

Reclamation Rest in Peace? The Eighth Circuit Will Soon Weigh in



Bruce S. 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 & 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 at bnathan@lowenstein.com.

Michael Papandrea, Esq., is an associate in Lowenstein Sandler's Bankruptcy, Financial Reorganization & Creditors' Rights Department focused on providing practical solutions for debtors, creditors' committees, individual creditors, and other interested parties involved in bankruptcy and creditors' rights matters. Prior to joining the firm, Mike clerked for multiple bankruptcy judges in the District of New Jersey and Eastern District of Pennsylvania. He can be reached at mpapandrea@lowenstein.com.

Trade creditors that provide goods on credit to struggling customers can assert reclamation rights prior to and after the customer's bankruptcy filing as part of their collection toolkit. Specifically, Bankruptcy Code Section 546(c) preserves a creditor's state law reclamation rights in goods sold to an insolvent debtor that the debtor receives within the 45 days of the debtor's bankruptcy filing.

However, creditors' reclamation rights have been chipped away over the years. This trend continues in the Chapter 11 cases of *Specialty Retail Shops Holding Corp.* ("*Specialty Shops*") involving the retailer, Shopko, where the U.S. District Court for District of Nebraska has recently affirmed the bankruptcy court's holding that denied a reclaiming creditor, McKesson Corporation ("*McKesson*"), an administrative claim or lien on account of the goods subject to its reclamation rights. The court concluded that Section 546(c) provides that a creditor's reclamation of goods is the sole remedy for a valid reclamation claim. The court's decision illustrates the significant impact of an amendment to Section 546(c) made by Congress through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("*BAPCPA*"). While the pre-BAPCPA version of Section 546(c) had explicitly provided creditors with additional remedies of an administrative claim or replacement lien where the creditor could no longer reclaim goods, the current version of Section 546(c) omits these remedies. The court also relied on Section 546(c)'s language that reclamation rights are explicitly subject to the prior

rights of the debtor's secured creditor with a security interest in the debtor's inventory that includes the goods subject to reclamation. The court's decision continues the adverse trend of eviscerating reclamation rights where the debtor sells goods subject to a creditor's reclamation rights and then uses the proceeds to pay down the debtor's secured indebtedness.

Section 546(c) provides that a creditor's reclamation of goods is the sole remedy for a valid reclamation claim.

McKesson has appealed the district court's decision to the United States Court of Appeals for the Eighth Circuit (the "*Eighth Circuit*"), which has the opportunity to weigh in on the issue.

State Law Reclamation Rights

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

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 state law reclamation rights. Section 546(c) 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 to a debtor in the ordinary course of the creditor's business that the debtor had received within 45 days prior to bankruptcy. The creditor must send the debtor a written reclamation demand identifying the goods subject to reclamation no 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. In any event, Section 546(c) (2) provides that a creditor can assert an administrative expense claim under Section 503(b)(9) for goods sold and delivered to the debtor within 20 days of the bankruptcy filing—even if the creditor lacks a valid reclamation claim.

Section 546(c) also provides that a reclaiming creditor's rights are subject to the prior rights of a creditor, such as the debtor's pre-petition lender, that holds a security interest in the goods subject to reclamation rights. Additionally, Section 546(c) provides that the reclaiming creditor's sole remedy is to recover the goods subject to its reclamation rights. Prior to the BAPCPA amendments, Section 546(c) granted creditors with valid reclamation rights the alternative remedies of an allowed administrative priority claim or a replacement lien in lieu of return of the goods. However, as part of BAPCPA, Congress amended Section 546(c) to strike these alternative remedies. The impact of this change to Section 546(c) is squarely at issue in the *Specialty Shops* case.

A trade creditor can reclaim goods delivered to a buyer if the creditor proves that the debtor was insolvent when it had received the goods, and the creditor demanded return of the goods within 10 days of the debtor's receipt of the goods.

Background Regarding the Specialty Shops Decision

Specialty Retail Shops Holding Corp. and its affiliated debtors, d/b/a Shopko (the "Debtors"), operated more than 300 general merchandise stores throughout the country, including more than 230 pharmacy locations. McKesson had supplied nearly all of the Debtors' pharmaceutical inventory. In December 2018—presumably in anticipation of the Debtors' bankruptcy filing—McKesson issued a reclamation demand and sued the Debtors in state court seeking the return of pharmaceutical goods that McKesson had delivered to the Debtors. However, the state court did not have an opportunity to resolve McKesson's reclamation rights because on January 16, 2019 (the "Petition Date"), the Debtors had filed for Chapter 11 bankruptcy protection.

On the Petition Date, the Debtors sought authority to obtain post-petition financing and to sell their pharmaceutical goods. McKesson objected to these requests, arguing that they would impair McKesson's reclamation rights with respect to the goods it had sold and delivered to the Debtors. As a result, the

Debtors and McKesson entered into a settlement agreement on January 25, 2019 (the "Settlement Agreement"). Pursuant to the Settlement Agreement, McKesson withdrew its objections subject to the parties' agreement that (1) McKesson would retain any reclamation and marshaling rights to the goods and, (2) if the bankruptcy court determined that McKesson had valid and enforceable reclamation and marshaling rights, McKesson would be entitled to a super priority administrative expense claim under Bankruptcy Code Section 507(b). With McKesson's objections having been withdrawn, the bankruptcy court authorized the Debtors to obtain post-petition financing and entered an order authorizing the Debtors to sell the pharmaceutical goods and pay the

proceeds from such sale to their secured lenders (the "Sale Order"). By March 1, 2019, the Debtors had sold most of their pharmaceutical goods and returned any unsold goods to McKesson.

On March 15, 2019, McKesson filed a proof of claim, asserting the Debtors owed McKesson approximately \$70.5 million on the Petition Date. McKesson's claim included an approximately \$36 million reclamation claim for pharmaceutical goods that McKesson had sold and delivered to the Debtors within the 45 days before the Petition Date, after deducting goods subject to McKesson's administrative priority claim in the amount of approximately \$2 million under Section 503(b)(9) for goods McKesson had delivered to the Debtors within 20 days of the Petition Date. On March 29, 2019, McKesson filed a request for payment of an administrative claim based on its alleged reclamation rights, asserting it was entitled to a super priority administrative expense claim in the amount of approximately \$36 million pursuant to the Settlement Agreement. The Debtors objected to McKesson's administrative claim.

The parties agreed to have the bankruptcy court hold an initial hearing to address whether McKesson was entitled to an administrative claim as a matter of law, followed by an evidentiary hearing, if necessary, to determine any factual issues regarding McKesson's request for an administrative claim. The dispute never made it past the initial hearing, as the bankruptcy court denied McKesson's request for an administrative claim based on its alleged reclamation rights. The bankruptcy court concluded that McKesson had no valid reclamation rights on the Petition Date because the Debtors' secured lenders held a prior security interest in all of the Debtors' inventory, including McKesson's goods subject to reclamation.

McKesson appealed the bankruptcy court's decision to the district court. McKesson asserted that it was entitled to an administrative claim under: (i) Bankruptcy Code

were receiving less than full payment of their secured claims.

In response, the Debtors argued that Section 546(c) provides no basis for McKesson to assert an administrative claim for goods subject to McKesson's reclamation demand. The current version of Section 546(c) does not grant McKesson an administrative claim for goods delivered to the Debtors between 21–45 days before the Petition Date. The Debtors also argued that McKesson lacked enforceable reclamation rights because McKesson's reclamation rights were always subject to the Debtors' secured lenders' prior security interest in the Debtors' inventory that included McKesson's reclamation goods. The Debtors further argued that McKesson was not entitled to an administrative claim under Section 503(b)(1)(A) for the actual and necessary costs of preserving the Debtors' estates because McKesson's

McKesson's reclamation claim. The court found that the secured lenders did not release their interests in the goods subject to reclamation or the proceeds from the sale of such goods. To the contrary, the Sale Order required the Debtors to use all pharmaceutical sale proceeds, after the Debtors' payment of budgeted operating expenses, to pay their secured indebtedness to their lenders—the net sale proceeds were simply not sufficient to fully pay the secured indebtedness. The district court considered Eighth Circuit precedent that rendered reclamation rights valueless where the secured creditor had foreclosed on the goods subject to reclamation and used all the proceeds to pay down its secured debt. The Eighth Circuit had upheld reclamation rights and granted the reclaiming creditor an allowed administrative claim or replacement lien where the debtor's secured creditor had released its security interest in the goods subject to reclamation rights and there were *traceable* proceeds available for the creditor to reclaim. However, that Eighth Circuit holding was based on the pre-BAPCPA version of Section 546(c). And, even if McKesson could prove that the lenders had released their prior security interest in the sale proceeds based on the lenders' approval of the Debtors' payment of budgeted operating expenditures from the proceeds of the lenders' collateral, McKesson presented no evidence to trace any sale proceeds to its reclaimed goods.

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."

Section 546(c) by virtue of McKesson's valid reclamation claim, (ii) the terms of the Sale Order, which provided that McKesson's reclamation rights attached to the proceeds of the sale of the goods, and (iii) Bankruptcy Code Section 503(b)(1)(A)—which grants administrative expense claims for the "actual, necessary costs and expenses of preserving the [debtors'] estate"—because the Debtors had used the proceeds of the reclamation goods to pay their post-petition operating expenses. McKesson had sought an administrative claim under Section 546(c) based on its reclamation rights, relying on prior court decisions that in turn relied on the pre-BAPCPA statute and awarded administrative priority claims to reclaiming sellers where the goods were no longer available to be reclaimed. McKesson further argued that the Debtors' secured lenders did not have a superior interest in the goods because the lenders had previously released their interests in the goods and proceeds implicitly by approving the Debtors' use of approximately \$300 million of the lenders' collateral proceeds to pay operating expenses, despite the fact that the lenders

reclamation claim was based on its prepetition transactions with the Debtors and administrative claims under Section 503(b)(1)(A) must be based on post-petition transactions.

The District Court Decision

The district court affirmed the bankruptcy court's decision, holding that McKesson was not entitled to allowance and payment of administrative expense claim on account of McKesson's alleged reclamation rights. Post-BAPCPA, the plain language of Section 546(c)(1) provides that the sole remedy for creditors with valid reclamation rights is the recovery of the goods subject to reclamation. The current version of Section 546(c)(1) contains no alternative remedies, such as an administrative claim or a replacement lien for creditors with valid reclamation rights, and the court cannot rely on case law based on the pre-BAPCPA version of Section 546(c) to craft such alternative remedies.

The district court also noted that the secured lenders' superior interest in McKesson's reclamation goods invalidated

The district court also held that McKesson was not entitled to an administrative claim under the Sale Order. Though the Sale Order stated that all interests in the pharmaceutical goods had attached to the net proceeds of the sale and listed McKesson's "alleged reclamation claim" as an interest, McKesson had not proven that there were any traceable excess proceeds against which its alleged interest could attach.

Finally, the district court rejected McKesson's argument that it is entitled to an administrative expense claim for the actual and necessary costs of preserving the Debtors' estate under Section 503(b)(1)(A). To qualify under Section 503(b)(1)(A), an expense must confer an actual benefit on the debtor's estate and the debtor's creditors, and arise from a post-petition transaction with the

debtor. The district court agreed with the bankruptcy court that McKesson's reclamation claim arose from its prepetition sale of goods to the Debtors and did not morph into a valuable post-petition administrative priority claim simply because the Debtors had properly sold the reclaimed goods after the Petition Date.


a significant blow to trade creditors asserting reclamation rights. The *Specialty Shops* decision made clear that trade creditors seeking relief on their reclamation claims will likely not be granted an administrative claim for the value of the goods subject to reclamation. It remains to be seen whether the Eighth Circuit, considering McKesson's

Trade creditors should assert their reclamation rights as soon as possible upon a customer's bankruptcy filing.

Conclusion

Trade creditors should assert their reclamation rights as soon as possible upon a customer's bankruptcy filing. Additionally, creditors should closely monitor the relief that a debtor requests shortly after its bankruptcy filing, such as approval of financing and asset sales, that could adversely impact reclamation rights.

Creditors asserting reclamation rights should also recognize the difficulty of enforcing their reclamation claims. The recent *Specialty Shops* decision certainly is

an appeal of the rulings of the bankruptcy and district courts, will continue the unfavorable treatment of reclaiming creditors seeking to enforce their reclamation rights. Stay tuned! 

**This is reprinted from Business Credit magazine, a publication of the National Association of Credit Management. This article may not be forwarded electronically or reproduced in any way without written permission from the Editor of Business Credit magazine.*