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A Bi-Annual Report on the Legal Developments Affecting Unsecured Trade Creditors in Bankruptcy

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Reclamation Demands are Subordinate to Rights of Secured Creditors

Whirlpool Corp. v. hhgregg, Inc. (In re hhgregg, Inc.), 578 B.R. 814 (Bankr. S.D. Ind. 2017)

Reclamation demands are, in theory, a powerful way for unsecured trade creditors to protect their interests in bankruptcy. Under the Uniform Commercial Code, sellers on credit may make a written demand to "reclaim" the goods within 10 days of the buyer receiving them. Section 546(c) of the Bankruptcy Code provides friendlier timelines for creditors—allowing written demands within 20 days of a bankruptcy filing for the return of goods received within 45 days of the petition date. Once the creditor issues a written demand, the goods are subject to the creditor's right to reclaim them. On the surface, reclamation claims are one of the most formidable tools an unsecured creditor has in bankruptcy.

However, Bankruptcy Code section 546(c) also makes clear that reclamation claims are "subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof." In the hhgregg, Inc. bankruptcy, Whirlpool Corporation found this out the hard way. In that case, Whirlpool submitted a written demand to hhgregg seeking to reclaim all goods the debtor received in the 45 days prior to the bankruptcy. Whirlpool delivered the written reclamation demand to hhgregg only five days after the petition date, but by that time, hhgregg already received court approval for a DIP loan. Whirlpool later sued to enforce these rights. Wells Fargo, serving as the administrative agent and primary DIP lender, interceded in the adversary proceeding and filed a motion for summary judgment.

Whirlpool argued that the UCC governed the priority of its reclamation demand rather than the Bankruptcy Code and that the UCC required a prior secured party to be a "good faith purchaser" as defined by the UCC. Whirlpool asserted that Wells Fargo was not a "good faith purchaser" because it lent to hhgregg knowing the company was insolvent. Wells Fargo argued that section 546 of the

Bankruptcy Code controlled, not the UCC, and that the Bankruptcy Code does not have a "good faith purchaser" requirement. The court sided with Wells Fargo, determining that the Bankruptcy Code, and not the UCC, was the controlling law. Under section 546(c) of the Bankruptcy Code so long as there is a secured claim, pre- or post-petition, a reclamation claim will be subordinate to that earlier security interest.

COMMENTARY

Does the *hhgregg* ruling mean that reclamation claims are generally worthless? Not necessarily. Preserving a reclamation claim may become important in cases where there is either no secured creditor or if the secured creditor's lien may be avoided. Further, while reclamation claims tend to be long shots, section 503(b)(9) claims (involving goods received by the debtor within 20 days of a filing) are highly valuable in bankruptcy and permit unsecured creditors to receive an administrative priority. Since the same data applies to both, it makes sense to prepare both at the same time. While the *hhgregg* case shows that reclamation claims are not the powerful tool they may appear to be, creditors should nevertheless still consider making reclamation demands as soon as possible after a bankruptcy filing.

Third Circuit Rules that Physical Possession Is Required for 503(b)(9) Claims

In re World Imports, Ltd., 862 F.3d 338 (3d Cir. 2017)

Section 503(b)(9) claims are an important way for trade creditors to be paid in a Chapter 11 bankruptcy. Bankruptcy Code section 503(b)(9) gives trade vendors who deliver goods that a debtor receives in the 20 days prior to a bankruptcy filing an administrative priority claim that must be paid ahead of other unsecured claims. However, one of the key questions has been what the statute means by "receive." Does it mean actual physical receipt of the goods, or does it refer to constructive receipt?

In the *World Imports* case, the Third Circuit Court of Appeals provided crucial clarity to this question. In that case, two Chinese furniture companies shipped goods to the debtor—World Imports, Ltd.—under FOB terms prior to 20 days before the bankruptcy. However, World Imports took physical possession of the goods within the 20-day period. The two creditors then filed motions asserting section 503(b)(9) priority claims for the goods, arguing that because the debtor physically received the goods in the 20-day period they were entitled to a payment priority. The debtor argued that constructive receipt is considered "receipt" under the Bankruptcy Code. The debtor further stated it constructively received the goods prior to the 20-day period because under international commercial law, shipment of goods by FOB shifts the burden of loss to the buyer at the point the goods are loaded onto a common carrier. Thus, the debtor argued that the creditors were not entitled to priority payment. Both the bankruptcy court and district court for the District of Delaware ruled in the debtor's favor, concluding that it is constructive possession that must occur in the 20-day period under section 503(b)(9) and, therefore, the two creditors did not have valid 503(b)(9) claims.

The Third Circuit reversed, stating that while the Bankruptcy Code does not define what "received" means for

purposes of section 503(b)(9), the dictionary and the UCC both define the term as physical receipt. Accordingly, because the debtor took physical possession of the goods within 20 days of the bankruptcy, the sellers were entitled to 503(b)(9) claims.

COMMENTARY

While *World Imports* was a victory for these particular creditors, for others the "physical possession" rule may limit their ability to assert a 503(b)(9) claim. For example, under the Third Circuit's physical receipt rule, drop shipments may not entitle the seller to a priority under section 503(b)(9). While 503(b)(9) claims are one of the best ways for unsecured trade creditors to ensure that they receive some payment in bankruptcy, determining if and when the debtor physically received the goods is key to successfully asserting these claims.

Critical Vendor Order Does Not Necessarily Protect Against Preference Liability

Devices Liquidation Trust v. KMT Wireless, LLC, 2018 WL 3968201 (Bankr. E.D.N.Y. Aug. 17, 2018)

In *Devices Liquidation Trust v. KMT Wireless, LLC*, the debtor paid a number of pre-petition trade creditors, including KMT Wireless, through critical vendor orders. A critical vendor order is an order that permits debtors to pay the pre-petition debts of certain trade vendors whose ongoing participation in bankruptcy is deemed critical to the success of a reorganization. Generally, debtors will require creditors paid under a critical vendor order to offer the same credit terms as they did prior to the bankruptcy.

KMT was a third-party electronics repair firm, performing a majority of the repair work for the debtor. In the 90 days prior to the bankruptcy, KMT received nearly $4 million in payments from the debtor. The liquidating trust established in the bankruptcy proceeding sued KMT to recover the payments. In response, KMT filed a motion for summary judgment. KMT argued that if the critical vendor order included a waiver of preference liability, no one would have objected because KMT's services were necessary to the ongoing bankruptcy. However, the critical vendor order did not explicitly waive preference liability. Rather, the critical vendor order merely permitted, but did not require, the debtor to pay particular pre-petition critical vendor claims.

The court found KMT's argument unpersuasive, stating that it would not "reimagine" how it would have ruled or what other creditors would have done had the proposed critical vendor order released preference claims against KMT. The court further stated that while a critical vendor order could provide a release from preferences, it would have to do so explicitly. Since the critical vendor order in this case had no such language, and did not even name KMT directly, the court denied KMT's motion for summary judgment.

COMMENTARY

Creditors who may have exposure to preference claims cannot assume that being paid as a critical vendor provides a release of preference liability. A release from preference liability must be clear and direct, not inferred.

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