

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

The Essential Resource for Today's Busy Insolvency Professional

Last in Line

BY BRUCE S. NATHAN AND SCOTT CARGILL

Rethinking Reclamation as a Trade Creditor Remedy



Bruce S. Nathan
Lowenstein Sandler
LLP; New York



Scott Cargill
Lowenstein Sandler
LLP; Roseland, N.J.

Goods sellers had previously relied on reclamation rights when customers were unable or unwilling to pay for goods delivered on credit terms. The enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) limited the reclamation rights of goods sellers by curtailing the available remedies. There have been post-BAPCPA court decisions that have denied relief on reclamation claims.

As a result, creditors asserting reclamation claims have continued to face significant obstacles in either securing the return of their goods or receiving a distribution on account of their claim. However, a few courts have ruled in favor of reclamation creditors. As a result, despite the unfavorable holdings, creditors seeking to increase their recoveries should continue to assert their reclamation rights. This article provides an overview of the issues reclamation creditors have litigated and how they have fared since BAPCPA's passage.

Reclamation Rights in Bankruptcy

The Uniform Commercial Code (UCC) provides goods sellers a state law right to reclaim (*i.e.*, demand the return of) goods sold and delivered on credit terms to an insolvent buyer under certain circumstances. Section 546(c) of the Bankruptcy Code recognizes reclamation rights that arise under UCC § 2-702(2), with limitations and additional requirements, following the buyer's bankruptcy filing. A seller seeking to reclaim its goods from a debtor buyer under UCC § 2-702 and § 546(c)(1) of the Bankruptcy Code must prove that (1) the debtor was insolvent when it received the goods; (2) the seller made a written demand for the return of the goods no later than 45 days after receipt of the goods by the debtor, or no later than 20 days following the bankruptcy petition date if the 45-day

period expired after the petition date; and (3) the goods were identifiable and in the debtor's possession when the demand was made.¹

According to § 546(c)(1), as amended by BAPCPA, a seller's reclamation rights are subject to the rights of a holder of a security interest in the reclamation goods and their proceeds. A seller's only remedy under § 546(c)(1) is the return of its goods. Section 546(c)(1) no longer contains the pre-BAPCPA provision affording courts discretion to grant an administrative claim or a lien in lieu of the return of the seller's goods.

Section 546(c)(2) references § 503(b)(9) of the Bankruptcy Code, which was added by BAPCPA and provides sellers with an administrative claim for goods sold in the ordinary course of business and received by the debtor within 20 days of the bankruptcy filing. Since § 503(b)(9) rights are independent of § 546(c), a seller does not have to satisfy § 546(c)(1)'s requirements for reclamation to obtain an administrative priority claim for goods the debtor receives within 20 days of a bankruptcy filing.

Post-BAPCPA Reclamation Rights

The BAPCPA amendment to § 546(c) raises the question of whether the sole remedy for reclamation claimants is now limited to the return of the goods. For example, in *In re First Magnus Fin. Corp.*,² a reclamation creditor timely made a written demand for the return of its goods. The debtor ignored the demand and instead surrendered the goods to one of its secured creditors.³ The court denied the reclamation creditor's request for an administrative claim for the goods delivered to the debtor between 21 to

Bruce Nathan is a partner in Lowenstein Sandler LLP's Bankruptcy, Financial Reorganization and Creditors' Rights Group in New York. Scott Cargill is Of Counsel in the firm's Roseland, N.J., office.

¹ Bankruptcy Code § 546(c)(1); see also *In re Hechinger Inv. Co. of Delaware Inc.*, 274 B.R. 402, 405 (Bankr. D. Del. 2001) (noting requirement that goods must be identifiable and in debtor's possession when reclamation demand is made).

² 2008 WL 5046596 (Bankr. D. Ariz. Oct. 16, 2008).

³ *Id.* at *1-*2.

45 days prior to the bankruptcy filing and granted an allowed administrative claim under § 503(b)(9) for goods delivered within 20 days of the filing.⁴ The court recharacterized as unsecured the portion of the seller's reclamation claim for goods delivered between 21 to 45 days before the bankruptcy.⁵ The court found § 546(c) no longer provides reclaiming sellers with an administrative claim unless they qualify under §§ 503(b)(9) or 503(b)(1).⁶

BAPCPA's amendment of § 546(c) also calls into question the continued validity of pre-BAPCPA cases holding that a reclaiming seller is entitled to reclaim the goods "or the traceable proceeds from those goods"⁷ once a secured creditor's claim has been fully satisfied. In *In re Circuit City Stores*,⁸ reclamation creditors sought an administrative expense claim after their goods were sold in going-out-of-business sales and the proceeds were used to satisfy debtor-in-possession (DIP) lender claims.⁹ The court held that the seller's reliance on pre-BAPCPA § 546(c) case law was misplaced because reclamation creditors are no longer entitled to an administrative expense claim, unless they can prove a benefit to the estate that would qualify under § 503(b)(1) or otherwise satisfy the requirements of § 503(b)(9).¹⁰ The court also held that sellers are not entitled to the proceeds of their goods because § 546(c) only grants sellers that satisfy its requirements an *in rem* right to reclaim the actual goods subject to reclamation and does not grant sellers rights in the proceeds of goods.¹¹

*In re Professional Veterinary Prods. Ltd.*¹² addressed a similar request by a reclamation seller whose goods were sold as part of a § 363 bankruptcy sale for an administrative claim. The seller relied on two pre-BAPCPA Eighth Circuit Court of Appeals cases, *In re Pester Refining Co.*¹³ and *In re Giffing Retreading Co.*,¹⁴ to argue that it was entitled to an administrative claim, even following the sale of the goods. The *Professional Veterinary* court rejected this argument, concluding that the current version of § 546(c) does not grant a seller the right to recover any assets other than its goods. The court also found that the Eighth Circuit cases that the seller relied upon were no longer precedential authority because they were decided under the pre-BAPCPA version of § 546(c).¹⁵

However, in a twist, the court refused to deny the seller relief on its reclamation claim. The court held that the debtor was judicially estopped from taking the position that the seller did not diligently pursue its right to reclaim its goods, notwithstanding the debtor's prior sale of the goods subject to reclamation and the debtor's argument that the seller had lost its reclamation rights by failing to vigorously pursue its reclamation claim.¹⁶

The debtors had filed their bankruptcy case on Aug. 20, 2010. On Aug. 25, the seller sent a written reclamation

demand, and on Sept. 8, it filed an adversary proceeding seeking immediate reclamation of its goods, the turnover and accounting of the goods subject to its reclamation demand, and an injunction prohibiting the sale of the inventory.¹⁷ On Sept. 14, the court approved the debtors' sale of assets, including the goods subject to the seller's reclamation rights, to a third party. On Sept. 29, the court approved exclusive global procedures to determine reclamation claims. The procedures expressly prohibited reclamation claimants from taking steps to protect their interests and stayed the seller's adversary proceeding.¹⁸

The court concluded that the debtors could not now claim that the seller did not pursue its rights where the reclamation procedures order prohibited vendors from pursuing their remedies. The court distinguished this case from the bankruptcy court's holding in *In re Circuit City Stores, supra*, that a reclamation seller that had not diligently prosecuted its reclamation rights had waived the right to relief on its reclamation claim. While the *Circuit City* court had also approved global procedures governing reclamation rights, unlike the procedures in *Professional Veterinary*, the procedures in *Circuit City* did not preclude reclamation creditors from enforcing their rights.¹⁹

The *Professional Veterinary* court also noted that the order approving the sale of the debtors' assets stated that all "interests" in the inventory being sold, including the goods subject to reclamation rights, were attached to the net sale proceeds.²⁰ While the sale order did not define the term "interests" to include reclamation rights, the court concluded that the definition of "interests" was broad enough to include reclamation rights and permitted the seller to assert that it held a lien on the proceeds from the sale of its goods.²¹

Post-Petition Refinancing of Pre-Petition Secured Debt

Courts have also split over whether reclamation rights are wiped out where a debtor had used its DIP lending facility, secured by the debtor's inventory, to repay the debtor's pre-petition lender's facility, also secured by the inventory. The U.S. Bankruptcy Court for the Southern District of New York analyzed this issue pre-BAPCPA in *In re Dairy Mart Convenience Stores Inc.*,²² where the debtor had received reclamation demands after the petition date but prior to the repayment of the pre-petition credit facility from the DIP facility. The court denied relief to the reclamation claimant, holding that the pre-petition lender's lien was effectively "sold" to the DIP lender and the reclamation creditor's claim was rendered valueless because liens were simultaneously granted to the new DIP lender in the same collateral.

It did not matter that the floating lien of the pre-petition secured creditor was released as part of the paydown of the pre-petition secured lender's debt.²³ The court viewed the pre-petition credit facility and the DIP facility as an "integrated transaction" because the DIP lender's security interest

4 *Id.* at *2.

5 *Id.*

6 *See id.* (finding that seller failed to present evidence of benefit to estate under § 503(b)(1)).

7 *In re Dairy Mart Convenience Stores Inc.*, 302 B.R. 128, 134 (Bankr. S.D.N.Y. 2003).

8 441 B.R. 496 (Bankr. E.D. Va. 2010).

9 *Id.* at 509-10.

10 *Id.* at 507.

11 *Id.* at 511.

12 454 B.R. 479, 483 (Bankr. D. Neb. 2011).

13 964 F.2d 842 (8th Cir. 1992).

14 795 F.2d 676 (8th Cir. 1986).

15 *Prof'l Veterinary*, 454 B.R. at 483.

16 *Id.* at 485.

17 *Id.* at 481-82.

18 *Id.* at 485.

19 *Id.*

20 *Id.* at 484.

21 *Id.* at 486.

22 302 B.R. at 128.

23 *Id.* at 136.

in the debtor's inventory was directly connected to the pre-petition secured lender's security interest in inventory.²⁴

Just four years later, in the post-BAPCPA case of *In re Dana Corp.*,²⁵ the same bankruptcy court faced a similar challenge by reclamation creditors to a transaction where a post-petition DIP lender received a blanket security interest in all of the debtor's inventory as part of a DIP financing that paid off the pre-petition secured debt. Expressly adopting the reasoning of *Dairy Mart*, the *Dana* court held that the reclamation claims were rendered valueless because the blanket security interest in inventory subject to reclamation rights "continued unbroken" and the goods remained subject to the DIP lender's prior lien defense.²⁶

However, the U.S. Court of Appeals for the Sixth Circuit, in the pre-BAPCPA case of *In re Phar-Mor Inc.*,²⁷ held that the debtor's post-petition secured credit facility, which was used to repay the debtor's pre-petition secured loan, did not extinguish the reclaiming seller's rights. The court, dealing with a factually similar case to *Dairy Mart* and *Dana*, concluded that *Dairy Mart* and *Dana* were "not practical and their reasoning is not compelling."²⁸

The court treated the blanket security interest in the debtor's inventory granted to the DIP lender as an entirely new security interest that did not relate back to the pre-petition lender's security interest in the debtor's inventory. As such, the DIP lender's security interest was subject to the intervening rights of the reclaiming seller.²⁹

The Sixth Circuit granted the creditor an administrative expense claim for the value of the goods subject to the reclamation demand because the court had denied reclamation as a remedy under the pre-BAPCPA version of § 546(c).³⁰ The precedential effect of *Phar-Mor* has been questioned because the *Phar-Mor* decision was based on the pre-BAPCPA version of § 546(c), and the current version of § 546(c) does not include granting a reclamation creditor an administrative claim (except to the extent that § 503(b)(9) applies).³¹

*In re Reichhold Holdings US Inc.*³² also broke with the reasoning of *Dairy Mart* and *Dana*. Unlike the *Phar-Mor* case, in *Reichhold* the DIP loan facility was not used to pay off the pre-petition facility until *after* the debtors had received reclamation demands.³³ Thus, the first-priority liens granted to the DIP lenders were granted after the seller's reclamation rights had arisen. The *Reichhold* court held that the DIP lenders' security interest was subject to the seller's reclamation rights, since the reclamation rights arose before the attachment of the DIP lenders' security interest.³⁴ The court also agreed with the Sixth Circuit in *Phar-Mor* that the pre-petition secured loan and DIP loan were not an integrated transaction: They were two different lenders at different times.³⁵ The court also rejected the debtors' invocation of *Dairy Mart* and *Dana* that the

debtor had sold the seller's reclamation goods as part of the repayment of the pre-petition loan from the proceeds of the DIP loan.³⁶

Notably, the *Reichhold* decision was limited to the issue of whether the reclaiming seller's rights were superior to those of the DIP lender. The court did not address whether the seller had satisfied all of the requirements for relief on its reclamation claim, including whether the goods subject to reclamation were in the debtors' possession at the time of the seller's demand.³⁷

*In re hhgregg Inc.*³⁸ also addressed the rights of a reclaiming seller where the DIP lender, secured by a blanket security interest in the debtors' inventory, had paid off the debtors' pre-petition secured debt. Relying on *Dana*, the court denied the reclamation claim.³⁹ The court instead focused on the pre-petition secured lenders' and the DIP lenders' continuous security interest in the debtors' inventory that was in place prior to when the seller's reclamation right arose, which (according to the court) was when the seller sent its reclamation demand.⁴⁰ The court also relied on the following provision in the order approving the DIP financing:

Based on the findings of fact and ruling herein concerning the integrated nature of the DIP Facility and the Pre-petition Financing Documents *and the relation back of the DIP liens*, in no event shall any alleged right of reclamation or return (whether asserted under Section 546(c) ... or otherwise) be deemed to have priority over the DIP Liens.⁴¹

The court disagreed with the *Phar-Mor* holding⁴² and distinguished *Reichhold* where the reclamation demand was received prior to the DIP lenders' payoff of the pre-petition facility and the DIP financing was ultimately paid down, which left the reclamation claim next in priority.⁴³ The reclaiming seller appealed the *hhgregg* bankruptcy court's decision, and the appeal is presently pending.⁴⁴

Conclusion

Creditors should be exercising their reclamation rights as a supplemental remedy to their administrative priority status under § 503(b)(9). Despite the post-BAPCPA decisions unfavorable to reclamation creditors, there have been a handful of favorable holdings that should encourage reclamation creditors to assert their rights and thereby improve their prospects of obtaining an enhanced recovery on their claims. **abi**

Reprinted with permission from the ABI Journal, Vol. XXXVII, No. 10, October 2018.

The American Bankruptcy Institute is a multi-disciplinary, non-partisan organization devoted to bankruptcy issues. ABI has more than 12,000 members, representing all facets of the insolvency field. For more information, visit abi.org.

²⁴ See *id.*

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

²⁶ *Id.* at 421.

²⁷ 534 F.3d 502 (6th Cir. 2008).

²⁸ *Id.* at 507.

²⁹ *Id.* at 508.

³⁰ *Id.* at 505.

³¹ Fredrick J. Glasgow III, "Reclaiming the Defenses to Reclamation," 26 *Emory Bankr. Dev. J.* 301, 306 n.38 (2010).

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

³³ *Id.* at 109.

³⁴ *Id.* at 111.

³⁵ *Id.* at 112.

³⁶ *Id.*

³⁷ *Id.* at 112, n.5.

³⁸ 578 B.R. 814 (Bankr. S.D. Ind. 2017).

³⁹ *Id.* at 819.

⁴⁰ *Id.*

⁴¹ *Id.* at 820 (emphasis added).

⁴² *Id.*

⁴³ *Id.* at 819-20.

⁴⁴ Case No. 17-cv-04662-WTL-TAB (S.D. Ind.).