Sixth Circuit's *Phar-Mor* Decision Breathes New Life into Reclamation Remedy

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About the Author

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For nearly 20 years, trade creditors and their counsel have bemoaned the evisceration of the vendor's reclamation remedy. However, on July 17, 2008, the Sixth Circuit Court of Appeals gave trade creditors something to smile about when it issued its opinion in *Phar-Mor Inc. v. McKesson Corp.*, ___F.3d ___, 2008 WL 2756588. In *Phar-Mor*, the Sixth Circuit Court of Appeals rejected and *refused* to follow the long line of cases that have rendered the reclamation remedy a toothless one.


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In 1979, at the beginning of my legal career, the reclamation remedy was nearly sacrosanct. Once a vendor established a valid right to reclaim,[2] the vendor was entitled to either reclaim the goods or else the bankruptcy court was *required* to give the vendor a lien or an administrative claim for the value of the goods sought to be reclaimed.[3]

Over time, however, the reclamation remedy began to erode via a line of cases holding that Bankruptcy Code §546(c) is designed only to *preserve* reclamation rights—not enhance them. Consequently, bankruptcy courts began to look at reclamation claims more critically. Some courts held that the vendor's right to reclaim was extinguished by a secured creditor with liens on after-acquired inventory. (*See, e.g., In re Lawrence Paperboard Corp.*, 52 B.R. 907, 911 (Bankr. D. Mass. 1985); *In re Shattuc Cable Corp.*, 138 B.R. 557, 563 (Bankr. N.D. Ill. 1992)). However, the majority position that developed in the 1990s was that reclamation claims were subordinate to (rather than extinguished by) security interests in after-acquired inventory. (*See, e.g., In re Pester*, 964 F.2d 842, 846 (8th Cir. 1992); *In re Arlco*, 239 B.R. 261, 267 (Bankr. S.D.N.Y. 1999)). Although these cases did not *kill* reclamation altogether, they rendered it a useless remedy—and far from the sacrosanct remedy that it once was.

Reasoning that the reclamation remedy itself was "inventory-specific," these courts held that §546(c)(2) did *not* empower them to grant a lien or administrative claim against *all* property of the estate, but instead, only allowed them to give a reclaiming vendor a lien or administrative claim on the goods sought to be reclaimed (or the traceable proceeds thereof). Under this line of cases, it is only when (1) the secured creditor releases its lien *on the goods sought to be reclaimed* (*see, e.g., In re Pester*, 964 F.2d 842, 847 (8th Cir. 1992)), or (2) the reclaiming vendor's goods (or traceable proceeds therefrom) *exceed* the amount of senior secured claims *in the goods sought to be reclaimed*, that the reclamation claim has value so as to entitle the vendor to an administrative claim or a lien. (*See, e.g., In re Pester*, 964 F.2d 842, 847 (8th Cir. 1992); *In re Houlihan's Restaurant Inc.*, 286 B.R. 137, 140 (Bankr. W.D. Mo. 2002); *In re Arlco Inc.*, 239 B. R. 261, 272 (Bankr. S.D.N.Y. 1999); *In re Steinberg's Inc.*, 226 B.R. 8,12 (Bankr. S.D. Ohio 1998)).

By the late '90s, case law had evolved to completely eviscerate the reclamation remedy. For example, *In re Arlco*, 239 B.R. 261 (Bankr. S.D.N.Y. 1999), held that reclamation rights evaporated when the debtor sold the inventory that the vendor sought to reclaim and the sale proceeds were paid to the senior secured lender. Cases like *Arlco* rendered the reclamation remedy so "toothless" that vendors often declined to file a reclamation claim—figuring that it was a waste of money to do so.

Having watched their reclamation remedy erode over last two decades, the Sixth Circuit's ruling in *Phar-Mor* is a "welcome relief" for trade creditors. In *Phar-Mor*, the issue was whether the vendor's reclamation claim was extinguished when the goods sought to be reclaimed were sold and the proceeds were paid to satisfy a secured creditor's superior claim. When Phar-Mor filed chapter 11, it owed its secured creditors $103 million. With court approval, Phar-Mor borrowed $135 million to pay its pre-petition secured creditors and gave its post-petition lenders post-petition security interests and superpriority status. Phar-Mor's assets were eventually liquidated and generated enough money so that Phar-Mor was able to repay the $135 million in post-petition secured debt, with $64.5 million left over. After attorneys' fees and the amount allotted to reclamation claims, Phar-Mor would have approximately $30 million to distribute toward $185.5 million in general unsecured claims. Apparently, there were 141 vendors who filed reclamation claims totaling $18 million. McKesson was the only trade creditor that did not settle.

Phar-Mor filed a motion to reclassify the reclamation claims as general unsecured claims, arguing that reclamation claims were *extinguished* when the inventory sought to be

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[1] With thanks to my partner, Tracy Litzinger, for her assistance.

[2] In order for a vendor to have the right to reclaim, §546(c) requires the vendor to establish that (1) it has a statutory or common law right to reclaim the goods, (2) the goods were sold to the buyer on credit, (3) the goods were sold in the ordinary course of the seller's business, (4) the debtor was insolvent when the goods were received, (5) the vendor made a written demand for reclamation within the statutory time limit after the debtor received the goods, (6) the buyer was still in possession or control of the goods when the reclamation demand was made and (7) the goods are identifiable as those sold to the debtor.

[3] *See, e.g., In re Marko Electronics Inc.*, 145 B.R. 25, 29 (Bankr. N.D. Ohio 1992); *In re Sunstate Dairy and Food Products*, 145 B.R. 341, 346 (Bankr. N.D. Fla. 1992); *Diversified Food Service*, 130 B.R. 427, 430 (Bankr. S.D.N.Y. 1991); *In re Roberts*, 103 B.R. 396, 399 (Bankr. N.D.N.Y. 1988); *In re Bosler Supply Group*, 74 B.R. 250, 254-255 (N.D. Ill. 1987).

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reclaimed was sold, and the sale proceeds were paid to the post-petition lender. The court denied Phar-Mor's motion, holding that even though the reclamation claims were "subject to" the claims of the post-petition lender, they still had administrative expense priority over general unsecured claims. After the court denied Phar-Mor's *two* motions for reconsideration, Phar-Mor appealed to the district court. The district court affirmed the bankruptcy court, and Phar-Mor appealed to the Sixth Circuit Court of Appeals.

On appeal, Phar-Mor argued that McKesson had no right to reclaim because McKesson did not have the *ability* to reclaim inasmuch as the Ohio version of the reclamation statute provides that the right to reclaim is subject to the rights of a "buyer in the ordinary course or other good faith purchaser or lien creditor." Phar-Mor argued that McKesson's right to reclaim evaporated once the inventory was sold and the proceeds thereof were paid to the secured creditor. In other words, Phar-Mor made the very arguments that the bankruptcy court for the Southern District of New York adopted in *In re Arlco*, 239 B.R. 261 (S.D.N.Y. 1999).

The Sixth Circuit *affirmed* both lower courts and expressly declined to follow *Arlco* and the line of cases that have gutted the reclamation remedy (including *Pittsburgh-Canfield Corp.*, 309 B.R. 277, 287 (B.A.P. 6th Cir. 2004)).[4] *Phar-Mor* was personally gratifying because the court agreed with my observation in a 2003 article (written for this column) that the holding in *Arlco* (1) is insensitive to the reality that inventory is often liquidated first and the proceeds paid to the secured creditor and (2) ignores the protection that UCC §§2-702 and 546(c) intended to give to reclaiming vendors. Throughout its opinion, the Sixth Circuit went "the extra mile" to remind us that the purpose of the reclamation remedy is to give rights to a "defrauded seller"—namely the vendor who discovers that it recently delivered goods to an insolvent buyer who purchased them on credit. In *Phar-Mor* the Sixth Circuit cites cases from "reclamation's golden era"—*e.g.*, *In re Mel Golde Shoes Inc.*, 403 F. 2d 658, 651 (6th Cir. 1968), and *In re American Food Purveyors Inc.* 17 UCC Rep. Serv. 436, 1974 WL 21665 (Bankr. N.D. Ga. 1974), both of which reasoned that any goods that were properly subject to reclamation remained the *vendor's* property and never became the debtor's property, so the secured creditor's claim could not attach to the properly reclaimed goods. These cases viewed the debtor as essentially holding the reclaimed goods "in trust" for the reclaiming vendor.

Phar-Mor clearly enlivens the reclamation remedy in the Sixth Circuit for cases filed before Oct. 17, 2005—but it raises two more interesting questions: Is Phar-Mor relevant to the post-BAPCPA version of §546(c) and does Phar-Mor have any impact on the "new" §503(b)(9) claims that BAPCPA created?

Phar-Mor's holding that the reclamation claims have administrative priority (and should *not* be reclassified as general unsecured claims) is based on two findings:

> We find that Ohio Rev. Code §1302.76(B) (UCC 2-207(2)) [sic] grants a properly reclaiming vendor, such as McKesson, a right to reclaim its goods and that §1302.76(C) (UCC 2-207(3)) [sic] does not allow a secured creditor's claim to defeat that right. *But, correspondingly*, we find that 11 U.S.C. §546(c)(2)(1998) grants the bankruptcy court the power to deny a properly reclaiming vendor, such as McKesson, its right to reclaim the goods, but only by granting the denied vendor either an administrative-expense priority in the amount of the goods or a lien on the proceeds resulting from the use of those goods by the debtor. In this case, the bankruptcy court granted McKesson an administrative-expense priority, and we have no basis to overturn its decision in this matter. [Emphasis and material in brackets added.]

Phar-Mor clearly enlivens the reclamation remedy in the Sixth Circuit for cases filed before Oct. 17, 2005 (which was the effective date of BAPCPA)—but it raises two more interesting questions: (1) Is *Phar-Mor* relevant to the post-BAPCPA version of §546(c), and (2) does *Phar-Mor* have any impact on the "new" §503(b)(9) claims that BAPCPA created?

Is Phar-Mor *Relevant to Post-BAPCPA §546(c)?*

The Sixth Circuit's holding in *Phar-Mor* is based on the court's finding that (1) McKesson had a valid reclamation claim under the Ohio version of UCC 2-702 and (2) the pre-BAPCPA version of §546(c) required the bankruptcy court to grant the properly reclaiming vendor either an administrative claim for the amount of the goods, or a lien on the proceeds of the goods, if the bankruptcy court denied the proper reclamation vendor the right to reclaim. However, BAPCPA made sweeping changes to §546(c) by, *inter alia*, expanding the reclamation period from 10 days to 45 days, and by *eliminating* the statutory requirement that a properly reclaiming vendor be awarded a lien or administrative claim if denied the right to reclaim.

Because *Phar-Mor* dealt with the UCC's narrower reclamation period, and because its holding is based on the language in the pre-BAPCPA version of §546(c) that required that the bankruptcy court grant the properly reclaiming vendor either a lien or an administrative claim if the right to redeem is denied, debtors and secured creditors are likely to argue that *Phar-Mor* is irrelevant to post-BAPCPA cases—but I disagree. After *decades*

[4] In declining to follow an opinion of the BAP in its own circuit, the Sixth Circuit expressly held that decisions by the BAP are not binding on the circuit court, and relied on *Weber v. U.S.*, 484 F.3d 154, 158 (2d Cir. 2007), and *In re Healthcentral.com*, 504 F.3d 775, 784 n.3 (9th Cir. 2007), in reaching its conclusion.

of cases that eroded the reclamation remedy, the Sixth Circuit's decision in *Phar-Mor* harkens back to the *intent* behind the reclamation remedy itself. The court's approving references to cases from the 1960s and 1970s[5] (which were decided when the reclamation remedy was sacrosanct) in support of its *refusal* to reclassify the reclamation claims to general unsecured status, coupled with the court's refusal to follow the recent decision of the BAP in its own circuit, conveys the court's disapproval with the erosion of the reclamation remedy. The Sixth Circuit's opinion in *Phar-Mor* clearly "sends a message" that it is time to stop robbing vendors of the rights that UCC 2-702 and 11 U.S.C. §546(c) were intended to preserve. Indeed, when read as a whole, the Sixth Circuit's opinion appears to affirm the lower courts *only* because the pre-BAPCPA version of §546(c) required the bankruptcy court to grant the properly reclaiming vendor an administrative claim. *But for* that statutory language, it appears that the Sixth Circuit may have given the properly reclaiming vendors rights superior to the secured creditors! Because the post-BAPCPA version of §546(c) does not contain the language requiring bankruptcy courts to grant administrative claims or liens to properly reclaiming vendors in lieu of actual reclamation, *Phar-Mor*'s impact will likely be a subject of vigorous debate. Reclamation claimants are likely to argue that *Phar-Mor* should be read as reinstating reclamation claims to their once-lofty position, and that properly reclaiming vendors should trump secured creditors. Other constituencies will argue that *Phar-Mor* interpreted a now-outdated version of a statute, and that its holding is therefore limited.

Does Phar-Mor *Have Any Impact on §503(b)(9) Claims?*

BAPCPA created §503(b)(9) claims—which are administrative claims for goods that the debtor received during the 20 days before a bankruptcy petition is filed and in the ordinary course of the debtor's business. Section 503(b)(9) claims have no analogue in the UCC—they arise solely under the Bankruptcy Code. §503(b)(9) claims are *much* easier for a vendor to prove because the vendor only has to demonstrate that the goods were received by the debtor within 20 days before the buyer filed bankruptcy and that the goods were sold to the debtor in the ordinary course of the debtor's business. Section 503(b)(9) claims are not "subject to" the rights of a purchaser in the ordinary course of business; they are "regular" administrative claims. Because §503(b)(9) claims are (1) widely regarded as "replacement" reclamation claims created in 2005 to "throw vendors a bone" in exchange for the evisceration of their once-sacrosanct reclamation claims and (2) based on the notion that a debtor *knows* of its insolvency within 20 days before filing a bankruptcy petition (and should stop buying goods on credit), §503(b)(9) claimants are likely to argue that *Phar-Mor* is relevant to their claims as well—even though the *Phar-Mor* decision never once mentions §503(b)(9).

The well-versed §503(b)(9) claimant might argue that *both* reclamation claims and §503(b)(9) claims constitute *remedies* that are designed to compensate the vendor who is defrauded into selling goods on credit to an insolvent customer on the eve of that customer's bankruptcy, and that *Phar-Mor* stands for the proposition that §503(b)(9) claims should *not* be eviscerated. Of course, debtors and other constituencies will argue that *Phar-Mor* (which was decided nearly three years after BAPCPA created §503(b)(9) claims) doesn't even *mention* §503(b)(9) claims and, consequently, *Phar-Mor* is simply irrelevant to any §503(b)(9) issue.

Amidst all this uncertainty, two things are clear. First, *Phar-Mor* is a stunning opinion—a "flashback" of sorts to the early reclamation decisions that hold that reclamation is designed to give defrauded vendors relief when they discover that they recently delivered goods on credit to an insolvent buyer. Second, despite BAPCPA's changes to §546(c) and its creation of §503(b)(9) claims, *Phar-Mor* is going to spark heated debate in the vendor's ongoing struggle to avoid being "last in line." ■

[5] *See, e.g., In re Mel Golde Shoes Inc.*, 403 F. 2d 658, 651 (6th Cir. 1968); *In re American Food Purveyors*, 17 U.C.C. Rep. Serv. 436, 1974 WL 21665 (Bankr. N.D. Ga. 1974); and *In re Federal's Inc.*, 553 F.2d 509, 518 (6th Cir. 1977).