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Reclamation Catch-22: Darned If You Do, Darned If You Don't

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) amended Bankruptcy Code Section 546(c)(1) and expanded the reclamation reachback period to 45 days in bankruptcy cases filed under BAPCPA. Although BAPCPA’s change to Section 546(c) suggests that trade creditors would have substantially expanded reclamation rights, it most certainly has not played out that way in practice.

Reclamation rights have already been besieged in cases, such as *Advanced Marketing Services* in the Bankruptcy Court for the District of Delaware, where the court denied a reclaiming creditor’s motion for injunctive relief to bar the debtor from selling that creditor’s goods, and *Dana Corporation* in the Bankruptcy Court for the Southern District of New York, where the court

had rejected because reclamation rights were viewed to be valueless by virtue of the debtor’s pre-petition secured lender’s floating inventory security interest. The United States District Court for the Eastern District of Virginia held that a creditor’s failure to diligently pursue its reclamation rights resulted in a forfeiture of those rights.

This leaves reclamation creditors in the lurch with the impossible choice of deciding whether to seek emergency injunctive relief at the beginning of the case, a battle they will likely lose at great expense, or forfeit the ability to assert their reclamation rights at a later date (perhaps when secured creditors with floating liens on the reclamation creditors’ goods have been paid in full).

State Law Reclamation Rights

Reclamation rights arise under state law and are governed by Section 2-702 of the Uniform Commercial Code (UCC), the uniform state law enacted in all 50 states. Under state law, a trade creditor could reclaim goods delivered to a buyer if the creditor satisfies all of the following conditions:

1. The goods were sold to the debtor on credit terms;
2. The debtor was insolvent at the time it received the goods; and
3. The creditor demanded return of the goods within ten days of the debtor’s receipt of the goods.

The UCC defines insolvency based on either a balance sheet test, of liabilities exceeding assets, or an “equity” test, where the debtor has ceased paying its debts in the ordinary course of business or is unable to pay its debts as they

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ruled that reclamation rights were rendered valueless by virtue of the debtor’s pre-petition and Chapter 11 secured lenders’ alleged floating security interest in all of the debtor’s inventory. More recently, in the *Circuit City Stores* Chapter 11 case, reclamation creditors were dealt a blow for failing to seek emergency injunctive relief at the beginning of the case, exactly the relief that the bankruptcy court in *Advanced Marketing Services*

become due. A trade creditor that can prove all of the elements of a state law reclamation claim is entitled to recovery of all goods in the debtor's possession that are the subject of its claim.

However, a creditor's state law reclamation rights are subject to the rights of a "good faith purchaser." The UCC defines a "good faith purchaser" to include a secured creditor with a security interest in the debtor's inventory. That means a secured creditor with a floating inventory lien has priority over the rights of a reclaiming creditor.

Section 546(c)(1) now states that the rights of a reclaiming creditor are subject to the prior rights of a creditor with a security interest in the debtor's inventory, including the goods subject to reclamation.

Reclamation Rights under Bankruptcy Code Section 546(c)

Bankruptcy Code Section 546(c)(1) addresses reclamation rights 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 of 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.

Section 546(c)(1), as enacted by BAPCPA, has brought about three significant changes to trade creditors' reclamation rights in bankruptcy cases, compared to their reclamation rights under the pre-BAPCPA version of Section 546(c). First, the reclamation reachback time period has been extended to 45 days. A creditor can reclaim goods that it had sold in the ordinary course of its business on credit to the debtor that the debtor had received within 45 days of bankruptcy. A creditor's reclamation rights are contingent upon the creditor sending a written reclamation demand, identifying the goods, to the debtor 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 bankruptcy filing to send a reclamation demand. This sounds like a substantial expansion of reclamation rights, compared to the shorter time periods provided to reclaiming creditors under state law and the reclamation rights provided in the pre-BAPCPA version of Section 546(c). But don't pop open the champagne bottles quite yet!

Section 546(c)(1) now states that the rights of a reclaiming creditor are subject to the prior rights of a creditor with a security interest in the debtor's inventory, including the goods subject to reclamation. This raises the specter of the pre-BAPCPA case law holdings that a pre-existing pre-petition floating inventory secured claim renders reclamation rights valueless, even when the value of the secured creditor's collateral substantially exceeds the amount of the secured creditors' claim.

Section 546(c)(1) has also eliminated the alternative remedies of an allowed administrative priority claim or replacement lien in lieu of return of the goods that existed in the pre-BAPCPA version of Section 546(c). Current Section 546(c)(1) provides that reclamation of the goods is the *sole* remedy for a creditor that has satisfied the requirements for reclamation. BAPCPA's deletion of the alternative remedies for reclamation has raised many questions. Is reclamation a "wasting" right that diminishes as the debtor continues to sell the goods subject to reclamation, because relief is limited to only the goods on hand when the court grants relief? Must reclaiming creditors immediately commence suit in the bankruptcy court to seek injunctive relief at the beginning of the bankruptcy case to block the debtor's sale of, or grant of a security interest in, the goods subject to reclamation? If so, at what cost will reclamation creditors pursue such rights where the probability of success, at least at the beginning of the case, appears bleak? If reclamation creditors choose not to seek injunctive relief at the beginning of the case, will they have forfeited their reclamation rights?

All these issues were addressed in the *Circuit City Stores* Chapter 11 case.

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Circuit City Stores

Background

On November 10, 2008 (the petition date), Circuit City Stores, Inc. and its affiliates filed Chapter 11 in the United States Bankruptcy Court for the Eastern District of Virginia. Prior to its liquidation, Circuit City was a national retailer of consumer electronics with approximately 40,000 employees and over 700 retail stores across the United States. Paramount Home Entertainment Inc. sold and delivered millions of dollars of home entertainment products to Circuit City each year.

Debtors' Financing Arrangement

On the petition date, Circuit City requested approval from the Bankruptcy Court to obtain debtor-in-possession (DIP) financing secured by a first priority lien in substantially all of Circuit City's existing and after-acquired assets, including "inventory" and the proceeds thereof. This inventory included

the goods that Paramount had sold to Circuit City. Paramount did not object to the proposed DIP financing. Upon approval of the DIP loan, Circuit City used the DIP loan proceeds to repay all of its outstanding indebtedness under its pre-bankruptcy credit facility, and to finance its ongoing post-petition operations.

Interestingly, one of the rationales asserted by Circuit City in support of the reclamation procedures order was that without the order, it would need to expend substantial time and limited resources contesting and litigating reclamation demands.

Reclamation Procedures

Shortly after the petition date, the Circuit City court approved an order for proposed reclamation procedures, which, among other things, required reclamation claimants to file reclamation demands consistent with Bankruptcy Code Section 546(c) no later than 20 days after the petition date, and required Circuit City to send notice by March 10, 2009 containing what Circuit City considered the allowed amount of reclamation creditors' claims. To the extent Circuit City did not believe a reclamation claimant had an allowed claim, Circuit City was not required to send notice and the claimant's reclamation demand was deemed rejected by Circuit City after March 10, 2009. The reclamation procedures order expressly provided that:

Nothing in this Order or the above procedures is intended to prohibit, hinder, or delay any Reclamation Claimant from asserting or prosecuting any of its rights to seek to reclaim goods provided to the Debtors, or affect, alter, diminish, extinguish, or expand the rights or interest, if any, to recover goods (or proceeds thereof) sought to be reclaimed.¹

Paramount's Reclamation Demand

Shortly before the entry of the reclamation procedures order, Paramount sent a reclamation demand—requesting the return of goods totaling approximately \$11.6 million—that was compliant with the reclamation procedures order. Circuit City, however, did not send a notice to Paramount by March 10, 2009, pursuant to the order, indicating that Paramount had an allowed reclamation claim, and accordingly, Paramount's demand was deemed rejected by Circuit City. Unrelated to Paramount's reclamation demand, Paramount also filed a proof of claim seeking priority status on account of its reclamation claim.

Circuit City Liquidates

Barely two months into its bankruptcy case, Circuit City decided to liquidate its assets by way of going out of business sales, which, of course, included the sale of Paramount's goods in Circuit City's possession. At no time after sending its reclamation demand did Paramount object to the sale of its goods, nor did Paramount take any steps to exercise its reclamation

rights, such as by commencing an adversary proceeding to stop Circuit City from selling the goods subject to Paramount's reclamation demand.

Circuit City Objects to Paramount's Claim

In June 2009, Circuit City objected to Paramount's priority proof of claim based on Paramount's reclamation claim. Circuit City sought to have the claim reclassified from a priority claim to a non-priority pre-petition general unsecured claim. Paramount objected to Circuit City's proposed reclassification of the priority status of Paramount's reclamation claim. Thereafter, Circuit City filed a summary judgment motion, asserting that there were no disputed issues of fact and that as a matter of law, Paramount's claim should be reclassified from a priority claim to a general unsecured claim.

The Bankruptcy Court granted Circuit City's summary judgment motion, sustained Circuit City's objection to Paramount's reclamation claim as a priority claim and reclassified the claim as a non-priority general unsecured claim. The Bankruptcy Court stated that reclamation rights are not self-executing and that Paramount had sat on its rights by failing to take the following actions to enforce its reclamation rights: (1) failing to seek relief from the bankruptcy automatic stay to enforce Paramount's rights in the goods that were subject to its reclamation demand; (2) failing to object to the proposed DIP financing that granted the secured party a floating lien on inventory, including Paramount's goods; and (3) failing to object to Circuit City's motion seeking approval of going out of business sales, which clearly included the liquidation of the goods subject to Paramount's reclamation claim. The court declared that simply following the reclamation procedures order and serving a reclamation demand was not sufficient to preserve Paramount's reclamation rights.

The Bankruptcy Court also ruled that Paramount would not have been granted relief on its reclamation claim, even if Paramount had timely taken action to enforce its reclamation rights. Paramount's reclamation rights were rendered valueless because the goods subject to Paramount's reclamation demand were encumbered by Circuit City's pre-petition lenders' floating lien on inventory on the petition date. Accordingly, Circuit City's secured lender was a "good faith purchaser" under the UCC with priority over Paramount's rights in the goods it sought to reclaim.

Furthermore, the Bankruptcy Court held that reclamation is an "*in rem*" remedy that under the UCC and the Bankruptcy Code would *solely* allow Paramount to seek the return of its goods and not take an interest in the proceeds of the goods once they were sold. The Bankruptcy Court also held that Paramount was not entitled to an administrative priority claim because Section 546 of the Bankruptcy Code, as amended by BAPCPA, does not require the Bankruptcy Court to grant an allowed administrative claim in favor of reclamation creditors.

Paramount Appeals

Paramount appealed the Bankruptcy Court's decision to the United States District Court. Paramount argued that it was entitled to relief on its reclamation claim because it had com-

plied with both the statutory requirements for reclamation, as well as the reclamation procedures order. Paramount had timely served a written reclamation demand, which is all that it was required to do. Paramount also argued that requiring reclamation creditors to commence suit at the beginning of the bankruptcy case would create a race to the courthouse, which bankruptcy is supposed to prevent, and would unduly burden and create expense for both trade creditors and the debtor. Interestingly, one of the rationales asserted by Circuit City in support of the reclamation procedures order was that without the order, Circuit City would need to expend substantial time and limited resources contesting and litigating reclamation demands. Paramount also argued that once a reclamation demand was served, Circuit City was prohibited from disposing of the goods subject to reclamation, without obtaining an order from the Bankruptcy Court.

Circuit City asserted that reclamation is a state law remedy and that Section 546 of the Bankruptcy Code simply allows creditors to enforce such state law rights to the extent they exist. It argued that state law and courts across the nation have ruled that serving a reclamation demand is not sufficient without, in fact, pursuing such demand on a timely basis with sufficient diligence. Paramount forfeited its reclamation rights by not taking any further action, such as (1) seeking relief from the bankruptcy automatic stay to enforce its rights in the goods that were subject to its reclamation demand, (2) objecting to the proposed DIP financing, to the extent the DIP secured lender was granted a security interest in the goods subject to Paramount's reclamation claim, or (3) objecting to Circuit City's motion seeking the approval of going out of business sales that included Paramount's goods subject to reclamation.

The District Court's Decision

The District Court sided with Circuit City and held that Paramount should have diligently asserted its reclamation rights, especially in the context of such a large bankruptcy case like the *Circuit City* case, and it forfeited such rights by failing to do so. In fact, the District Court stated that Paramount's failure to take action in the manner enumerated above likely created more litigation and pressure on the Bankruptcy Court. Although Paramount served a reclamation demand, it failed to seek court intervention to "perfect" that right. In addition, Paramount's failure to take further action was fatal because, in the words of the Bankruptcy Court, the Bankruptcy Code is not "self executing." Once Paramount became aware that its goods were being pledged as collateral in connection with Circuit City's DIP financing facility, Paramount should have taken action. "To make matters worse," Paramount should have objected once it became aware that Circuit City was seeking permission to conduct going out of business sales, which undoubtedly included the sale of Paramount's goods.

The District Court did not consider whether Paramount's reclamation claim was deemed "valueless" because on the petition date, the goods that were subject to the reclamation demand were encumbered by Circuit City's pre-petition lenders' floating lien on inventory; and whether Paramount's reclamation rights extended to the proceeds of its goods. The

District Court, however, made clear that Section 546, as amended by BAPCPA, does not require granting an administrative expense if the Bankruptcy Court denies a reclamation claim, and even assuming the Bankruptcy Court has the discretion to award an administrative claim, the District Court did not believe the Bankruptcy Court erred in denying any relief to Paramount where Paramount had failed to diligently pursue its reclamation rights.

Once Paramount became aware that its goods were being pledged as collateral in connection with Circuit City's DIP financing facility, Paramount should have taken action.

Conclusion

The United States District Court's decision in *Circuit City* is ample proof that reclamation has become a hollow remedy in bankruptcy cases. Even worse, as a result of the court's holding, a creditor who is not willing to incur the expense to enforce its reclamation rights at the beginning of the bankruptcy case, in what will likely be a losing effort, will lose those rights altogether. Where there are no reclamation procedures in place in a bankruptcy case, reclamation creditors should decide whether to act fast or risk losing their reclamation rights. If a debtor is proposing reclamation procedures, reclamation creditors should object to the procedures unless the procedures, like the procedures in the *Advanced Marketing Services* case, make clear that reclamation creditors will not be prejudiced by their failure to commence a reclamation lawsuit or seek injunctive relief to prevent the debtor from selling their goods, thus allowing reclamation creditors in such case the opportunity to fight another day. ●

1. In contrast to the reclamation procedures in *Circuit City*, the reclamation procedures in *Advanced Marketing Services* made clear that reclamation creditors would not be prejudiced by their failure to commence a reclamation lawsuit or seek injunctive relief to prevent the debtor from selling their goods.

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