



Delaware Bankruptcy Court Creates Vendor-Friendly Forum by Preserving Reclamation Rights in the Face of DIP Lenders' Liens

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Introduction

Reclamation is the right of a vendor “to recover possession of goods delivered to an insolvent buyer.”¹ This right is codified in section 2-702 of the Uniform Commercial Code as adopted in each of the several states.² Where an insolvent buyer has filed for bankruptcy after receiving goods on credit, section 546(c) of title 11 of the United States Code (the “Bankruptcy Code”) affords the vendor of those goods a remedy in reclamation.³ In the event an insolvent buyer in bankruptcy has disposed of the goods subject to reclamation, the bankruptcy court may grant the vendor a lien or an administrative expense claim on the assets of the buyer’s estate equal to the value of the goods.⁴

Reclaiming vendors, however, must often contend with the presence of senior secured creditors in a bankruptcy case.⁵ Section 546(c)(1) of the Bankruptcy Code subjects a vendor’s reclamation rights to the prior rights of a secured creditor with a blanket lien on the debtor’s

¹ *In re Pester Refining Co.*, 964 F.2d 842, 844 (8th Cir. 1992).

² *See* Seller’s Remedies on Discovery of Buyer’s Insolvency, UCC § 2-702.

³ *See* 11 U.S.C. 546(c)(1) (2012).

⁴ *See In re Pester*, 964 F.2d at 848–49.

⁵ *See, e.g., id.* at 844 (“This appeal concerns a seller’s right to reclaim goods from a buyer in bankruptcy when the goods are subject to superior competing claims of the buyer’s secured creditors.”).

assets in inventory. *See* 11 U.S.C. 546(c)(1) (2012).⁶ Thus, a vendor’s right to reclaim becomes “subordinated to the secured creditor’s claim.”⁷

Consequently, section 546(c)(1) is often invoked by a debtor or trustee as a “Prior Lien Defense” to effectively bar relief on a vendor’s reclamation claim.⁸ Recognizing the statutory priority of senior secured lenders to reclaiming vendors, a number of courts presiding over reclamation claims have made reclamation the “most illusory of remedies” in bankruptcy practice, providing little or no protection for vendors of goods from insolvent buyers.⁹

There are two scenarios in the context of reclamation that warrant distinction. The first is where a debtor procures a loan prior to purchasing goods on credit from a vendor. The second is where a debtor first purchases goods on credit and subsequently procures a loan. The distinction is significant because it speaks to the priority of reclamation rights as against the competing claims of secured creditors. The first scenario presents a situation where, assuming the creditor received a security interest in the debtor’s assets, the vendor’s reclamation claim would yield priority to the creditor’s claim as it arose *after* the creditor obtained a security interest. However, the second scenario presents a situation where the vendor’s reclamation claim would take priority over a secured creditor’s claim as it arose *prior* to the debtor’s granting of the creditor’s security interest.

⁶ Section 546(c)(1) provides that, “[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 . . . are subject to the right of a seller of goods that has sold goods to the debtor, in the ordinary course of the seller’s business, to reclaim such goods if the debtor has received such goods while insolvent[.]”

⁷ 5 *Collier on Bankruptcy* ¶ 546.04[2][b][vii] (16th ed. rev. 2015).

⁸ *See, e.g., In re Dana Corp.*, 367 B.R. 409, 411 (Bankr. S.D.N.Y. 2007) (“The Debtors also asserted that certain legal defenses to the reclamation claims based upon the existence of prior liens on the goods to be reclaimed (collectively, the ‘Prior Lien Defense’) rendered all of the reclamation claims valueless.”).

⁹ Deborah L. Thorne, *The Courts Begin to Speak: Deciphering §546(c)*, 26-APR, AM. BANKR. INST. J., 38 (2007).

The presence of *both* pre- and post-petition creditors can further complicate a bankruptcy case in this context. This memo focused on the issue of determining the priority of a reclamation claim as against that of a post-petition creditor, particularly where the proceeds of post-petition financing are used to repay prepetition debt. The courts are split in their analyses of this issue; one camp taking a lender-favored approach that subordinates reclamation claims to the liens of post-petition lenders, and the other a vendor-favored approach that preserves the right to reclamation despite the presence of a post-petition lender with a security interest in the goods sought to be reclaimed.

I. The Issue of Reclamation Rights as Against a Post-Petition DIP Lender and the Resulting Circuit Split

Courts have considered the validity or value of reclamation claims as against a post-petition debtor-in-possession (“DIP”) lender holding blanket liens on inventory, as opposed to a pre-petition lender holding similar liens.¹⁰ A DIP lender may be treated differently in this instance due to the temporal nature of the DIP financing.¹¹ The precise issue, as addressed by the courts in *Dairy Mart*, *Dana Corp.*, *Phar-Mor*, and most recently, *Reichhold*, asks whether a DIP lender’s subsequently perfected security interest defeats a vendor’s reclamation rights when the proceeds from the DIP loan are used to satisfy the debtor’s prepetition loan.¹²

Courts have taken either one of two approaches in determining whether a DIP lender’s subsequently granted lien on goods defeats a vendor’s reclamation rights in those goods. The

¹⁰ See *In re Dairy Mart Convenience Stores Inc.*, 302 B.R. 128 (Bankr. S.D.N.Y. 2003); see also *In re Dana Corp.*, 367 B.R. 409; *In re Phar-Mor*, 301 B.R. 482 (Bankr. N.D. Ohio 2003), *aff’d* 534 F.3d 502 (6th Cir. 2008); *In re Reichhold Holdings US, Inc.*, 556 B.R. 107 (Bankr. D. Del. 2016).

¹¹ In this context, a DIP lender is defined as a post-petition creditor who provides financing to a debtor in bankruptcy *after* a vendor has delivered goods. See John D. Ayer, Johnathan P. Friedland, & Michael L. Bernstein, *Obtaining DIP Financing and Using Cash Collateral*, 23-SEP, AM. BANKR. INST. J., 16 (2004) (explaining that debtor-in-possession financing is also known as post-petition lending).

¹² See *In re Dairy Mart*, 302 B.R. at 135; see also *In re Dana Corp.*, 367 B.R. at 418; see also *In re Phar-Mor*, 534 F.3d at 503; see also *In re Reichhold Holdings US, Inc.*, 556 B.R. at 110–11.

result is a split amongst the respective decisions. The analysis employed by the Bankruptcy Court for the Southern District of New York in *Dairy Mart* and *Dana Corp.*, reflects a lender-favored approach.¹³ In contrast, the analysis employed by the Sixth Circuit in *Phar-Mor* and by the Bankruptcy Court in Delaware in *Reichhold*, reflects a vendor-favored approach.¹⁴

I. The Competing Approaches Expanded

A. New York's Approach: What is an "Integrated Transaction?"

The analysis of an "integrated transaction" approach begins with *In re Dairy Mart Convenience Stores Inc.*¹⁵ In that case, the debtor's prepetition lender had a lien on prepetition assets, including the goods that reclaiming vendors sought to reclaim.¹⁶ Through the proceeds of its DIP loan, the debtor satisfied the prepetition lender's claim in full, thus releasing the lien. The debtor then granted the DIP lender an identical security interest in prepetition assets.¹⁷

Ultimately, the *Dairy Mart* court held that where a prepetition secured lender held a lien on inventory and was subsequently paid from the proceeds of a DIP loan supported by a new floating lien, the inventory securing the prepetition debt was effectively used to satisfy that debt.¹⁸ Despite the post-petition lien being granted after the vendors' reclamation rights arose, it

¹³ See *In re Dairy Mart*, 302 B.R. at 136 (holding that "Reclamation Claims were rendered valueless because the proceeds from the disposition of the reclamation goods were used to satisfy [the pre-petition lender's] secured claim."); see also *In re Dana Corp.*, 367 B.R. at 421 (holding that "[T]he Reclamation claims [were] valueless as the goods remained subject to the Prior Lien Defense.").

¹⁴ See *In re Phar-Mor*, 534 F.3d at 503 (holding that a vendor's reclamation right is not extinguished "when the goods subject to reclamation are sold and the proceeds used to satisfy a secured creditor's superior claim."); *In re Reichhold US Inc.*, 556 B.R. at 111 (holding that where a pre-petition loan was paid from the proceeds of a DIP loan, the prepetition lender's lien was satisfied, but the vendor's reclamation rights remained in force.).

¹⁵ 302 B.R. 128.

¹⁶ *Id.* at 130–31.

¹⁷ *Id.* at 131.

¹⁸ *Id.* at 136.

was related back to the prepetition lien as an “integrated transaction,” thus rendering the reclamation claims valueless.¹⁹

Relying on the approach used in *Dairy Mart*, the court in *In re Dana Corp.*,²⁰ under similar facts, held that the secured lenders’ liens had priority over the claimant-vendors. The *Dana Corp.* Court reasoned that because the post-petition lender’s loan proceeds were used to pay the prepetition loan and the DIP lender subsequently obtained a lien against the debtor’s inventory, then that lien took priority over an intervening seller’s reclamation claim against that inventory.²¹ Consequently, the reclamation claims were rendered valueless.²²

B. The Sixth Circuit and *Reichhold*: Skepticism of the “Integrated Transaction” Approach

Decided in the same year as *Dairy Mart*, *In re Phar-Mor* explicitly rejected the notion of an integrated transaction.²³ Again, in the context of post-petition DIP financing used to satisfy prepetition debt, the Sixth Circuit in *Phar-Mor* affirmed that a DIP Lender’s subsequently granted lien on inventory did not relate back to the prepetition lender’s lien, but created an entirely new lien subject to a vendor’s valid reclamation right.²⁴ The Bankruptcy Court in that case explained, “[a] debtor’s decision to grant a security interest in inventory to a *subsequent*

¹⁹ *Id.* at 135-36 (“The transaction releasing Citizen’s [prepetition] lien and simultaneously granting the lien to the post-petition lender, Foothill, must be viewed as an integrated transaction.”).

²⁰ 367 B.R. 409.

²¹ *See id.* at 421 (“The DIP Lien granted to the DIP Lenders . . . provided a security interest in, and lien upon, all of the collateral constituting the prepetition collateral [including reclaimed goods]. Thus the lien chain continued unbroken.”).

²² *Id.*

²³ *See In re Phar-Mor*, 301 B.R. 482.

²⁴ *Id.* at 507-08 (“We find that Ohio Rev.Code § 1302.76(B) (UCC 2-702(2)) grants a properly reclaiming vendor . . . a right to reclaim its goods and that § 1302.76(C) (UCC 2-702(3)) does not allow a secured creditor’s claim to defeat that right.”).

secured lender cannot defeat a seller's reclamation rights before the security interest is granted."²⁵

It is *Phar-Mor* that ultimately informs the more recent decision by the Delaware Bankruptcy Court in *In re Reichhold Holdings US, Inc.*²⁶ The *Reichhold* Court, in analyzing whether a DIP Lender's blanket lien in inventory, granted after a vendor's reclamation rights arose, related back to the prepetition lender's rights and corresponding lien, explained that "when the Prepetition Loan was repaid from the DIP loan, the Prepetition Lender's lien was satisfied but [the vendor's] reclamation rights remained in force."²⁷ The court explained, "The fact that funds obtained from the DIP Loan were used to satisfy the Prepetition Loan, or that the Debtor granted the DIP Lenders a lien in inventory to obtain such funds, is irrelevant."²⁸ It is worth noting the *Reichhold* Court's emphasis on the nature of a lien as it relates to the distinct security interests of pre- and post-petition lenders against reclamation claims. The court further noted, "[t]he function of a lien is to secure a debt; once that debt is repaid, the lien and the rights of the lien-holder terminate."²⁹

Viewing the two liens as separate and distinct, the court in *Reichhold* declined to find an "integrated transaction" where the proceeds of a DIP loan were used to satisfy prepetition debt, and the reclaimed goods were used to secure that loan. There merely existed two different transactions with "two different loans by two different lenders at two different times."³⁰ This logic rests on temporal grounds and the notion of when in time particular rights arose.

²⁵ *Id.* at 497.

²⁶ 556 B.R. 107.

²⁷ *Id.* at 111.

²⁸ *Id.*

²⁹ *Id.* (citing *Unisys Fin. Corp. v. Resolution Trust Corp.*, 979 F.2d 609, 611 (7th Cir. 1992)) ("A lien is parasitic on a claim. If the lien disappears—poof! The lien is gone.")

³⁰ *Reichhold*, 556 B.R. at 112.

Covestro’s reclamation rights came into existence before the DIP Lenders’ lien attached, and further, that lien was “expressly subject to reclamation rights under section 546.”³¹

Conclusion

There is still a great deal of uncertainty surrounding reclamation rights under section 546(c) of the Bankruptcy Code and section 2-702 of the UCC.³² As illustrated by the circuit split regarding this issue, whether or not the reclamation rights under section 546(c) retain their priority against a post-petition lender depends on the circumstances as well as the analytical approach adopted by the court in question.³³

³¹ *Id.* at 111.

³² See Ryan J. Works & Amanda M. Perach, *Holding On to Reclamation Rights under In re Reichhold Holdings*, 36-JAN, AM. BANKR. J., 14 (2017) (“[T]he recent decision in *Reichhold Holdings* indicates that this area of law is simply premature and will likely be the subject of litigation for years to come.”).

³³ See *id.*; Compare *In re Dana Corp.*, 367 B.R. 409 and *In re Dairy Mart Convenience Stores Inc.*, 302 B.R. 128, with *In re Phar-Mor Inc.*, 301 B.R. 482 and *In re Reichhold Holdings US, Inc.*, 556 B.R. 107 (Bankr. D. Del. 2016).