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Court Ruling a Reprieve for Bankruptcy Reclamation Rights?

Bankruptcy Code Section 546(c)(1), as amended in 2005, subjects a creditor's reclamation rights to the prior rights of a secured creditor with a blanket security interest in the debtor's inventory. This provision has been frequently invoked to block relief on a creditor's bankruptcy reclamation claim.

The Delaware Bankruptcy Court's decision in the *In re Reichhold Holdings US, Inc.* case might breathe new life into trade creditors' bankruptcy reclamation rights. The *Reichhold* court followed the rarely invoked holding of the U.S. Court of Appeals for the Sixth Circuit, in *Phar-Mor*, that a reclaiming creditor's rights were not extinguished when a pre-petition loan secured by a blanket security interest in the debtor's inventory was subsequently repaid by the proceeds of a Chapter 11 loan also secured by the debtor's inventory. The court held that the creditor's reclamation rights arose before, and had priority over, the Chapter 11 secured loan. The court rejected the holdings of the U.S. Bankruptcy Court for the Southern District of New York in the *Dairy Mart* and *Dana Corporation* cases, upon which



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many courts have relied in denying relief on reclamation claims. These courts held that creditors' reclamation rights were extinguished by pre-petition loans secured by the debtors' inventory that the debtors had subsequently repaid with the proceeds of the debtors' Chapter 11 secured financing. Both the *Dairy Mart* and *Dana Corporation* courts treated the pre-petition and Chapter 11 secured loans as one transaction that allowed the Chapter 11 secured lenders' security interests in the debtors' inventory to retain priority over creditors' reclamation rights because the security interests related back, prior to the assertion of reclamation rights, to the attachment and perfection of the pre-petition security interests.

Reclamation Rights under Bankruptcy Code Section 546(c)

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

(1) . . . [S]ubject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under Sections 544(a), 545, 547 and 549 are subject to the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days 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.

Under Section 546(c)(1), 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 prior to bankruptcy. A creditor's reclamation rights are contingent upon the creditor sending a written reclamation demand to the debtor identifying the goods 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. The reclaiming creditor must also prove the debtor was insolvent when the goods were received and that the goods were identifiable and on hand when the demand was made.

A reclaiming creditor's rights are subject to the prior rights of a creditor with a security interest in the debtor's inventory. Put another way, a secured lender with a lien

on inventory that arises before a reclamation demand has priority over the goods sought to be reclaimed because those goods are part of the debtor's inventory.

Section 546(c)(1) also states that reclaiming goods is the *sole* remedy for a creditor that has satisfied the requirements for reclamation, as opposed to the previous version of Section 546(c)(1), which provided creditors alternative remedies of receiving an allowed administrative priority claim or a replacement security interest in lieu of reclaiming the goods.

The Dana Corporation and Dairy Mart View vs. the Phar-Mor View

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

In both *Dairy Mart* and *Dana Corporation*, the debtors' pre-petition lenders had security interests in substantially all of the debtors' assets, including inventory. After their bankruptcy filings, the debtors used part of the proceeds of their Chapter 11 loans to fully pay the pre-petition loans. As is typical in Chapter 11 cases, the debtors granted their Chapter 11 lenders security interests in substantially all of the debtors' assets, including inventory.

The *Dairy Mart* court denied relief to the reclamation creditors, holding that their reclamation claims were valueless. The

court concluded that the debtor had used the goods subject to reclamation, along with all other goods securing the pre-petition lenders' debt, to repay that debt. The court treated the pre-petition and Chapter 11 secured loans as an "integrated transaction." As a result, the Chapter 11 lender's security interests in the debtor's inventory related back to the pre-petition secured lenders' security interest in inventory, which was prior to and, therefore, enjoyed priority over, reclamation rights.

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The *Dana Corporation* court agreed with the *Dairy Mart* court and denied relief to reclamation creditors. The *Dana* court also held reclamation rights were rendered valueless based on an unbroken chain between the pre-petition lenders' and the Chapter 11 lenders' security interests in the debtor's inventory where the debtor had used the proceeds of its secured Chapter 11 loan to fully repay its pre-petition secured loan. Reclamation rights remained subject to the Chapter 11 lenders' security interest in the debtor's inventory since it was deemed to relate back to the pre-petition lenders' security interest.

But not all decisions have rejected reclamation rights in this context. In the *Phar-Mor* case, the debtor had also paid off its pre-petition loan, which was secured by the debtor's inventory, with the proceeds of a Chapter 11 loan, also secured by inventory. However, this time, in 2008, the Court of Appeals for the Sixth Circuit upheld creditors' reclamation rights, finding that the pre-petition loan was fully paid from the proceeds of the Chapter 11 financing, and not from the disposition of reclamation goods, explicitly rejecting the holdings of *Dairy Mart* and *Dana Corporation*. The court also relied on the fact that the pre-petition lenders' security interests were

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released and the Chapter 11 lenders' security interests were entirely new and unrelated to the prior liens on the debtor's inventory. The Sixth Circuit then went further and held, based on old precedent, that a secured lender with a blanket security interest in the debtor's inventory does not have a prior interest in reclamation goods because reclamation creditors retain title to their goods. However, it has always been unclear, at least until the *Reichhold* court's decision, whether the Sixth Circuit's holding in the *Phar-Mor* case, which dealt with the prior version of Section 546(c) (and not Section 546(c) as amended by the 2005 amendments to the Bankruptcy Code), still applies to reclamation rights.

The *Reichhold* Holding

Background

On Sept. 30, 2014 (the petition date), Reichhold Holdings U.S., Inc. filed Chapter 11 in the U.S. Bankruptcy Court for the District of Delaware. Reichhold and its affiliates were leading suppliers of intermediate products for the composites and coatings industry.

Debtors' Financing Arrangement

At the time of the bankruptcy filing, Reichhold's pre-petition lender had a security interest in substantially all of Reichhold's assets, including inventory. After the bankruptcy filing, Reichhold entered into a court-approved Chapter 11 financing arrangement that granted the Chapter 11 lenders a first-priority security interest in all of Reichhold's assets, including inventory. Reichhold used the proceeds of the Chapter 11 financing to pay off its pre-petition secured indebtedness.

Covestro's Reclamation Demand

Within a few days of the bankruptcy filing, Covestro, a trade creditor, sent Reichhold a timely written reclamation demand for the return of goods Reichhold had received between 21 and 45 days prior to the Chapter 11 filing date. Covestro had previously received full payment for goods Reichhold had received within 20 days of the filing by virtue of Covestro's Section 503(b)(9) administrative priority claim. Covestro also timely filed a proof of claim in the amount of \$411,781.72, asserting administrative priority status for the goods that were part of Covestro's reclamation demand.

Trustee Objects to Covestro's Reclamation Claim

The liquidating trustee of Reichhold's bankruptcy estate objected to Covestro's reclamation claim on the ground that the Chapter 11 lenders' security interest in Reichhold's inventory had extinguished Covestro's reclamation rights. The trustee relied on the *Dairy Mart* and *Dana Corporation* decisions to argue that the Chapter 11 lenders' security interest in inventory related back to the pre-petition lender's security interest and, therefore, had priority over Covestro's reclamation rights since the pre-petition and the Chapter 11 secured loans were an "integrated transaction." The trustee also asserted that the debtor had used the reclamation goods to repay the pre-petition secured loan.

Covestro's Response

Covestro responded that its reclamation rights were not subject to the Chapter 11 lenders' security interest in Reichhold's inventory because the lenders' security interest was distinct and separate from the pre-petition lender's security interest and arose after Covestro's reclamation rights arose.

The Bankruptcy Court's Decision

The *Reichhold* court overruled the trustee's objection to Covestro's administrative claim based on Covestro's reclamation rights.¹ The court held that Covestro's reclamation claim had priority over, and was not extinguished by, the Chapter 11 secured loan.² The court agreed with the *Phar-Mor* decision that creditors' reclamation rights have priority where a pre-petition secured loan was satisfied and the reclamation rights arose before the Chapter 11 lenders' security interest had attached to the reclamation goods. The court rejected the *Dairy Mart* and *Dana Corporation* holdings that extinguished reclamation rights based on pre-petition debt secured by the debtor's inventory, notwithstanding that it was subsequently repaid by the Chapter 11 secured financing.

The *Reichhold* court reasoned that a security interest is terminated once the debt is repaid. In this case, the pre-petition lender's security interest was satisfied when Reichhold used the proceeds of the Chapter 11 financing to pay off the pre-petition loan. Meanwhile, Covestro's reclamation rights remained in force and had priority over the Chapter 11 lenders' security interest in inventory that attached thereafter.

The *Reichhold* court rejected the *Dairy Mart* and *Dana Corporation* courts' view that the pre-petition and Chapter 11 secured loans were an "integrated transaction." These were "two different loans by two different lenders at two different times." The Chapter 11 lenders had no prior rights in the goods under Section 546(c) of the Bankruptcy Code because Covestro's reclamation rights arose before the Chapter 11 lenders had any rights in the reclamation goods.

Moreover, the court found that the pre-petition lender's secured claim was paid from the proceeds of the Chapter 11 financing and not from the sale of Covestro's reclamation goods; Covestro's goods were merely pledged to secure the Chapter 11 financing. As a result, Covestro had continuing reclamation rights that were not extinguished when the pre-petition loan was paid off. The Chapter 11 lenders' security interest in

Reichhold's inventory was subject to Covestro's reclamation rights under Section 546(c) since Covestro's reclamation rights arose before the Chapter 11 lenders' inventory security interest attached. Therefore, Covestro's reclamation claim still retained priority over the Chapter 11 lenders' lien.

Conclusion

It remains to be seen whether future courts will follow the *Reichhold* and *Phar-Mor* view that favors reclamation rights or the contrary *Dairy Mart* and *Dana Corporation* view. It is also likely that creative attorneys will attempt to draft around the *Reichhold* court's holding, particularly with respect to orders approving Chapter 11 financing. Nonetheless, the *Reichhold* decision might resurrect trade creditors' bankruptcy reclamation rights that were previously written off as all but worthless. ■

1. Interestingly, the bankruptcy court never addressed the fact that allowance of an administrative claim is no longer a remedy available to reclamation creditors under Section 546(c) of the Bankruptcy Code.

2. The court also noted that its decision did not address the trustee's other grounds for objecting to Covestro's reclamation claim.

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