Court's Dismissal of Whirlpool's Complaint

The bankruptcy court dismissed Whirlpool's complaint, ruling that Whirlpool's reclamation rights were subordinate to the DIP Lenders' security interest in the Whirlpool Reclamation Goods. Relying on the *Dairy Mart* and *Dana Corporation* decisions, the *hhgregg* court focused on the Pre-Petition Secured Lenders' and the DIP Lenders' continuous security interest in the debtors' inventory, including the Whirlpool Reclamation Goods, that arose prior to the onset of Whirlpool's reclamation rights. By the time Whirlpool had sent its reclamation demand to the debtors subsequent to the Petition Date, the Whirlpool Reclamation Goods were already subject to both the Pre-Petition Secured Lenders' and DIP Lenders' prior interest in the goods.

The court also relied on the financing order provision that stated as follows:

Based on the findings of fact and ruling herein concerning the integrated nature of the DIP Facility and the Prepetition Financing Documents *and the relation back of the DIP liens*, in no event shall any alleged right of reclamation or return (whether asserted under [11 U.S.C.]

## A debtor's Chapter 11 secured lenders' rights trumped reclamation rights based on an unbroken lien chain.

Fargo Bank, as the administrative agent and collateral agent for certain financial institutions (collectively, the "Pre-Petition Secured Lenders"). The Pre-Petition Secured Lenders' advances to the debtors were secured by a first priority security interest in substantially all the debtors' assets, including all of the debtors' existing and after-acquired inventory, which included goods subject to trade creditors' reclamation rights.

Pursuant to orders dated March 7, 2017, and May 22, 2017 (the "Financing Orders"), the bankruptcy court approved the debtors' entry into a post-petition secured financing arrangement with Wells Fargo and GACP Finance Co. (collectively the "DIP Lenders"). The bankruptcy court authorized the debtors to obtain up to \$80 million in secured financing from the DIP Lenders and, effective as of the Petition Date, granted the DIP Lenders a priming first priority lien in virtually all of the debtors' assets, including all existing and after-acquired inventory and proceeds, and a superpriority administrative expense claim. The financing order also authorized the debtors to use the post-petition secured loans to repay the Pre-Petition Secured Lenders' claims exceeding \$66 million.<sup>1</sup>

Whirlpool Corp. ("Whirlpool") had sold goods on credit to the debtors in the ordinary course of the debtors' business during the 45-day period prior to the Petition Date (the

Section 546(c) of the Bankruptcy Code or otherwise) be deemed to have priority over the DIP Liens. (emphasis added)

The *hhgregg* court also rejected Whirlpool's argument that its reclamation rights had priority over the Pre-Petition Secured Lenders' security interest in the debtors' inventory because the Pre-Petition Secured Lenders were not good faith purchasers that trumped Whirlpool's reclamation rights under UCC Section 2-702(3). Whirlpool had argued that the Pre-Petition Secured Lenders had not acted in good faith, and therefore, did not qualify as "good faith" purchasers because they had continued to make advances to the debtors on the eve of bankruptcy when the lenders knew goods suppliers, like Whirlpool, were not being paid. The court held that Section 546(c) subjects an otherwise valid reclamation claim to the prior rights of a creditor with a security interest in the reclamation goods, regardless of whether the secured creditor was a "good faith purchaser" under UCC Section 2-702.

## Conclusion

The *hhgregg* court's decision highlights the division among the courts over whether reclamation rights are wiped out by the debtor's Chapter 11 lender's blanket security interest in the debtor's inventory, including the goods subject to reclamation, where the Chapter 11 loan was used to pay off a pre-petition loan also secured by the debtor's inventory. The *hhgregg* court followed the *Dairy Mart* and *Dana Corporation* holdings that a debtor's Chapter 11 secured lenders' rights

trumped reclamation rights based on an unbroken lien chain, starting with the debtor's pre-petition secured loan and then continuing with the debtor's Chapter 11 secured loan, that long preceded the onset of reclamation rights.

However, that is not the end of the story here. Whirlpool has filed an appeal from the *hhgregg* court's decision and this matter is now before the United States District Court for the Southern District of Indiana. In addition, other courts following the *Phar-Mor* and *Reichhold* decisions might be more sympathetic to reclamation rights. As a result, trade creditors should not ignore this remedy! ■

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1. The financing order also granted the Pre-Petition Secured Lenders, as adequate protection, a replacement lien in the debtors' assets and a superpriority administrative expense claim, both of which were subordinate to the DIP Lenders' secured and superpriority administrative priority claims.

*Bruce Nathan, Esq., is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy, Financial Reorganization and Creditors' Rights Group and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM, a former member of the board of directors of the American Bankruptcy Institute and a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached via email at [bnathan@lowenstein.com](mailto:bnathan@lowenstein.com).*