



BuchalterNemer
A Professional Law Corporation

LENDER ALERT

Legal Issues Affecting Financial Institutions

January 2007

Debtor-In-Possession Loans Must Be Carefully Structured To Preserve Priority Over Reclamation Claims


By Paul S. Arrow, Esq.

In one of the first decisions under Bankruptcy Code Section 546(c) as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), a Delaware bankruptcy court held that a secured lender’s prepetition and postpetition liens were superior to a vendor’s reclamation right. In *In re Advanced Marketing Systems, Inc.* 2007 Bankr. LEXIS 135 (“Advanced”), the debtor is a distributor of books to membership warehouse clubs, and its vendors are large publishers, including Simon & Schuster (“Simon”). On the day Advanced commenced its bankruptcy case, Simon made a reclamation demand seeking return of approximately \$5 million in goods delivered to Advanced prepetition. Simon also commenced an adversary proceeding seeking return of the goods, and sought a temporary restraining order barring Advanced from disposing of the goods in the meantime (the “TRO”).

Prepetition, Advanced obtained a working capital line of credit from a group of lenders, including (and agented by) Wells Fargo Foothill, Inc. (“Foothill”). Under the prepetition facility, Foothill held a security interest on substantially all of Advanced’s assets, including a floating lien on its inventory. Shortly after the case was commenced, the bankruptcy court entered an interim order approving postpetition financing by Foothill. The dip facility was structured as a “creeping roll-up” in which the prepetition obligations are paid down over time from the disposition of assets. The dip facility also provided that the prepetition liens were preserved in favor of the postpetition lenders in order to secure the postpetition advances.

In denying the TRO, the Court noted that amended section 546(c) provides that a seller’s reclamation rights are subject to the prior rights of a holder of a security interest in the goods and the proceeds thereof. The Court held that “under the express language of §546(c) of the Bankruptcy Code, as amended, [Foothill’s] prepetition and postpetition liens on [Advanced’s] inventory are superior the [Simon’s] reclamation claim.” The Court also noted that it would have reached the same result under the prior version of section 546(c).

(continued)



Simon nonetheless argued that its reclamation rights were subject only to Foothill's prepetition liens, and because the prepetition obligations would soon be paid off through the "creeping roll-up", it was ultimately likely to succeed on the merits of its claim. The Court rejected the argument for three reasons. First, the argument ignored the fact that the prepetition obligation still existed, and while it may at some time be paid off, Simon could not establish when that would occur, and whether any of its goods would still be in Advanced's possession. Second, the argument ignored the terms of the dip facility providing that the prepetition liens continued to secure the postpetition advances. Thus, it was irrelevant whether the prepetition obligations were satisfied. Third, Simon's reliance on *In re Phar-Mor, Inc.*, 301 B.R. 482 (Bankr. N.D. Ohio 2003), a case where reclamation rights were held superior to the liens of a postpetition lender, was misplaced because in *Phar-Mor* the prepetition lenders' claim was satisfied from the proceeds of the dip facility, and not from the liquidation of the collateral. Finally, the Court noted that Simon was really asking the Court to invoke the equitable doctrine of marshaling, which is unavailable to unsecured creditors. Moreover, Foothill's prepetition and dip facilities prohibited marshaling.

This case, in which our firm represented Foothill, points out the dangers that can befall an unwary debtor-in-possession lender, and underscores the need to carefully structure such transactions in order to ensure a postpetition lender's superiority over reclamation claims.

Paul Arrow is a Shareholder in the Financial Restructuring and Insolvency Practice Group at Buchalter Nemer. He can be reached at (213) 891.0700 or parrow@buchalter.com

Buchalter Nemer is a full-service business law firm representing national and global clients in eight primary areas of practice: Bank and Finance, Business Practices, Financial Restructuring and Insolvency, Litigation, Labor and Employment, Intellectual Property, Real Estate and Tax. The firm has offices in Los Angeles, San Francisco, Orange County and Phoenix.

This article is published as a service to our clients and friends. The material contained here is provided for informational purposes only and is not intended to constitute advertising, solicitation or legal advice.