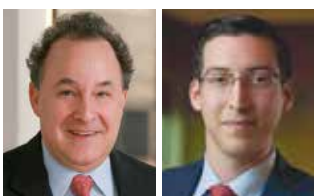




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Seventh Circuit Upholds Chapter 11 Secured Lenders' Priority over Reclamation Claimants

Trade creditors of financially distressed customers that filed for bankruptcy relief can assert reclamation rights as part of their recovery toolkit. However, the Bankruptcy Code restricts reclamation rights by explicitly subjecting them to the prior rights of a secured creditor with a blanket security interest in the debtor's inventory (which includes goods subject to reclamation).

Courts have issued conflicting opinions as to whether a lender providing Chapter 11 financing with a blanket lien in the debtor's inventory has priority over a reclamation creditor where the post-petition loan is used to pay off a prepetition loan secured by a blanket security interest in the debtor's inventory. In the Chapter 11 cases of *In re hhgregg, Inc.*, the United States Court of Appeals for the Seventh

Circuit (the "Seventh Circuit") recently concurred with other courts in ruling in favor of the post-petition lenders where the debtors had obtained the bankruptcy court's approval of Chapter 11 financing granting the post-petition lenders a prior security interest in all of the debtors' inventory. The Seventh Circuit concluded the post-petition secured lenders had retained a prior interest in the goods subject to reclamation rights because the "lien chain" between the prepetition and post-petition secured lenders had not been broken.

Other courts, including the United States Court of Appeals for the Sixth Circuit (the "Sixth Circuit"), in *In re Phar-Mor, Inc.*, a bankruptcy case that predated the change to the reclamation statute arising in the Bankruptcy Abuse Prevention and

Consumer Protection Act enacted in 2005 (“BAPCPA”), and the Delaware bankruptcy court, in *In re Reichhold Holdings, U.S., Inc.*, have held that a trade creditor’s reclamation rights had priority over a Chapter 11 lender’s post-petition security interest in the reclaimed goods. The courts relied on the fact that the reclamation rights had arisen prior to the creation of the lenders’ post-petition security interest in the debtor’s inventory.

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 goods were sold to the debtor on credit terms, the debtor was insolvent when it had received the goods, and the creditor demanded return of the goods within 10 days of their receipt by the debtor. There are two definitions for insolvency under the UCC: (i) a balance sheet definition of a debtor’s liabilities exceeding its assets, and (ii) an equitable definition of a debtor’s inability to pay its debts as they become due or in the ordinary course of business.

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)

In bankruptcy, reclamation rights are set forth in Section 546(c) of the Bankruptcy Code, which 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 on credit terms to the debtor in the ordinary course of the creditor’s business that the debtor had received within 45 days prior to bankruptcy. A creditor seeking reclamation of its goods must send a written reclamation demand to the debtor identifying the goods subject to reclamation 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 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 creditor made its reclamation demand.

Section 546(c)(1) also provides that reclaiming goods is the *sole* remedy for a creditor that has satisfied the requirements for reclamation. This is in contrast to the prior version of Section 546(c)(1) in place before BAPCPA, which granted creditors alternative remedies of an allowed administrative priority claim or a replacement security interest in lieu of return of the goods.

The Seventh Circuit, in its *hhgregg* decision, relied on Section 546(c)’s statement that a reclaiming creditor’s rights are subject to the prior rights of a creditor with a security interest in the debtor’s inventory. And, as illustrated by the *hhgregg* decision, the prior rights of the secured creditor should be clear where the competing secured creditor is the debtor’s prepetition lender with a blanket security interest in all of the debtor’s inventory, including the reclamation goods. The division among the courts has occurred in cases where the debtor’s post-petition secured lender had paid off

the prepetition secured loan and asserted priority status over creditors asserting reclamation rights.

Background and Procedural History of the *hhgregg* Case

On March 6, 2017 (the “Petition Date”), appliance retailer hhgregg, Inc. and affiliated entities (collectively, the “Debtors”) filed their Chapter 11 bankruptcy cases in the bankruptcy court in the Southern District of Indiana. On the Petition Date, the Debtors owed approximately \$66 million under a prepetition revolving credit facility with Wells Fargo Bank (“Wells Fargo”), as administrative agent and collateral agent for certain financial institutions (collectively, the “Prepetition Secured Lenders”). All advances by the Prepetition Secured Lenders were secured by a first priority security interest in substantially all of the Debtors’ assets, including existing and after-acquired inventory and, therefore, goods subject to trade creditors’ reclamation rights.

On the Petition Date, the Debtors entered into an agreement with Wells Fargo and GACP Finance Co. (collectively, the “DIP Lenders,” and together with the Prepetition Secured Lenders, the “Secured Lenders”) to obtain up to \$80 million in secured post-petition financing (i.e., “DIP financing”). On March 7, 2017, the Debtors moved for interim approval of the DIP financing, and the bankruptcy court granted the request that same day. The bankruptcy court entered an order approving the DIP financing on an interim basis, which granted the DIP Lenders a priming first priority lien in virtually all of the Debtors’ assets, including all existing and after-acquired inventory and proceeds, and a superpriority administrative expense claim. The lien was “effective immediately upon the entry of [the interim order]” and was “senior and superior in priority to all other secured and unsecured creditors.” The financing order also authorized the debtors to use the post-petition secured loans to repay the Prepetition Secured Lenders’ claims exceeding \$66 million.¹

Three days later, on March 10, 2017, Whirlpool Corporation sent a reclamation demand to the Debtors seeking the return of approximately \$16.3 million of unpaid

inventory delivered to the Debtors during the 45-day period prior to the Petition Date. In April 2017, Whirlpool filed an adversary complaint against the Debtors and the Secured Lenders seeking a declaration that its reclamation claim was first in priority with respect to the reclaimed goods. Among other things, Whirlpool argued that the Secured Lenders had not acted in good faith because, despite knowing the Debtors were insolvent, the Secured Lenders enabled the Debtors to buy additional inventory from Whirlpool and other vendors by continuing to provide financing to the Debtors.

The bankruptcy court entered orders on April 7, May 10, and May 17, 2017, that authorized the Debtors to sell their inventory, including the goods subject to Whirlpool's reclamation rights, in going-out-of-business sales. The bankruptcy court's April 7, 2017 order reserved Whirlpool's reclamation rights by attaching these rights to the proceeds from the sale of Whirlpool's reclaimed goods with the same validity, defects and priority (or lack of priority) as prior to entry of the order.

On May 18, 2017, the Secured Lenders moved to dismiss Whirlpool's complaint, arguing that the Secured Lenders' security interest in the Debtors' inventory had priority over Whirlpool's rights to the reclaimed goods because the security interest related back to the Prepetition Secured Lenders' blanket security interest in the inventory. Whirlpool argued that it had "jumped into first position" with respect to the reclaimed goods during a "gap in the lien chain" because Whirlpool's reclamation claim allegedly existed as of the Petition Date, a day before the DIP Lenders had obtained their security interest. Whirlpool also argued that the Prepetition Secured Lenders were not good faith purchasers under UCC Section 2-702(3), and, therefore, Whirlpool's reclamation claim was not subject to the rights of the Prepetition Secured Lenders.

The bankruptcy court treated the Secured Lenders' motion to dismiss as a motion for summary judgment, and granted the motion. The Bankruptcy Court held that the Secured Lenders' "lien chain ... remains unbroken and prior to Whirlpool's reclamation demand." On the Petition Date,

the Prepetition Secured Lenders held a first-priority, perfected floating lien on the Debtors' inventory, and the next day (March 7, 2017), the DIP Lenders were granted a first-priority, perfected lien on the Debtors' assets, including inventory, effective immediately. Therefore, when Whirlpool made its reclamation demand on March 10, 2017, its goods were already subject to the Secured Lenders' post-petition security interest in the Debtors' inventory. The bankruptcy court also held that it did not need to address the issue of whether the Prepetition Secured Lenders were "good faith purchasers" because Bankruptcy Code Section 546(c) subjects an otherwise valid reclamation claim to the prior rights of a creditor with a security interest in the reclamation goods, regardless of whether the secured creditor was a "good faith purchaser" under UCC Section 2-702.

Whirlpool appealed the bankruptcy court's decision to the district court, which affirmed and largely adopted the bankruptcy court's opinion. Whirlpool then appealed the district court's decision to the Seventh Circuit.

Seventh Circuit Affirms Summary Judgment in the Secured Lenders' Favor

The Seventh Circuit affirmed the lower courts' decisions, holding that the Secured Lenders' security interests had priority over Whirlpool's rights to the reclaimed goods. The Seventh Circuit explained that Bankruptcy Code Section 546(c) creates "a federal priority rule for resolving disputes between reclamation sellers and secured lenders over the same goods ... it's crystal clear that a seller's reclamation claim is subordinate to 'the prior rights of a holder of a security interest.'" The Seventh Circuit noted that, as a practical matter, if the value of any given reclamation claimant's goods does not exceed the amount of debt secured by the prior existing lien, the reclamation claim is valueless.

The Seventh Circuit rejected Whirlpool's argument that its reclamation claim was in effect as of the Petition Date and jumped ahead of the Secured Lenders' security interests due to a gap in the lien chain. First, the Seventh Circuit held that

Whirlpool's reclamation claim did not arise on the Petition Date; rather, it arose when Whirlpool made its reclamation demand on March 10, 2017, three days after the DIP financing liens had attached to the Debtors' inventory. Second, the Seventh Circuit agreed with the lower courts that there was no gap in the lien chain. Whirlpool's goods were continuously encumbered by the Secured Lenders' prepetition and post-petition liens. Therefore, Whirlpool's reclamation claim did not jump into first priority when the Secured Lenders' prepetition lien was extinguished by the Debtors' use of DIP financing to satisfy the prepetition secured debt.

The Seventh Circuit also affirmed the lower courts' holding that the issue of the Prepetition Secured Lenders' good faith is irrelevant to the analysis. Bankruptcy Code Section 546(c) expressly subordinates a seller's reclamation claim to the prior rights of a lienholder without reference to state law or the UCC, so there is no need to import the good faith purchaser inquiry from the UCC when reviewing reclamation claimants' rights in bankruptcy.

Conclusion

The Seventh Circuit, in its *hhgregg* decision, continues the adverse trend that reclamation claimants face when their financially distressed customers file bankruptcy, particularly where the bankruptcy court approves post-petition secured financing at the inception of a bankruptcy case that is used to pay off a debtor's prepetition secured debt. Courts that are bound by the Seventh Circuit's holding or rely on other like-minded court decisions, such as decisions by the Southern District of New York bankruptcy courts (in the bankruptcy cases of *Dana Corporation and Dairy Mart Convenience Stores, Inc.*) will similarly rule that reclamation claims are subject to the unbroken chain of the debtor's prepetition and post-petition secured lenders' security interests in the debtor's inventory.


That said, reclamation claimants can take solace in the fact that other courts, relying on the reasoning of the Sixth Circuit and the Delaware bankruptcy court, may be more sympathetic to the rights of reclamation claimants. These courts have granted reclamation claims priority over

a debtor's post-petition lenders with a security interest in the debtor's inventory where the post-petition lenders' loans had paid off prepetition loans that were also secured by the debtors' inventory. One must wonder whether the Seventh Circuit, in the *hhgregg* case, would have reached a different decision had there been no overlap between the Prepetition Secured Lenders and the DIP Lenders. Similarly, perhaps the Seventh Circuit would have held differently, and considered the "lien chain" to have been broken, had Whirlpool asserted its reclamation rights by sending its written reclamation demand on the first day of the case—prior to the bankruptcy court's interim approval of, and granting of liens in connection with, the Debtors' DIP financing.

Bottom line, the *hhgregg* decision suggests that trade creditors considering asserting reclamation rights should pay close attention during the initial days of their

customer's bankruptcy case. Particularly, creditors should review the debtor's "first day" motions that seek immediate relief to facilitate the debtor's business operations, specifically, the motion seeking approval of post-petition financing. The "first day" orders, even if approved on an interim basis, usually greatly impact the debtor's creditors and stakeholders. Trade creditors should assert their reclamation rights by sending a written reclamation demand as soon as possible after a customer's bankruptcy filing, preferably on the first day of the case. Trade creditors should also consider objecting to post-petition financing that "rolls up" prepetition debt into a Chapter 11's post-petition secured claim and grants the lender a post-petition security interest in the debtor's inventory that has priority over reclamation rights.

Better yet, creditors should be requiring cash on delivery terms when selling goods to distressed customers in order to avoid

the risk of nonpayment of their claims when their financially distressed customers file for bankruptcy. 

1. The financing order also granted the Prepetition Secured Lenders, as adequate protection, a replacement lien in the debtors' assets and a superpriority administrative expense claim, both of which were subordinate to the DIP Lenders' secured and superpriority administrative priority claims.

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