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Holding On to Reclamation Rights under *In re Reichhold Holdings*

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Section 546 of the Bankruptcy Code has long been considered a provision with all bark and no bite.[1] Other than *In re Phar-Mor Inc*., the majority of bankruptcy court decisions concerning the priority of reclamation rights under § 546(c) of the Bankruptcy Code versus the priority of a post-petition loan facility have concluded that the reclamation rights of sellers of goods are inferior to the rights of post-petition lenders, essentially rendering § 546(c) a nullity where post-petition financing is required.[2]

For example, under *In re Dana Corp*. and similar decisions, a post-petition security interest can extinguish reclamation rights simply by using the funds of the post-petition loan to pay off pre-petition debt that was secured by a floating lien on the inventory. Under these decisions, the sellers of goods had diminished rights in bankruptcy such that a debtor could extinguish a seller's reclamation rights that might otherwise have existed outside of bankruptcy. Given the impact of these decisions, many critics opined that § 546(c) would essentially be rendered nugatory.[3] However, the 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.

Rights of Reclamation under the UCC

Generally, in states that have adopted the Uniform Commercial Code (UCC),[4] under § 2-702 of the UCC a seller of goods who sells goods to a third party, on credit, obtains a right to reclaim such goods under state law if the seller makes a demand within 10 days after receipt of goods. The official comments to subsection (2) note: "Subsection (2) takes as its base line the proposition 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."[5]

Thus, the UCC makes it clear that the drafters intended to protect sellers from buyers who were aware of their ailing financial condition yet chose to continue to buy goods on credit without considering the repercussions of their actions on third-party sellers. By providing an immediate remedy to sellers, this provision encourages sellers to continue to do business with buyers who might otherwise be heading toward bankruptcy. It also helps protect sellers of goods by providing them with an immediate remedy in the event that they discover a buyer is insolvent.

Rights of Reclamation under the Bankruptcy Code

In enacting the Bankruptcy Code in 1978, Congress included a provision that addressed the reclamation rights of sellers following a bankruptcy filing, which, until that time, remained unclear. This provision ensured that the same statutory and common law rights available outside of bankruptcy would be extended to sellers inside of bankruptcy. By enacting § 546, Congress sought to eliminate the ambiguities that existed when a company filed for bankruptcy and its creditor/sellers sought to utilize § 2-702 of the UCC to reclaim their goods. Given the existence of the automatic stay and the general prohibition against seeking to recover against a debtor for pre-petition debt, the enforcement of § 2-702 was suspect. Thus, as Congress explained, "The purpose of the provision is to recognize, in part, the validity of section 2-702 of the [UCC], which has generated much litigation, confusion, and divergent decisions in different circuits."[6]

In 2005, § 546 of the Bankruptcy Code was amended for the first and only time. That amendment did four substantive things:

1. It removed any reference to statutory and common law rights and merely referred to the "right of a seller";[7]

1 Deborah L. Thorne, "The Courts Begin to Speak: Deciphering § 546(c)," *ABI Journal*, Vol. XXVI, No. 3, p. 38, April 2007, *available at* abi.org/abi-journal; *see also* Anthony M. Sabino, "The Death of Reclamation: How Congress and the Courts Have Eviscerated Reclamation Rights, and What Can Be Done About It," 2008 *Ann. Surv. of Bankr. Law* at 31.

2 *Compare In re Dana Corp*., 367 B.R. 409 (Bankr. S.D.N.Y. 2007), *and In re Dairy Mart Convenience Stores Inc*., 302 B.R. 128 (Bankr. S.D.N.Y. 2003), *with In re Phar-Mor Inc*., 301 B.R. 482 (Bankr. N.D. Ohio 2003), *aff'd*, 534 F.3d 502 (6th Cir. 2008).

3 *See* Thorne, "The Courts Begin to Speak," *supra* fn.1; Sabino, "The Death of Reclamation," *supra* fn.1; Deborah L. Thorne, "Reclamation under the New § 546(c)(1): Illusory Remedy as Ever: *In re Dana Corp.* and *Incredible Auto Sales LLC*," *ABI Journal*, Vol. XXVI, No. 5, p. 46, June 2007, *available at* abi.org/abi-journal; *see also* Lawrence Ponoroff, "Reclaim This! Getting Credit Seller Rights in Bankruptcy Right," 48 *U. Rich. L. Rev.* 733 (2014) (critiquing amendments to § 546).

4 While different states have adopted slightly differing versions of the UCC, all versions that have been adopted provide for the same type of reclamation rights. *See* § 2-702, Seller's Remedies on Discovery of Buyer's Insolvency, UCC Local Code Variations § 2-702. For example, a few states have adopted a variation of the provision to allow "lien creditors" to be added before or after "good-faith purchaser." Also, North Dakota has included an exception for agricultural products.

5 Official Comments to U.C.C. § 2-702.

6 S. Rep. 95-989, 86-87, 1978 U.S.C.C.A.N. 5787, 5872-73; *see also* H.R. Rep. 95-595, 372, 1978 U.S.C.C.A.N. 5963, 6328.

7 This has created significant commentary concerning whether the amendment was intended to create a new federal right to reclamation. This issue will not be addressed in detail herein. For further discussion, *see generally* Sabino, "The Death of Reclamation," *supra* fn.1; James M. Sullivan and Gary O. Ravert, "A Vendor's Guide to Bankruptcy," 1 *Bloomberg Corp. L.J.* 494 (2006)

2. It added in a notation that the rights of a seller are "subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof.…";

3. It expanded the notice period for reclamation rights from 10 days to the later of 45 days after receipt of goods or 20 days after the commencement of the bankruptcy case; and

4. It provided an avenue to obtain an administrative claim under § 503(b)(9) of the Bankruptcy Code.

In interpreting § 546, several courts have concluded that despite amendments that may indicate otherwise, § 546 was not intended to create any federal right of reclamation.[8] Rather, this provision was intended only to extend state law rights into bankruptcy. Notwithstanding this purpose, many decisions under this provision have dulled its force, allowing other claimants' rights to be elevated above those of reclamation claimants. The rationale of these decisions is generally based on the vague concept of integrating a pre-petition loan into a debtor-in-possession (DIP) loan so that the rights of the pre-petition lender are carried over to the DIP lender. While these decisions operate to encourage DIP lending, they also tend to discourage sellers from continuing to do business with buyers who appear to be nearing bankruptcy — that is, until *In re Reichhold Holdings*.[9]

In re Reichhold Holdings US Inc.

On Sept. 30, 2014, Reichhold Holdings US Inc., Reichhold Liquidation Inc. (f/k/a Reichhold Inc.), Canadyne Corp. and Canadyne-Georgia Corp. (collectively, "Reichhold") filed for chapter 11 protection in Delaware.[10] Reichhold produced intermediate products for the composites and coatings industry, which "are used in such applications as marine manufacturing, tub and shower components, energy windmill blades, solid surface applications, large diameter water pipe manufacturing, automotive manufacturing and advanced composites/prepregs."[11] Reichhold employed 379 people as of the petition date.[12]

Prior to bankruptcy, Reichhold purchased goods, such as polyurethane raw materials, from suppliers on credit to manufacture its composites and coatings.[13] One such supplier was Covestro LLC (f/k/a Bayer MaterialScience LLC).[14] Covestro delivered goods, including "Desmodur, Mondur TD and Arcol Polyol products," to Reichhold on credit prior to Reichhold's bankruptcy filing.[15]

On Oct. 3, 2014, Covestro sent its demand for return of goods to Reichhold pursuant to § 546.[16] On Dec. 26, 2014, Covestro filed a proof of claim for $965,248.14, which was subsequently reduced on two occasions after payments were made by Reichhold to Covestro.[17] According to Covestro, Covestro and Reichhold "expressly agreed that the remaining unpaid balance of Covestro's claim would be subject to Covestro's asserted reclamation rights."[18]

Prior to bankruptcy, Reichhold was indebted to its secured creditor for approximately $87 million, which was secured by liens on substantially all of Reichhold's assets, including floating liens on its inventory.[19] On Dec. 4, 2014, the bankruptcy court approved post-petition DIP financing for Reichhold in the amount of $103,190,000, secured by a perfected lien on all of the same assets.[20] These funds were used to satisfy the full amount of the pre-petition secured debt.[21]

On May 26, 2016, the liquidating trustee filed an objection to Covestro's reclamation claim.[22] Covestro opposed, arguing that Reichhold consented to this treatment and that in any event, any pre-petition lien was extinguished when the debt was paid in full; therefore, any superior lien was extinguished.[23] In response, the trustee contended that even though the pre-petition loan was paid, "there was an unbroken chain of superior liens on the goods for which Covestro seeks reclamation."[24] The trustee further argued that "Covestro's reclamation claim [was] valueless and its claim should be reclassified as a general unsecured claim."[25]

In its decision, which ultimately found in Covestro's favor, the court pointed out the circuit split concerning this issue and analyzed each of the cases. In particular, the court noted that *Dairy Mart* and *Dana Corp*. supported the liquidating trustee's position concluding that those cases found that a post-petition DIP lender's rights should relate back to the date of perfection of a pre-petition lender's security interest in the same collateral.[26] Thus, if a post-petition lender's loan proceeds are used to satisfy a pre-petition loan and the DIP lender obtains a perfected lien against the debtor's inventory, that lien will have priority over an intervening seller's reclamation rights in goods.[27] On the other hand, the court noted that *Phar-Mor* supports Covestro's position — that this was an entirely new lien that could not defeat a preceding reclamation right.[28]

After discussing these cases, the court rejected the reasoning in *Dairy Mart* and *Dana Corp*., finding that "it is too much of a stretch to conclude ... that the repayment of the Pre-petition Loan from the DIP Loan was repayment from the sale of the reclaiming creditor's goods."[29] The court emphasized that "Covestro's goods were *not* sold and their proceeds were *not* paid to the Pre-petition Lender."[30] In adopting the reasoning in *Phar-Mor*, the court explained that

8 *In re Dairy Mart Convenience Stores Inc.*, 302 B.R. at 132-33 (citing various decisions to support this contention); *see also In re Dana Corp.*, 367 B.R. at 416.

9 While *Phar-Mor* was previously decided, this decision was before the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). The only decision post-BAPCPA concerning this particular issue was *Dana Corp.*

10 Second Amended Disclosure Statement, *In re Reichhold Holdings US Inc., et al.*, Case No. 14-12237 (ECF No. 1246) at 1.

11 *Id.* at 9.

12 *Id.*

13 Response and Objection of Covestro LLC to Debtor's Fifteenth Omnibus Objection (Substantive) to Claims, *In re Reichhold Holdings US Inc., et al.*, Case No. 14-12237 (ECF No. 1569) at 3 and Ex. A.

14 *Id.*

15 *Id.* at Ex. A.

16 *Id.*

17 *Id.* at 1-2.

18 *Id.* at 2.

19 *See* Final Order (1) Authorizing Debtors to Obtain Post-Petition Secured Financing Pursuant to 11 U.S.C. §§ 105, 362, 363 and 364 and (2) Granting Liens and Superpriority Claims, *In re Reichhold Holdings US Inc., et al.*, Case No. 14-12237 (ECF No. 310) at ¶ 3(b)(ii) and (iii).

20 *Id.*

21 *In re Reichhold Holdings US Inc.*, No. 14-12237 (MFW), 2016 WL 4479286, at *3 (Bankr. D. Del. Aug. 24, 2016). Note: The Westlaw citation has "*Reichold*" instead of "*Reichhold.*" The latter has been used throughout this article for consistency.

22 Fifteenth Omnibus Objection (Substantive) to Claims, *In re Reichhold Holdings US Inc., et al.*, Case No. 14-12237 (ECF No. 1563).

23 Response and Objection of Covestro LLC to Debtor's Fifteenth Omnibus Objection (Substantive) to Claims, *In re Reichhold Holdings US Inc., et al.*, Case No. 14-12237 (ECF No. 1569) at 3-4.

24 Omnibus Reply in Support of Fifteenth Omnibus Objection (Substantive) to Claims, *In re Reichhold Holdings US Inc., et al.*, Case No. 14-12237 (ECF No. 1580) at 8.

25 *Id.*

26 *Reichhold Holdings*, 2016 WL 4479286, at *3.

27 *Id.*

28 *Id.*

29 *Id.* at *4.

30 *Id.* (emphasis supplied).

continued on page 61

from page 15

the goods were only pledged and the debt was satisfied upon payment such that the pre-petition lien was extinguished.[31] The court further noted that this could not be an integrated transaction as the liquidating trustee suggested because this concerned two different loans to two different lenders at two different times.[32]

Now What?

It is unclear whether this decision will have ripple effects. Indeed, the decision was factually distinct from many other cases that reached contrary findings. For example, in *Reichhold*, the post-petition lender had already been paid in full, so the only question remaining was whether Covestro's claim should be entitled to full payment as well. Thus, the court did not need to consider the effects such a decision could have on the DIP lender and its future application to the DIP lending industry.

Notwithstanding, this decision could result in DIP lending facilities refusing to loan to debtors that have potential reclamation claims for fear that their claims could be subordinated to the claims held by reclamation claimants. On the other hand, the decision may also encourage sellers of goods to sell goods to potentially insolvent buyers when they would otherwise be wary, thereby discouraging future bankruptcy filings.

In reality, the likely result is that both industries will pull back from working with these types of debtors because of the uncertainty. As the circuit split grows wider, both DIP lenders and sellers of goods are left in an abyss of the unknown. Thus, the likely result of this decision is a greater number of insolvency reviews from sellers of goods and a refusal from DIP lenders to provide post-petition financing to debtors unless the collateral, excluding inventory, is more than sufficient to satisfy the DIP loan in full. Consequently, *Reichhold* appears to have created more doubt than guidance concerning whether a seller of goods can maintain its reclamation rights post-bankruptcy. If anything, this decision should serve as a lesson to sellers: If you want to keep your right to reclaim goods, you had better hold on tight. abi

31 *Id.*
32 *Id.*