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Section 546(c) and Reclamation Rights after BAPCPA: A Response to Wilson and LeHane

Written by:
Russell C. Silberglied
Richards, Layton & Finger PA
Wilmington, Del.
silberglied@rlf.com

Marcos A. Ramos
Richards, Layton & Finger PA
Wilmington, Del.[1]
ramos@rlf.com

Last month, readers of the *ABI Journal* learned[2] that the Delaware Bankruptcy Court issued what appears to be the first written post-BAPCPA opinion in the world addressing reclamation-related issues under amended §546(c) of the Bankruptcy Code.[3] As ably described in a well-written article by Eric Wilson and Robert LeHane, the opinion denied a motion for a temporary restraining order filed by Simon & Schuster Inc. (Simon & Schuster) against debtor AMS. Simon & Schuster's underlying complaint sought reclamation of books and other inventory (the goods) Simon & Schuster alleges it delivered to AMS during the 45-day period preceding AMS's bankruptcy filing; its TRO application sought to prevent AMS from selling the goods pending trial on its reclamation and other claims.


Russell C. Silberglied

Wilson and LeHane argue that the opinion is an important decision that addresses significant issues of first impression under the newly amended §546(c). We agree. We also agree that the opinion is a positive precedent for debtors and lenders defending against reclamation claims and, particularly, reclaiming creditors seeking immediate—and often potentially debilitating—injunctive relief.

About the Authors

Russell Silberglied is a director and Marcos Ramos is an associate of Richards, Layton & Finger PA in Wilmington, Del. Richards, Layton & Finger PA is counsel to Advanced Marketing Services Inc. (AMS) and its associated debtors (collectively with AMS, the debtors) in their pending bankruptcy cases in the Delaware Bankruptcy Court, and the authors represented AMS in the specific case described herein.


Marcos A. Ramos

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However, we disagree with Wilson and LeHane's position that unless the opinion is immediately overturned on appeal, BAPCPA will largely have failed to provide new rights to vendors who ship goods to a debtor shortly pre-petition where, as was the case in AMS's bankruptcy and many other cases, the lender has a lien on the debtor's inventory. That position (1) ignores new §503(b)(9), a very significant addition to the landscape of remedies available to the reclamation creditor, and (2) assumes that a reclamation creditor is left without a remedy just because it cannot enforce specific performance by emergency injunctive relief. The latter proposition might be true in some cases, but certainly will not be true in all, any more than it was before BAPCPA. Of course, there remains the underlying issue of whether an appeal from the court's denial of a temporary restraining order is even permitted.[4]

Second, while we agree with Wilson and LeHane's observation that the opinion relied not only on the lender's pre-petition liens on the goods but also on post-petition liens on the same goods, we think that one of the reasons that the post-petition liens were permitted is crucial and not described in Wilson and LeHane's article. We will describe it below and point out that where these are not the facts presented in a future case, the result potentially could differ, at least on that point. Third, we take issue with Wilson and LeHane's statement that the opinion did not address Simon & Schuster's argument that it would be irreparably harmed because Simon & Schuster's "statutory right" to reclaim the goods would be lost once AMS sold the goods. The opinion in fact directly addressed this argument and found that Simon & Schuster had not met its threshold burden to prove that it had a statutory right to reclamation given the lenders' liens, and thus refused to permit Simon & Schuster to put the proverbial cart before the horse.[5] In any event, we will show (although it was not a subject covered by the opinion) that this argument proves too much. As long as a vendor is paid in full for the goods sought to

1 The analysis and conclusions set forth in this article are those of the authors alone and not necessarily of Richards, Layton & Finger PA nor its clients.

2 *See* Wilson, Eric R., and LeHane, Robert L., "Secured Lenders' Pre-and Post-Petition Liens Trump Reclamation Rights under Amended §546(c)," *ABI Journal*, Vol. XXVII, No. 2 (March 2007) (hereinafter, the "article").

3 *See Simon & Schuster Inc. v. Advanced Marketing Services Inc.* (*In re Advanced Marketing Services Inc.*), 2007 WL 162685 (Bankr. D. Del. Jan. 22, 2007) (Sontchi, J.) (hereinafter, the "opinion").

4 It is far from clear that any court—the Third Circuit (to which Simon & Schuster seeks to certify its appeal) or the Delaware District Court—will accept an interlocutory appeal of a denial of a temporary restraining order. AMS has objected to an interlocutory appeal precisely because denials of temporary restraining orders are not typically reviewable (*see Richardson v. Kennedy*, 418 F.2d 235 (3d Cir. 1969) ("we hold that the refusal to issue [a temporary restraining] order is equally not appealable"), and for many other reasons. Simon & Schuster's motion for leave to appeal only recently has been submitted and no ruling was available as of the time this article was prepared.

5 *See* Opinion, 2007 WL 162685, *5.

be reclaimed—for example, either through §503(b)(9) or a general administrative expense claim—it defies the entire purpose of the concept of reclamation to allow specific goods to be reclaimed.

Fourth, Wilson and LeHane argue that the BAPCPA amendments to §546(c)(2)—which deleted specific reference to alternative replacement liens or administrative expense claims—require the court to find that it only may respond to a §546(c) reclamation claim by forcing the debtor to return the subject goods. We do not believe that this change tied the court's hand, and the opinion certainly does not so conclude. Indeed, it can equally be said that BAPCPA did not insert new language stating that alternative remedies are not available, and that the effect of the BAPCPA amendment was to eliminate language that *restricted* the panoply of remedies that a court might award instead of specific reclamation of goods.

Finally, we agree with Wilson and LeHane that the opinion stated that Simon & Schuster in essence sought marshaling and that a reclaiming creditor cannot invoke the doctrine of marshaling over the interests of a secured lender. Wilson and LeHane do not say much more about this point, but we will explore it more below, because the court's treatment of this issue demonstrates that the law has not changed on this point after BAPCPA—a welcome result.

Brief Factual Discussion

This article assumes that the reader reviewed last month's article by Wilson and LeHane and therefore dispenses with a lengthy recitation of the facts. For our purposes, we want to mention only certain facts related to AMS's financing agreements that are relevant to the issues described below.

Prior to their petition date, the debtors' senior revolving debt facility (the senior facility) was secured by a floating lien on substantially all of the debtors' assets including inventory, and importantly for the court and its Opinion, the goods. The very same lenders agreed to provide a DIP loan on virtually identical terms—so similar, in fact, that the debtors and lenders were able to blackline the DIP loan against the pre-petition senior facility for presentation at the interim hearing on the DIP motion.

Largely because the very same lender provided the pre-petition and post-petition facilities, the debtors' interim DIP loan did not extinguish their pre-petition obligations under the senior facility or discharge or release any related security interests. Instead, the senior lenders' pre-petition liens were converted, or "rolled," over time into a senior post-petition lien on the debtors' pre and post-petition assets, and the debtors were required to pay their pre-petition obligations to the lenders under the senior facility before paying their post-petition obligations. The court also "ratified and confirmed" the senior lenders' pre-petition security interests and liens in favor of the debtors' post-petition lenders.[6] While only the interim DIP order was in place at the time of the opinion, subsequently a final DIP order, bearing the same terms, has been entered.

Lenders' Pre- and Post-Petition Liens Are Critical to the Merits of the Reclamation Claim

The court relied on the lenders' pre- and post-petition liens in deciding that Simon & Schuster had not demonstrated a likelihood of success on its reclamation claim. First, the court clearly rejected Simon & Schuster's argument that the court should ignore the senior lenders' pre-petition liens because, pursuant to the "creeping roll" provided in the DIP agreement, eventually the claims underlying the pre-petition liens would be paid and replaced by post-petition advances secured by post-petition liens. The court instead found that Simon & Schuster's argument "ignore[d] the fact that the [pre-petition] senior facility is still in place" and, in any event, Simon & Schuster had "failed to establish when [repayment of the pre-petition senior facility] will occur and, more importantly, whether any of the goods subject to its reclamation claim will still be in the debtors' possession at that time."

These holdings were perhaps not surprising; the court's holding with respect to the post-petition liens likely will garner more attention. The court found that "the [eventual] satisfaction of the [pre-petition] senior facility is of no moment" as the debtors' interim DIP order provided that the senior lenders' pre-petition liens also secured the debtors' *post-petition* DIP facility. Indeed, as noted above, under the Interim DIP order the court had "ratified and confirmed" the senior lenders' pre-petition liens to secure the debtors' post-petition obligations. Accordingly, the court found that "[e]ven if the [pre-petition] senior facility is satisfied, the senior lenders' pre-petition *and post-petition* liens on the debtors' inventory are superior to [Simon & Schuster's] reclamation claim."[7]

This key holding was not discussed at length by Wilson and LeHane. The relevant provision from the DIP order was supported *inter alia* by facts found in some but by no means all cases. First, the debtors' post-petition financing was provided by the debtors' pre-petition lenders. Second, as noted above, the debtors' post-petition credit agreement was substantially similar to their pre-petition senior facility; indeed, the court was presented with a blackline of the pre-petition credit agreement to illustrate the debtors' post-petition obligations. Given these facts, the lender persuasively argued that the pre-petition liens should collaterize post-petition advances to avoid having the very same lender being "leap frogged" by reclamation claims while the pre-petition obligations were rolled.

Specific Performance: Not a Required Remedy for Reclamation

Simon & Schuster also argued that the deletion in §546(c)(2) of the alternatives of granting an administrative claim or a replacement lien created a federal "statutory right" to reclamation, and that specific performance of this statutory right was mandated. Wilson and LeHane state that the court did not address this argument. We do not agree. The opinion states that "S&S has not met their burden of proving that they do in fact have any statutory rights."[8] In other words, because the statutory "right" is "subject to" the prior liens, the right itself had not been established.

Because the right itself had not been established, the opinion did not resolve Simon & Schuster's argument that specific performance is mandated by the deletions to §546(c)(2). While enjoying some facial appeal, we do not believe that this argument should succeed in future cases, even if a "right" is established (*i.e.*, no prior liens of lenders). Amended §546(c) does not state that the court may not award a reclamation claimant an administrative expense claim or a replacement lien; it is silent on the point. Indeed, one could persuasively argue that by eliminating the court's *obligation* to award a replacement lien or administrative expense claim if it denies actual reclamation,[9] BAPCPA actually *increased* a bankruptcy court's flexibility. Moreover, post-BAPCPA §546(c) does not purport to limit the bankruptcy court's traditional equitable powers. Simply put, the amended statute does not state on its face that specific performance is necessary and should not be

6 *See* Interim Order under 11 U.S.C. §§361, 362, 363 and 364, Fed. R. Bankr. P. 4001(B), and Del. Bankr. L.R. 4001-2, (A) Authorizing Debtors to Incur Post-petition Indebtedness, (B) Granting Security Interests and Superpriority Expense Claims, (C) Authorizing Use of Cash Collateral and (D) Granting Other Relief [Dkt. No. 46] (the "interim DIP order").

7 *See* Opinion, 2007 WL 162685, ** 3-4 (emphasis supplied).

8 *See* Opinion, 2007 WL 162685, *5.

9 The eliminated language reads: "the court may deny reclamation to a seller…*only if*" it grants an administrative expense claim or a lien (emphasis supplied).

read to do so.

In this context, it should be noted that Simon & Schuster's "specific performance" argument plainly overstates the very purpose of such a "right." If the vendor will be paid—through §503(b)(9), by an administrative expense claim, by a cure when a contract is assumed or otherwise—requiring specific performance of returning the goods instead of payment is fundamentally inconsistent with the underlying rationale for reclamation. Simply stated, when a vendor contracts with its customer, the vendor expect payment in return for goods, not return of the goods that it believes it has sold. Indeed, the historical justification for the remedy of reclamation is that an insolvent company has committed a type of fraud by purchasing goods on credit for which it knew that it would be unable to pay, without disclosing its insolvency to the vendor.[10] Consistent with this rationale, UCC Article 2-702(1) provides that the reclaiming creditor may not prevent a debtor from receiving goods in transit where the debtor tenders cash payment for those goods. Thus, if paid, the reclaiming creditor receives the full benefit of its expected bargain with the debtor. It makes little sense to posit that a seller's legitimate interests were somehow meaningfully curtailed or its expectations frustrated when it was paid for its goods as required by the parties' terms. Under this rationale, it is hard to fathom why an administrative expense claim should be an insufficient response to a reclamation demand, unless the bankruptcy estate is administratively insolvent.

The Opinion Did Not Decide the Contours of the Term "Prior Rights"

The court also did not expressly decide Simon & Schuster's argument that any right of a secured party created after shipment of the goods could not defeat a reclamation claim under §546(c). In other words, Simon & Schuster argued that liens securing obligations under a DIP loan could not be "prior rights" to the rights of reclamation claimants under §546(c). The court at oral argument noted that the language "prior rights" of a secured lender might be a reference to the *priority* of the claims rather than, as Simon & Schuster argued, a temporal issue.[11] The legislative history confirms that pre-BAPCPA §546(c) was intended to protect the "superior rights" of holders of security interests.[12] Moreover, under §2-702(3) of the UCC, the reclaiming seller's rights expressly are subject to the superior rights of a *subsequent* buyer in the ordinary course of business. Accordingly, a court might conclude that later-acquired rights (such as the super-priority liens of a DIP lender) may be "prior," or superior, rights for the purpose of §546(c). This issue will have to await another opinion for resolution.

The Opinion Reaffirms that Reclaiming Creditors Cannot Invoke Marshaling

As briefly discussed by Wilson and LeHane, the opinion applied the well-settled pre-BAPCPA rule that a reclaiming creditor cannot invoke the doctrine of marshaling over the interests of a secured lender with valid liens on the debtor's inventory. The pre-BAPCPA cases recognized that a reclaiming creditor is not a secured creditor, and only secured creditors may, in certain circumstances, request marshalling. Thus, the court noted that "[a]t the end of the day, [Simon & Schuster] is doing little more than urging the court to apply the doctrine of marshaling" and held that as an unsecured creditor Simon & Schuster could not invoke the doctrine of marshaling to force the secured senior lenders to satisfy their claim out of collateral other than the goods.[13] This ruling is good news for debtors and senior lenders alike, as it confirms that well settled law on this point has not changed post-BAPCPA.

Conclusion

We suspect that the Delaware Bankruptcy Court may have the occasion to consider these and additional reclamation-related issues in the *AMS* case in the near future. The court recently approved the debtors' request for certain uniform procedures for its consideration of all reclamation claims, pursuant to which the debtors are required to file a written report with the court proposing specific treatment for each reclamation and related administrative expense claim.[14] If any reclaiming creditors object to the debtors' proposed treatment of their claims in the report, the court might be required to again discuss §546(c) and its contours to resolve those objections. ■

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10 *See Pester Refining Co. v. Ethyl Corp.* (*In re Pester Refining Co.*), 964 F.2d 842, 844 (8th Cir. 1992) (reclamation is a "recessional remedy, based upon the theory that the seller has been defrauded").

11 *See* Transcript of Proceedings Before the Hon. Christopher S. Sontchi, dated Jan. 17, 2007 [Dkt. No. 240], Bk. Case No. 06-11480 (CSS) (Bankr. D. Del.), p. 55 line 20-p. 57 line 17.

12 *See In re Robinson Hardware Co.*, 103 BR 396, 398 (Bankr. N.D.N.Y. 1988) (quoting legislative history; "as under nonbankruptcy law, the right [of reclamation] is subject to any superior rights of other creditors"); *accord, In re Kravitz*, 278 F.2d 820, 822-823 (3d Cir. 1960) ("the seller's right of rescission is not an absolute right at all but is subject to the right of a lien creditor who extended credit subsequent to the sale.").

13 *See* Opinion, 2007 WL 162685, *4.

14 *See* Order Establishing Procedures for Reconciliation of Reclamation Claims Pursuant to §§105(a) and 546(c) of the Bankruptcy Code [Dkt. No. 248], entered Jan. 24, 2007.