

# Bankruptcy Court Holds That Reclamation Claims Asserted In Dana Corporation Chapter 11 Cases Are Valueless

APRIL 19, 2007

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A decision entered today in the Dana Corporation chapter 11 cases by Bankruptcy Judge Lifland is sure to have a significant impact on the enforceability of a seller's rights to reclaim goods sold to an insolvent buyer who subsequently files for bankruptcy. The opinion makes it likely that reclamation claims asserted by sellers in most chapter 11 cases will be found to be valueless, not entitled to priority payment as an administrative expense claim and will only be allowed as a general unsecured claim against the debtor's estate.

## **A SELLER'S RIGHTS TO RECLAIM GOODS RECEIVED BY AN INSOLVENT BUYER:**

Generally, a supplier can reclaim goods that have been received by an insolvent buyer if the supplier can satisfy the following conditions: (1) the buyer has received the goods; (2) the goods were sold to the buyer in the ordinary course of business; (3) the buyer must have possession of the goods at the time of the demand; and (4) the buyer was insolvent when it received the goods. (UCC 2-702).

Under applicable non-bankruptcy law, a reclamation demand is effective only with respect to goods received by the buyer within ten days of the date the reclamation demand is made. In a bankruptcy, however, because of recent changes to the Bankruptcy Code effected by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), a seller may seek the return of goods received by the debtor within 45 days prior to the commencement of the case. If, however, the 45 day period expires after the date on which the debtor commenced its bankruptcy case, the supplier must make its demand no later than 20 days after the date on which the bankruptcy case was commenced.

A supplier that timely asserts a right to reclamation is generally entitled to recover possession of the reclaimed goods. Unfortunately for the supplier, when the buyer of the goods is in bankruptcy this rarely happens. Because the goods at issue are frequently critical to the postpetition business operations of a debtor, the bankruptcy court usually awards the reclaiming creditor an administrative priority claim or a replacement lien on other assets of the debtor. A supplier's reclamation rights, however, are subject to the rights and interests of third parties. Thus, if there is a secured creditor with a security interest in the buyer's inventory, the supplier's reclamation claim may be denied in whole or in part.

## **JUDGE LIFLAND'S RULING:**

The decision rendered by Judge Lifland addresses the situation where a secured lender has a floating lien on a debtor's inventory. Specifically, he considered two issues: (1) whether Congress had created a new federal reclamation right when it amended Bankruptcy Code section 546(c) and (2) whether the existence of prior liens on the goods to be reclaimed rendered all of the reclamation claims valueless.

### **No Independent Federal Right to Reclamation**

In his decision, Judge Lifland persuasively disposed of the argument that the BAPCPA amendments to section 546(c) created an independent federal right of reclamation. He found that neither the specific language of section 546(c) nor the legislative history indicated Congressional intent to create such a new federal right. Noting the negative impact that such a federal reclamation right would have on buyers in the ordinary course, other good faith purchasers and lien creditors, whose interests had been protected under the reclamation provisions of the UCC and relying on Supreme Court precedent requiring a clear statement of Congressional intent to change pre-BAPCPA practices with respect to the enforcement of reclamation rights in the legislative history, Judge Lifland concluded that the limitations on reclamation rights imposed under the UCC and related case law were not replaced by a federal right of reclamation but remained relevant to the analysis of reclamation claims.

Thus, issues relating to matters such as proof that the goods were delivered to the debtor in the timeframe established by the statute and were in the debtor's possession and had not been commingled or used by the debtor at the time of the reclamation demand continue to be important. Indeed, being able to prove a debtor's receipt of such goods will be crucial in the enforcement of claims under section 503(b)(9) of the Bankruptcy Code, the provision granting administrative expense priority for the value of goods received by a debtor in the 20 days prior to the commencement of a debtor's bankruptcy case.

### **Reclamation Claims Rendered Valueless When Prior Floating Lien Satisfied by Post-Petition Financing**

Judge Lifland's ruling appears likely to have eliminated the ability to assert viable reclamation claims in most chapter 11 cases. In most such cases, a debtor's prepetition financing arrangement will include an existing floating lien on inventory that is subsequently satisfied from the proceeds of a postpetition credit facility secured by a new floating lien - a replacement lien - on inventory. Since well established case law holds that reclaiming creditors have no right to compel a prepetition lienholder to look to its other collateral to satisfy the lien and since it is unlikely that any reclaiming creditor will be able to demonstrate that the value of the goods subject to its reclamation claim exceeds the amount of the prepetition lienholder's lien, it appears that most reclamation claims asserted by a reclaiming creditor in a bankruptcy will ultimately be determined to have no value.

Although this result may seem unfair where, as here, the pre-petition lienholders were oversecured and the prepetition collateral was subsequently used to secure a significantly larger post-petition claim, this result is consistent with the longstanding precedent cited in today's opinion. Although Judge Lifland does not say it expressly in his decision, he has essentially said to Congress if you want a different result you must so indicate by clearly and explicitly amending the Bankruptcy Code.

In light of business trends in recent years where businesses have implemented just-in-time production processes and have attempted to minimize inventory stocks, reclamation rights may not have retained the significance in bankruptcy that they once appeared to have. The relative certainty provided by the administrative priority granted under section 503(b)(9) of the Bankruptcy Code - which entitlement to priority is not dependent on the assertion of a timely and valid reclamation demand - and the emerging case law under Bankruptcy Code section 546(c) may be the death knell for the enforcement of reclamation rights in all but the rarest of cases under the Bankruptcy Code.