

**RETAIL RECLAMATION CLAIMS:
“GIVE ME BACK MY STUFF (OR AT LEAST PAY ME FOR IT)”**

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A. Introduction

For financially troubled retailers, two of the most significant amendments to the Bankruptcy Code effected by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005¹ (“BAPCPA” or the “2005 Amendments”) are (i) the establishment of a new administrative priority for creditors who provide goods to the debtor in the ordinary course of business within twenty days prior to the commencement of the debtor’s bankruptcy case and (ii) the expansion of the reclamation period for creditors from ten days to forty-five days.² Typically, these retailers depend almost exclusively on products provided by third-party vendors and suppliers for revenue generating inventory and the goods necessary to operate on a day-to-day basis. The ability for their vendors and suppliers to elevate their claims to administrative priority status, or to look further back in time to assert reclamation claims, dependent solely on the fortuitous timing of product shipments, puts tremendous pressure on the reorganization process for retailers, particularly in the current ultra-soft retail economy.³

B. Administrative Expense Priority Under § 503(b)(9)

¹ In general, the provisions of BAPCPA apply to bankruptcy cases filed on or after October 17, 2005. See BAPCPA, Pub. L. No. 109-8, § 1227, 119 Stat. 23, 26 (2005).

² In fact, the concerns in the retail sector are so great regarding the deleterious effects of BAPCPA’s §§ 503(b)(9) and 546(c) that in April, 2009, legislation was proposed to amend these sections back to their pre-2005 forms. See H.R. 1942 cp-sponsored by Congressman Jerrold Nadler, D-NY and Steven Cohen, D-TN. The proposed legislation is entitled the “Business Reorganization and Job Preservation Act of 2009.” The legislation also seeks to amend § 365 to the extent it imposes a 210-day limit on assumption/rejection decisions and to circumscribe the rights of utilities under § 366.

³ Data for April 2009, the last available before submission of this article, show that retail sales fell 0.4 percent in the month, following a 1.3 percent drop in March, a decline that was worse than first estimated by economists. Declines in sales were experienced across retail sectors, including furniture stores, electronic and appliance stores, food and beverage stores and gasoline stations, according to the United States Commerce Department.

In contrast with the Bankruptcy Code's reclamation provisions, BAPCPA's § 503(b)(9)⁴ priority applies even if the goods sold are no longer in the possession of the debtor or are otherwise not identifiable. The 503(b)(9) priority also applies (again, unlike reclamation) even if the goods are encumbered by a senior security interest.

Although the legislative history for this new priority is scant, according to Professor Resnick:

[T]he rationale for granting priority to such vendors is that within twenty days before bankruptcy, a debtor is likely to know that bankruptcy is imminent and that it will not be able to pay for goods delivered within that time period. Moreover, goods delivered so close to the bankruptcy filing are likely to benefit the bankruptcy estate.

Alan N. Resnick, The Future of the Doctrine of Necessity and Critical-Vendor Payments in Chapter 11 Cases, 47 B.C. L. Rev. 183, 204 (2005).

As Collier emphasizes, the new priority represents a windfall to trade creditors who provide goods to the debtor prior to the commencement of its bankruptcy case:

The addition of this provision represents a dramatic departure from bankruptcy precedent. It is also likely to lead to disparate treatment of otherwise similarly situated creditors since vendors of goods will be treated differently than other creditors providing value to the debtor during the 20-day period preceding the filing of the case.

5 Collier on Bankruptcy, ¶ 503.16[1], at 503-79 (15th ed. rev. 2008).

In fact, because of the concerns raised by the effects of § 503(b)(9) on a struggling retail economy, members of the U. S. House of Representatives have proposed amendments to § 503 that would strike entirely the provisions of subsection (b)(9), completely eliminating the right to the 20-day administrative priority claim period. Commentators suggest that the additional administrative expenses the follow from § 503(b)(9) place tremendous cash flow constraints on

⁴ Section 503(b)(9) provides, in pertinent part: “[a]fter notice and a hearing there shall be allowed administrative expenses [for] . . . [t]he value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which goods have been sold to the debtor in the ordinary course of such debtor's business.”

cash-strapped debtors by making administrative expenses of claims that, otherwise would be treated as general unsecured prepetition claims in a plan. Section 503(b)(9) is also seen as a skewing of the overarching policy of similar treatment for similarly situated creditors, elevating the claims of some pre-petition vendors over others by dint of timing.

However, before trade creditors celebrate the victories gained by the 2005 Amendments, they should carefully consider the following, unresolved issues associated with § 503(b)(9):

- **Procedure for Asserting § 503(b)(9) Claims.** Section 503(a) of the Bankruptcy Code contemplates that administrative creditors file requests for payment of post-petition expenses which are allowed under § 503(b) only after “notice and a hearing.” On the other hand, § 501 of the Bankruptcy Code contemplates that pre-petition creditors merely file proofs of claim and pursuant to § 502(a) such claims are deemed allowed unless objected to. As administrative expense priority claims, § 503 jurisprudence arguably applies to § 503(b)(9) claims. In addition, bankruptcy courts are likely to establish case-specific procedures for asserting § 503(b)(9) claims as well as adopt local rules of more general application. *In the District of Massachusetts, Local Bankruptcy Rule 3002-1 requires that creditors asserting administrative expense claims under § 503(b)(9) file them in writing with court within 60 days of the first date set for the meeting of creditors pursuant to § 341, unless the court orders otherwise.*
- **Timing of Payments.** Prior to a confirmation of a plan of reorganization, determining when an administrative expense claim is to be paid is within the discretion of the bankruptcy court. *See, e.g., In re Photo Promotion Assocs., Inc.*, 881 F. 2d 6, 9 (2d Cir. 1989); *In re Verco Indus.*, 20 B.R. 664, 665 (BAP 9th Cir. 1982). The same rule applies to claims asserted pursuant to § 503(b)(9). *See In re Global Home Products, LLC*, 2006 WL 3791955 (Bankr. D. Del. Dec. 21, 2006) (holding that the decision regarding the timing of payment of administrative expense claims is left to the discretion of court and, using the following factors—(1) the prejudice to the debtor, (2) the hardship on the administrative expense holder, and (3) the potential detriment to other parties in the case—rejecting request for immediate payment of § 503(b)(9) claim); *In re Bookbinders’ Restaurant, Inc.* 2006 WL 3858020 (Bankr. E.D. Pa. Dec. 28, 2006) (holders of allowed § 503(b)(9) claims do not have “unqualified legal entitlement to be paid at the same time as post-petition creditors who are being paid in the ordinary course pursuant to 11 U.S.C. § 363(c)(1)”). Of course, courts routinely exercise their discretion to permit immediate payment of other pre-petition claims, such as wage claims, when such claims are entitled to priority treatment and, therefore, likely to be paid in

full later in the case.

- **A New Rationale for Critical Vendor Orders.** In addition, this discretion concerning the timing of the payment of administrative expenses leaves judges (and advocates) concerned about the continued validity of the doctrine of necessity and the use of Section 105(a) of the Bankruptcy Code to pay pre-petition claims with a new justification for entry of critical vendor orders. By allowing the payment on the first day of a Chapter 11 case of § 503(b)(9) claims held by vendors deemed essential, a bankruptcy court is arguably not altering statutory priorities established by the Bankruptcy Code; but, instead, is exercising its long recognized discretion to accelerate the payment of administrative expenses which must be paid in full in any case. See generally, Shirley S. Cho, The Intersection of Critical Vendor Orders and Bankruptcy Code Section 503(b)(9), 29 Cal. Bankr. J. 7 (2007); In re Fashion Shop of Kentucky, 364 B.R. 283, 284 (Bankr. W.D. Ky 2007), *aff'd*, 2008 WL 2002256 (W.D. Ky May 5, 2008) (overruling the objection of a § 503(b)(9) creditor to the payment of a debtor's financial advisor's fees prior to the payment of its own § 503(b)(9) claim and recognizing that § 331 of the Bankruptcy Code permits a professional employed under § 327 to apply for interim compensation every 120 days, a right not afforded to § 503(b)(9) claimants.)
- **Defenses to Payment of § 503(b)(9) Claims under § 502(d) of the Bankruptcy Code.** Section 502(d) of the Bankruptcy Code requires disallowance of claims of a transferee of certain avoidable transfers, in toto, if the transferee does not pay or turn over the property received to the estate. There is a split of authority, however, over whether administrative claims (as opposed to pre-petition unsecured claims) are subject to § 502(d). Cf. In re Triple Star Welding, Inc., 324 B.R. 778 (B.A.P. 9th Cir. 2005), *abrogated on other grounds by In re AFI Holding, Inc.*, 530 F.3d 832, 851 (9th Cir. 2008) (Section 502(d) applies to administrative expense claims); In re Lids Corp., 260 B.R. 680, 683 (Bankr. D. Del. 2001) (“administrative expense claims are accorded special treatment under the Bankruptcy Code and are not subject to Section 502(d)”); Camelot Music, Inc. v. MHW Adver. & Pub. Relations, Inc. (In re CM Holdings, Inc.), 264 B.R. 141, 158 (Bankr. D. Del. 2000) (because administrative claim did not arise pre-petition, it is not a claim under § 101(10), and accordingly, § 502(d) does not apply). The new “20-day” claim, of course, is a hybrid. Such claims arise from goods furnished to the debtor pre-petition but the claims are afforded administrative expense priority and the purpose of this priority (like the priority afforded to post-petition claims) is to encourage trade creditors to do business with distressed firms. To circumvent § 502(d) defenses, accordingly, § 503(b) creditors will need to persuade courts that their claims are analogous to post-petition administrative claims and rely on the jurisprudence that holds that such claims are not subject to § 502(d). In re Plastech Engineered Products, Inc., 397 B.R. 147, 150 (Bankr. E.D. Mich. 2008) (Section 502(d) does not apply to the

allowance and payment of claims under § 503 (b)(9)).

- **The Effect of to § 503(b)(9) Awards on Preference Liability.** Pursuant to § 547(c)(4) of the Bankruptcy Code, estate representatives cannot avoid preferential transfers to the extent that after such transfer, the creditor gave new value in goods or services to or for the benefit of the debtor “on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.” In general, courts have interpreted this defense to allow a preference defendant to reduce its preference liability by the dollar value of the new goods or services it provided to the debtor after the alleged preference payment as long as the new value remains “unpaid.” Courts disagree, however, on the issue of whether post-petition payments made by the estate, as opposed to the pre-petition debtor, reduce a creditor’s subsequent new value defense. For instance, relying on the distinction between the pre-petition “debtor” and its bankruptcy estates, the court in In re Phoenix Rest. Group, Inc., 317 B.R. 491 (Bankr. M.D. Tenn. 2004) held that post-petition payments to a creditor do not negate the “new value” provided to such creditor:

Had Congress intended §547(c)(4)(B) to account for payments made post petition, the section would have included something like “an otherwise unavoidable transfer of an interest of the estate in property to or for the benefit of such creditor.” Instead, Congress disqualified only new value paid for by “the debtor” with an otherwise unavoidable transfer.

Id. at 497. On the other hand, in Moglia v. American Psychological Ass’n (In re Login Bros. Books Co., Inc.), 294 B.R. 297, 300 (Bankr. N.D. Ill. 2003), the court ignored the use of the word “debtor” in § 547(c)(4) and held that “the plain language and policy behind the statute” required a holding “that the timing of a repayment of new value is irrelevant.” In sum, as a result of § 503(b)(9), many more preference defendants will receive post-petition payments on account of goods furnished to the debtor prior to the commencement of its bankruptcy case, going forward, this issue is likely to be heavily litigated.

- **Is the Debtor Entitled to Exercise a Right of Setoff Against a Section 503(b)(9) Claim.** Generally speaking, pre-petition claims held by a debtor against a creditor cannot be setoff against administrative claims held by a creditor because they lack “mutuality.”⁵ Despite this general rule, in a case of first impression, the Bankruptcy Appellate Panel (“BAP”) for the Ninth Circuit held that, unlike other administrative priority claims that arise post-petition, § 503(b)(9) claims are pre-petition claims and are subject to setoff

⁵ Section 553(a) provides, in pertinent part, that: Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case.

against claims the debtor has against the creditor arising prior to the petition date. In re Brown & Cole Stores, LLC, 575 B.R. 873, 843-844 (B.A.P. 9th Cir. 1998). Going forward the rule announced by the BAP is likely to be tested by further litigation.

- **When does a Debtor “Receive” Goods Under Section 503(b)(9).** Section 503(b)(9) rights are triggered when it is determined that a debtor “received” the subject goods within 20 days of the petition date. The question arises particularly in the context of goods delivered through third-parties, when does the debtor “receive” the goods at issue. There is scant case law addressing the issue. See In re Pridgen, 2008 LEXIS 1274 (Bankr ED N.C. April 22, 2008) (reasoning in dictum that the Uniform Commercial Code § 2-103(1)(c) defines "receipt" of goods as "taking physical possession of them" and therefore gasoline purchased by debtor was received when it took physical possession of the gas from seller, not when title passed upon resale to the debtor's customers as urged by the seller); In re Plastech Engineered Prods. Inc., 2008 LEXIS 3130 (Bankr. ED Mich October 7, 2008) (finding little guidance from Pridgen and punting on issue of “receipt” pending evidentiary hearing; the seller later dropped its 503(b)(9) claim). For example, in the case of goods shipped internationally by shipment designated “free on board” to the debtor, does the debtor “receive” those goods when they are delivered by the vendor to the designated port for further international shipment or rather when the goods are actually received into the physical possession of the overseas debtor. Under the standard published by the International Chamber of Commerce (“Incoterm”), FOB stands for "Free On Board", and is always used in conjunction with a designated port of loading, i.e “FOB Seattle.” See "FOB Preamble", International Chamber of Commerce. Indicating "FOB" under Incoterm means that the seller pays for transportation of the goods to the port of shipment, plus loading costs. The buyer pays cost of marine freight transport, insurance, unloading, and transportation from the arrival port to the final destination. The passing of risks occurs when the goods pass the ship's rail at the port of shipment. If the goods are delivered to the arrival port 45 days before the buyer files for bankruptcy, but arrive in the debtor's possession at the final destination 15 days before a petition date, which one of those events constitutes the date of receipt of goods under § 503(b)(9)?

C. What's All the Fuss About – Revised § 546(c).

The 2005 Amendments also purport to substantially expand trade creditors' right to reclaim goods. Despite the anticipated expansion of rights, practically speaking, the effect of the revisions appears not to have altered creditor's reclamation rights significantly. In contrast with § 503(b)(9), the amendments to § 546(c) of the Bankruptcy Code effected by BAPCPA have not resulted in much benefit to trade creditors. As detailed below, the two reported decisions

published since the 2005 amendment of § 546(c) confirm that reclamation rights remain subordinate to floating liens in after-acquired inventory, including later-in-time, post-petition liens. Similarly, because retail debtors are more likely to alter, use, or dispose of goods subject to reclamation the longer they are in possession of them, the practical utility of the expanded 45-day reclamation period effected by BAPCPA remains unknown and of dubious value to creditors.

Reclamation at State Law. Reclamation potentially provides trade creditors with *in rem* rights in specific goods comparable to a security interest in the goods. Outside of bankruptcy, § 2-702 of the Uniform Commercial Code (“UCC”) governs reclamation. Section 2-702 allows a seller of goods on credit to rescind the sale and obtain a return of the goods upon “discovery” of the buyer’s insolvency. To do so, the seller must make demand on the buyer within ten (10) days of the buyer’s receipt of the goods.⁶ (The ten day limitation does not apply if a misrepresentation of solvency has been made to the particular seller in writing within three months before delivery).

This state law remedy is premised on the judgment that “any receipt of goods on credit by an insolvent buyer amounts to a tacit business misrepresentation of solvency and therefore is fraudulent as against the particular seller.” U.C.C. § 2-702(2) cmt. 2 (2004). Furthermore, under state law, reclamation is understood as a rescissional remedy that relates only to particular goods. Successful enforcement of reclamation rights, thus, requires that the very goods sold must still be

⁶ UCC § 2-702(2)-(3) provide:

(2) Where the seller discovers that the buyer has received goods on credit while insolvent, he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer’s fraudulent or innocent misrepresentation of solvency or intent to pay.

(3) The seller’s right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser under this Article (Section 2-403). Successful reclamation of goods excludes all other remedies with respect to them.

in the possession of the buyer and “identifiable” when the demand is received. See, e.g., Flav-O-Rich, Inc. v. Rawson Food Serv., Inc. (In re Rawson Food Serv., Inc.), 846 F.2d 1343, 1347 (11th Cir. 1988); Galey & Lord Inc. v Arley Corp. (In re Arlco, Inc.), 239 B.R. 261, 266-67 (Bankr. S.D.N.Y. 1999). And it is incumbent upon the reclaiming seller to “diligently pursue” its reclamation rights by filing an action to reclaim and seeking to restrain the buyer from using, consuming, commingling or selling any of the goods subject to reclamation.

Section 2-702(3). By far, however, the biggest obstacle to reclaiming goods from insolvent buyers – both inside and outside of bankruptcy – is the existence of a floating lien in favor of a secured party on the buyer’s inventory. Section 2-702(3) of the UCC provides that: “[t]he seller’s right to reclaim . . . is subject to the rights of a buyer in the ordinary course *or other good faith purchaser* under this Article.” U.C.C. § 2-702(3) (emphasis added). Section 1-201(b)(29) of the UCC., in turn, defines “purchase” as “taking by . . . lien” and a “purchaser” as a “person that takes by purchase.” U.C.C. § 2-702(29)-(30). Prior to enactment of BAPCPA, accordingly, the vast majority of courts held that secured creditors with liens on a buyer’s after-acquired inventory qualify as “good faith purchasers” within the meaning of this sub-section and thus have rights superior to a reclaiming seller. See, e.g., Allegiance Healthcare Corp. v. Primary Health Sys., Inc. (In re Primary Health Sys., Inc.), 258 B.R. 111, 114 (Bankr. D. Del. 2001) (“a creditor with a prior perfected security interest in inventory which contains an after-acquired property clause is a good faith purchase under the UCC”); In re Arlco, 239 B.R. at 266-67 (stating that “[m]ost courts have treated ‘a holder of a prior perfected, floating lien on inventory... as a good faith purchaser with rights superior to those of a reclaiming seller’” and collecting cases demonstrating the majority rule) (internal citations omitted).

Amended § 546(c). Reclamation rights in bankruptcy are governed by § 546(c) of the

Bankruptcy Code which was subject to significant amendment under BAPCPA⁷. First, rather than requiring the seller to make demand for reclamation within 10 days after the buyer's receipt of goods (or 20 days if the 10-day period expired after commencement of the bankruptcy case), § 546(c), as amended, gives the seller reclamation rights if the debtor has received the goods within 45 days of the bankruptcy case and the seller demands reclamation in writing within 45 days after the date of receipt of the goods or, if the 45-day period expires after the commencement of the case, within 20 days after the case is commenced.

Second, the amendments to § 546(c) delete the reference to any statutory or common-law right of reclamation included in the prior version of § 546(c). Third, the amendments to § 546(c) confirm that a seller's right of reclamation is subject to the "prior" rights of secured creditors that have security interests in the goods or the proceeds thereof. Fourth, the 2005 Amendments delete the judicial option of giving the seller, in lieu of reclamation, either administrative claim priority or a lien to secure its claim. Fifth, and finally, § 546(c)(2), as amended, provides that if a seller fails to make a timely, written demand for reclamation, "the seller still may assert the rights contained in section 503(b)(9)."

Even two years later, it remains to be seen whether the amendments to § 546(c) have

⁷ For the benefit of comparison, the following annotated version of 11 U.S.C. § 546(c) uses ~~strike through~~ to show deletions from the old version and *italics* to show additions:

(c)(1) Except as provided in subsection (d) of this section *and in section 507(c), and subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof*, the rights and powers of ~~a~~ *the* trustee under sections 544(a), 545, 547, and 549 ~~of this title~~ are subject to ~~any statutory or common law~~ *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 date of the commencement of a case under this title*, but ~~(1)~~ such a seller may not reclaim ~~any~~ such goods unless such seller demands in writing reclamation of such goods – (A) ~~before 10~~ *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 commencement of the case~~, if ~~such 10-day~~ *the 45-day* period expires after the commencement of the case. ~~before 20 days after receipt of such goods by the debtor; and~~ (2) *If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9).* ~~(2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court (A) grants the claim of a such seller priority as a claim of a kind specified in section 503(b) of this title; or (B) secures such claim by a lien.~~

materially improved trade creditors' ability to get paid ahead of other unsecured creditors. On its face, the expanded 45-day reclamation period appears to be a dramatic improvement. As a practical matter, however, trade creditor recoveries will only be enhanced if trade creditors can prevent the debtor from consuming, commingling or selling the goods subject to reclamation. If those goods are no longer identifiable or no longer in the debtor's possession, the expanded reclamation period is worthless. The simple fact is the longer the buyer is in possession of the goods before reclamation is attempted, the more likely the buyer will have disposed of the goods.

More importantly, under the 2005 Amendments, trade creditors' reclamation rights are expressly subordinated "to the prior rights of a holder of a security interest" in the goods to be reclaimed. In other words, "the seller may be given possession of the goods, but the seller must pay the secured creditor the value of its lien prior to obtaining possession." 5 Collier on Bankruptcy, ¶ 546.04 [2][a][vii] (15th ed. rev. 2008); cf. In re Shattuc Cable Corp., 138 B.R. 557, 563 (Bankr. N.D. Ill. 1992) ("Reclamation is in the nature of an *in rem* property right and if it cannot be exercised due to superior title vested in a good faith purchaser, then it must necessarily be extinguished.").

Nor do the 2005 Amendments appear to relieve reclaiming sellers of the rule adopted by the vast majority of courts under the prior version of § 546(c) that a reclaiming creditor is entitled to relief only to the extent it can show that the value of the specific goods to be reclaimed exceeds the entire amount of the buyer's obligations to the secured party. See, In re Dairy Mart Convenience Stores, Inc., 302 B.R. 128, 134-36 (Bankr. S.D.N.Y. 2003) (holding that reclamation claims were without value in light of a secured lender's prior floating lien on the debtor's inventory.); In re Primary Health Sys., Inc., 258 B.R. at 118 ("Under state law, a reclaiming seller would not have been able to reclaim its goods if the goods were not worth more than the value of the floating lien, because the holder of the first lien would have asserted its

rights and been entitled to all of the inventory”); In re Arlco, Inc., 239 B.R. at 272 (“it is only when the reclaiming seller’s goods or traceable proceeds from those goods are in excess of the value of the superior claimant’s claim that the reclaiming seller will be allowed . . . to reclaim the goods”); Charles J. Shaw and Brent Weisenberg, Effect of a Preexisting Security Interest in Debtor’s Inventory on the Rights of Reclamation Creditors, 2005 Norton Ann. Surv. of Bankr. Law Part I § 15 (Sept. 2006) (collecting cases); Collier at ¶ 546.04 [2][a][vii] (summarizing the law on the competing lien defense).

The rationale for this rule is that Congress did not intend to make reclaiming sellers better off in bankruptcy than outside bankruptcy where the seller could only get back goods subject to senior liens. In re Pester Refining Co., 964 F.2d 842, 847 (8th Cir. 1992). If the proceeds of the goods are ultimately used to pay senior secured creditors, accordingly, reclaiming sellers are not entitled to relief either inside or outside of bankruptcy. On the other hand, if secured creditors are paid in full from other collateral or the secured creditors otherwise release their interests in the subject goods, reclamation is available:

[o]nly when the reclaiming seller’s goods or traceable proceeds from those goods are in excess of the value of the superior claimant’s claim that the reclaiming seller will be allowed . . . to reclaim the goods The payment on the reclamation claim must derive from the goods sold by the reclaiming creditor. When goods subject to a reclamation demand are liquidated and the proceeds used to pay the secured creditor’s claim, the reclaiming seller’s subordinated right is rendered valueless Once the secured creditor is paid in full, the reclaiming seller is only entitled to reclamation when the surplus collateral remaining consists of the very goods sold by the reclaiming seller or traceable proceeds from those goods.

In re Dairy Mart Convenience Stores, Inc., 302 B.R. at 134.

Post-BAPCPA Decisions Interpreting Amended § 546(c). The few reported decisions which have construed revised §546(c), Simon & Schuster, Inc. v. Advanced Marketing Services, Inc., 360 B.R. 421 (Bankr. D. Del. 2007), appeal denied, 2008 LEXIS 27581 (D. Del. April 3,

2008); In re Dana Corporation, 367 B.R. 409 (Bankr. S.D.N.Y. 2007); and Auto Auction Assocs. of Mont., Inc. v. Incredible Auto Sales, LLC et al (In Re Incredible Auto Sales, LLC), 2007 Bankr. LEXIS 1024 (Bankr. D Mont. March 26, 2007) each confirm that the 2005 Amendments did not, as advertised, substantially expand trade creditors' reclamation rights. Instead, each decision follows pre-amendment § 546(c) jurisprudence and comes down squarely in favor of asset-based lenders with floating liens on inventory.

AMS. The first reported decision interpreting the effect of the 2005 Amendments arose out of Advanced Marketing Services, Inc.'s ("AMS") Chapter 11 case in the District of Delaware. AMS was a wholesaler of general interest books to warehouse clubs as well as certain specialty retailers, e-commerce companies, traditional bookstores and bookstore chains. Within hours of AMS's bankruptcy filing, one of its principal suppliers, Simon & Schuster, Inc. ("S&S"), served AMS with a reclamation demand seeking the immediate return of \$5,105,629.65 in goods furnished to AMS prior to the commencement of its Chapter 11 case. Less than a week later, S&S commenced an adversary proceeding against AMS seeking, among other things, to reclaim the goods and an entry of a temporary restraining order ("TRO") to enjoin AMS from selling the goods and to segregate the goods pending resolution of the adversary proceeding.

The goods S&S sought to reclaim, however, were "subject" to both pre- and post-petition liens granted to the same lender. As of the petition date, the goods were encumbered by pre-petition liens of not less than \$41,514,347.38 (the "Pre-Petition Facility"). Following the commencement of the Chapter 11 case, the bankruptcy court approved a debtor-in-possession loan (the "DIP Loan") from the same lender in the amount of \$75 million secured by a lien on all of AMS's "pre-petition, present, and future assets."

Significantly, the terms of AMS's post-petition financing did not pay off AMS's

obligations under its Pre-Petition Facility (or discharge or release any related security interests) all at once. Instead, the DIP Loan was structured as a “creeping roll up” which contemplated that pre-petition obligations would be satisfied by the proceeds of the sale of AMS’s inventory before payment of AMS’s post-petition obligations under the DIP Loan. Finally, the post-petition financing approved by the bankruptcy court contemplated that all pre-petition liens would “continue in full force and effect and secure repayment of all obligations” to the lender including obligations under the DIP Loan.

In support of its request for a TRO, S&S argued that its reclamation claim was subject only to the lender’s pre-petition lien and that, because the Pre-Petition Facility would be “soon satisfied through the ‘creeping rollup’ under the DIP Loan, S&S ultimately would succeed on the merits of its reclamation claim.” The bankruptcy court emphatically rejected this argument and its reasoning is fully consistent with pre-BAPCPA jurisprudence disfavoring reclamation rights.

First, the court found that the Pre-Petition Facility was still in place and that S&S had failed to establish whether any of the goods subject to its reclamation claim would be in AMS’s possession after satisfaction of AMS’s pre-petition obligations. Although that finding was certainly sufficient, by itself, to dispose of S&S’s motion, the court went on to hold that even if the Pre-Petition Facility were satisfied, the lenders’ later-in-time, post-petition lien would still be superior to S&S’s reclamation rights. In reaching this conclusion, the court stressed that the lenders had not released their pre-petition security interests and that the court’s previous order approving AMS’s post-petition financing expressly provided that the lenders’ pre-petition liens would secure post-petition indebtedness under the DIP Loan.

Finally, AMS further illustrates that the new 45-day reclamation period established by the 2005 Amendments may be of limited utility because the debtor may not be in possession of the goods when a seller seeks to enforce reclamation rights. Although S&S sought to reclaim goods

within hours of the commencement of the bankruptcy case and obtained a hearing on its request for a TRO within three weeks of the petition date, by the time the bankruptcy court held a hearing on S&S's request for a TRO, only \$808,000 out of the \$5,105,629.65 of the goods S&S sought to reclaim remained in AMS's possession.

Dana. Dana, another decision published since the 2005 Amendments, also involves a “prior lien” defense asserted by a later-in-time, post-petition lender. In that case, trade creditors asserted that because pre-petition liens encumbering the debtor's inventory had been satisfied by the proceeds of a debtor-in-possession loan rather than the goods themselves, the goods had been “liberated” from the prior pre-petition lien and were subject to reclamation.

In support of their claims, the trade creditors relied on the pre-amendment decision, In re Phar-Mor, Inc., 301 B.R. 482 (Bankr. N.D. Ohio 2002), amended on rehearing, 2003 Bankr. LEXIS 2009 (Bankr. N.D. Ohio Dec. 18, 2003). In Phar-Mor, as in Dana, a pre-petition secured creditor released its lien after being paid from the proceeds of a debtor-in-possession loan. The Phar-Mor court reasoned that because the “prior” lien of the pre-petition lenders had been released, the reclaiming sellers were entitled to assert the full value of their reclamation claims. The Phar-Mor court further found that because the post-petition lenders had notice of reclamation claims, they were not good faith purchasers within the meaning of § 2-702(3) of the UCC.

Even though, in contrast with AMS, all pre-petition indebtedness had been paid off and the loan documents memorializing the post-petition facility apparently lacked “cross-collateral” provisions like the ones that were dispositive in AMS, the bankruptcy court in Dana nonetheless rejected the trade creditors' reclamation claims. Instead, the court held that: “where the claim of a pre-petition secured lender with a floating lien on inventory is paid out of the proceeds of a post-petition credit facility supported by a new floating lien on inventory, the reclaimed goods

securing the pre-petition lender's debt have been disposed in satisfaction of that debt." In re Dana Corp., 367 B.R. at 419. To reach that result, the Court expressly rejected Phar-Mor and adopted the reasoning of another pre-amendment decision, In re Dairy Mart Convenience Stores, Inc., 302 B.R. 128 (Bankr. S.D.N.Y. 2003). Under Dairy Mart, irrespective of how post-petition financing is structured or documented, the release of pre-petition liens and the granting of liens to a DIP lender "must be viewed as an integrated transaction" which in effect transfers the senior pre-petition liens to the DIP lender. 302 B.R. at 135.

Similarly, the trade creditors' claim in Dana that the post-petition lenders were not "good faith purchasers" did not give the court much pause. Instead, the court held that for purposes of § 546(c) and § 2-702 of the UCC, "good faith" just means "honesty in fact and the observance of reasonable commercial standards of fair dealing." In any event, the Court further found that the creditors' claim was conclusively adjudicated and rejected in the Court's previous orders approving the post-petition financing, each of which contained "explicit findings of good faith" that were "final and non-appealable."

Although apparently not necessary to disposition of the debtor's prior lien defense, Dana also confirms that, contrary to the speculation of some academics and practitioners, the deletion of the reference to "any statutory or common-law right" in § 546(c) effected by BAPCPA did not create a new federal right of reclamation independent from state law. The court began its analysis by observing that Congress provided no explanation in the legislative history of § 546(c) for what it intended by this deletion. The Dana court next emphasized that in amending § 546(c) "Congress did not use the language of creation - Congress did not say that a seller may reclaim goods when..." 367 B.R. at 416. The court also reasoned that following the 2005 Amendments, § 546 remained entitled "Limitation on avoiding powers" and that if Congress established "a new federal reclamation right arising under the Bankruptcy Code, it would not be subject to the

avoiding powers.” Id.

The Dana court continued its analysis by stressing that when Congress amends the Bankruptcy Code, it does not write “on a clean slate” and that from its enactment § 546(c) was not construed as “the source of a right of reclamation, but simply allowed a seller to exercise a right of reclamation under non-bankruptcy law, subject to certain limitations.” Id. at 414. Next, the court observed construing § 546(c) as creating an independent federal right of reclamation that replaced state law would lead to absurd results. By way of example, the court reasoned that if § 546(c) created an independent federal reclamation right:

then in bankruptcy a reclaiming seller would conceivably have broad rights superior to those of buyers in the ordinary course of business, lien creditors or good faith purchasers other than a holder of a prior security interest. Clearly, Congress could not have intended to permit reclamation of goods sold that have been sold to consumers or other good faith purchasers.

Id. at 417.

Finally, the court concluded that construing amended § 546(c) as creating a federal reclamation right would be “contrary to the purpose of the Bankruptcy Code [as it would] enhance the rights of one set of creditors at the expense of other creditors simply because a bankruptcy petition has been filed.” Id. at 418.

Incredible Auto Sales. The Incredible Auto Sales case also highlighted with the tension between reclamation rights under “new” § 546(c) and the rights of a prior existing lien holder, in this case a lender with a floating, floor inventory lien on automobile inventory. The Debtor, Incredible Auto Sales, was a retail and wholesale dealer of automobiles. The lien holder, floor plan lender Hyundai Motor Finance Company (“HMFC”), held a blanket security interest in all of debtor's used vehicle inventory. HMFC held a properly perfected security interest in, *inter alia*, “[a]ll inventory of new and used motor vehicles and other personal property held for sale or lease including, but not limited to, display or demonstration items, returns and repossessions, and

all accessories and additions thereto." HMFC's security interest was evidenced by an Inventory Loan and Security Agreement, an Addendum, and three financing statements filed with the Montana Secretary of State's office.

A third-party wholesaler, Auto Auction Associates of Montana, Inc. d/b/a Auto Auction of Montana ("AAM") had sold seven used vehicles to debtor pre-petition. AAM delivered to the Debtor original certificates of title for six of the vehicles, but not for the seventh, a Chevy Blazer. The Debtor took possession of the vehicles in early October, 2006.

The Debtor tendered checks to AAM for three of the vehicles, all of which checks ultimately were returned for insufficient funds. The Debtor also informed AAM that there would also be insufficient funds to pay the checks for the remainder of the subject vehicles. On October 17, 2006, within days of taking delivery of the seven vehicles, the Debtor filed for bankruptcy relief. AAM served a reclamation notice for the vehicles on the petition date. When AAM sold the subject vehicles to the Debtor, it did so in the ordinary course of business at a time when the Debtor was insolvent, all of which occurred within forty-five (45) days of the commencement of the bankruptcy case.

To receive floor plan advances to buy used vehicle inventory, the Debtor first was required to pay for the vehicle with its own money. When the Debtor received signed certificates of title for the vehicles, the Debtor would send those certificates to HMFC by facsimile. HMFC would then advance the Debtor the funds.

HMFC advanced the Debtor new money under the Inventory Loan and Security Agreement for all but one of the subject vehicles, on the same dates that the Debtor purchased the subject vehicles. Before advancing funds, HMFC received copies of signed certificates of title for each of the Subject Vehicles, except for the one for which no new funds were advanced and the Chevy Blazer for which no certificate of title was provided. AAM disputed that HMFC's

lien rights extend to the subject vehicles.

On December 7, 2006, AAM and HMFC filed a joint motion for relief from stay, asking that the subject vehicles be sold at auction and their proceeds be segregated, in order to minimize further depreciation of the subject vehicles. The vehicles were eventually sold at a court-ordered auction.

The bankruptcy court held that HMFC was entitled to all of the proceeds of the subject vehicles, except the Blazer, by virtue of its security interest because AAM delivered the titles for the six vehicles and Debtor tendered checks for and took possession of the vehicles. The Court noted that, even before BAPCPA, and with rare exception, flooring lenders for businesses with perfected security interests in pre- and postpetition inventory held superior rights to a seller's reclamation rights under the Uniform Commercial Code ("UCC") or the bankruptcy code. The Court then looked to Montana state law to determine the property rights of the respective parties.

AAM argued that, pursuant to industry custom, title to an auctioned vehicle does not pass and the sale is not complete until good funds have been paid for the vehicle. The court, however, found that there was no evidence that the parties "explicitly agreed" that title would pass only after payment for the vehicles.

The court further held that no evidence existed in the record on the six vehicle transactions that personnel for Debtor knew when it tendered its checks that insufficient funds would prevent the bank from processing the checks tendered to AAM and subsequently deposited by the AAM.

The court held that AAM was entitled to recover the proceeds derived from the sale of one vehicle and that HMFC was entitled, by virtue of its perfected pre-petition inventory lien, to recover the proceeds derived from the sale of the remaining six vehicles.

Practical Lessons. Retail debtors can draw the following practical lessons from AMS,

Dana and Incredible Auto Sales:

- First, reclamation rights of trade creditors are often worthless if, as is usually the case, a debtor’s inventory is subject to a floating lien on after acquired property. See, e.g. Richard McQueen and Jack F. Williams, Tax Aspects of Bankruptcy Law and Practice § 7:11 (3d ed. 2006) (“The reality is that, in most cases, asset-based financing provides a prior protected lien on most goods such that the right of reclamation is rendered moot.”). A trade creditor relying on reclamation rights is no more likely to succeed in reclaiming goods sold and would be better served seeking (i) payment in advance, (ii) cash on delivery payment terms, or, (iii) alternatively, taking a purchase money security interest in the goods sold to a distressed buyer.
- Second, notwithstanding the recent case law, retail debtors must be wary of the effects that refinancing senior secured pre-petition debt with DIP financing may have in revitalizing reclamation claims. Trade creditors may have an opportunity to recover on otherwise out-of-the-money reclamation claims because, under § 546(c), as revised by BAPCPA, trade creditors’ reclamation rights are subject only to “the prior rights of a holder of a security interest” in goods otherwise subject to reclamation. (emphasis supplied). Depending on how DIP financing is structured and documented, Phar-Mor and its progeny can provide trade creditors with a powerful argument that, where prior liens are satisfied by sources other than the goods to be reclaimed, reclamation rights trump later in time post-petition liens on the goods. And Dana teaches that in order to preserve their reclamation rights, trade creditors need to timely object to good faith findings and other provisions inconsistent with their reclamation rights in the boilerplate DIP financing orders that debtors and post-petition lenders present to bankruptcy courts for approval.
- Third, even in the absence of competing liens, the burden is squarely on trade creditors to show that goods delivered to a debtor during the expanded 45-day reclamation period are in the possession of the debtor when their reclamation demands are ultimately served. Consequently, establishing a reclamation claim may require that the seller seek expedited relief to enjoin the buyer from altering, processing, or disposing of goods and/or authority from the court to immediately inspect and inventory the goods in the buyer’s possession.

Despite the apparent limited utility of § 546(c) in expanding the reclamation rights of trade creditors, there is nevertheless tremendous pressure being exerted from the retail sector to amend this section of the Bankruptcy Code. The retailers concerns again focus on the negative



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implications for cash flow and the increased administrative burden and expense in dealing with a possible quadrupling of the reclamation reach-back period. Proposed legislation seeks to roll back the language of § 546 to pre-2005 status, eliminating the 45-day reach back period, supplanting it with the traditional, UCC-based 10 day demand period.