UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re: ADVANCED MARKETING SERVICES, INC., a Delaware corporation, *et al.*, Debtors.	Chapter 11 Case No. 06-11480-CSS- Jointly Administered
SIMON & SCHUSTER, INC., a New York corporation, Plaintiff, - against - ADVANCED MARKETING SERVICES, INC., a Delaware corporation, Defendant.	Adv. Pro. No. 07-50004-CSS Related to Adv. D.I. 8 Hearing Date: January 17, 2007

REPLY BRIEF IN SUPPORT OF EMERGENCY APPLICATION OF SIMON & SCHUSTER FOR TEMPORARY RESTRAINING ORDER PURSUANT TO BANKRUPTCY RULE 7065

SAUL EWING LLP
Mark Minuti (No. 2659)
J. Kate Stickles (No. 2917)
Jeremy W. Ryan (No. 4057)
222 Delaware Avenue, Suite 1200
P.O. Box 1266
Wilmington, DE 19899
Tel.: (302) 421.6840
Fax: (302) 421.5873

KELLEY DRYE & WARREN LLP
Craig A. Wolfe
Robert L. LeHane
101 Park Avenue
New York, New York 10178
Tel: (212) 808-7800
Fax: (212) 808-7897

Co-Counsel to Plaintiff
Simon & Schuster, Inc.

Dated: January 17, 2007

TABLE OF CONTENTS

PAGE

TABLE OF AUTHORITIES

PAGE

CASES

STATUTES

I. ARGUMENT

Simon & Schuster, Inc. ("Plaintiff"), a creditor and supplier of goods to defendant Advanced Marketing Services, Inc. ("Defendant"), respectfully submits this Reply Brief in support of its Emergency Application for Temporary Restraining Order Pursuant to Bankruptcy Rule 7065 (the "Application").

A. The Secured Lender's Lien Does Not Defeat Plaintiff's Reclamation Claim.

Defendant relies on this Court's decision in *In re Primary Health Systems, Inc.*, 258 B.R 111 (Bankr. D. Del. 2001) and its progeny to support its argument that the mere existence of a secured creditor with a blanket lien on a debtor's assets either automatically extinguishes reclamation claims or renders them valueless. Plaintiff's reliance on *Primary Health* is misplaced. The Court's holding in *Primary Health* was based on a particular set of facts that are not present in this case. Specifically, in *Primary Health*, and the cases upon which it relied, (i) the debtor's assets had already been liquidated, including the goods (or proceeds) which were the subject of the reclamation demand; and (ii) the funds realized from the liquidation were insufficient to satisfy the secured lender's claim. Here, the Defendant Debtor has not liquidated its assets. Nor has the Defendant Debtor alleged that the goods subject to the Reclamation Demand have been, or will be, used to satisfy the Pre-Petition Lender's claims. As such, the holding in *Primary Health* cannot be applied to the facts of the present case.

Defendant also incorrectly relies on the Southern District of New York's holding in *In re Dairy Mart Convenience Stores,* 302 B.R. 128, 131 (Bankr. S.D. N.Y. 2003). Unlike this case, *Dairy Mart* was a liquidation case in which the reclamation creditor's goods were sold more than a year before the Court adjudicated an objection to the

reclamation claim. Significantly, *Dairy Mart* illustrates the harm to a creditor who does not timely seek a TRO on disposition of its goods.

The mere existence of a blanket lien is insufficient to defeat a reclamation claim. Indeed, if such a proposition were correct, a pre-petition secured creditor with a blanket lien on inventory could defeat reclamation claims with only $1 of debt. The leading case to lay to rest the fallacy of that argument was *In re Pester Refining Co.*, 964 F.2d 842 (8th Cir. 1992).

In *Pester*, a creditor made a timely reclamation demand. As in the present case, there were secured creditors with perfected security interests in all of the debtor's assets. In addition, the secured creditor's claims exceeded the value of the debtor's assets. Pursuant to the plan of reorganization, the secured creditor's claims were not satisfied out of the goods (or proceeds of the goods) sought to be reclaimed, but were instead satisfied from other sources. The debtor in *Pester* sought to deny the reclamation claim, relying on the mere existence of the secured creditor's lien and the amount of the secured creditor's claim. The court rejected the argument that the mere existence of a blanket lien defeated a reclamation claims. To the contrary, the court held that a creditor's right to reclaim is not extinguished because a debtor has secured creditors with perfected security interests in the goods sought to be reclaimed. *Pester*, 964 F.2d at 846. Instead, the right to reclaim is only "subject to" or subordinate to the rights of prior secured creditors.

The debtor in *Pester* then argued that the reclamation claims were worthless because the secured creditor's claims exceeded the value of all of the debtor's assets. The court declined to summarily deny the creditor's reclamation claim on that basis. Id. at 847. Rather, the court held that the reclamation claim would only be rendered

valueless if the secured creditor satisfied its claim out of the goods to be reclaimed. Id. at 847-48. Because the secured creditor's claim was not satisfied out of the goods to be reclaimed, but was satisfied from other sources, the court found that the reclamation claim had value. Id.

Subsequent to the *Pester* decision, the Bankruptcy Court for the Northern District of Ohio further clarified the status of reclaiming creditors in its decision in *In re Phar-Mor, Inc.*, 301 B.R. 482 (Bankr. N.D. Ohio 2003). *Phar-Mor* is instructive because of its similarities to the instant case. In *Phar-Mor* the pre-petition lenders were oversecured and were ultimately paid in full through the interim and final debtor-in-possession financings. When faced with reclamation claims, the *Phar-Mor* debtors argued that the claims had no value because of the pre-petition indebtedness and blanket liens. The court in *Phar-Mor* rejected that argument. The court held that reclamation claims were merely subordinate to the pre-petition lenders. *Phar-Mor*, 301 B.R. at 495. The pre-petition lenders' claims were not satisfied out of proceeds from the reclaiming creditors' goods. Id. at 497. Thus, upon extinguishment of the pre-petition indebtedness, the reclaiming creditors had a superior right in the goods to be reclaimed. Id. Most importantly, the reclaiming creditors had priority over the lender because a "a **subsequent** secured creditor cannot defeat a seller's reclamation rights if the seller asserted its rights before the security interest is granted." Id. (emphasis in original).

Two important and oft-cited principles come from the *Pester* and *Phar-Mor* cases:

First, the mere existence of a secured creditor with a blanket lien on the debtor's assets does not automatically extinguish a reclamation claim. *Pester*, 964 F.2d at 847;

Phar-Mor, 301 B.R. at 495; *see also In the Matter of Reliable Drug Stores, Inc.*, 70 F.3d 948, 950 (7th Cir. 1995); *In re Hartz Foods, Inc.*, 264 B.R. 33, 37 (Bankr. D. Minn. 2001); *In re Victory Markets, Inc.*, 212 B.R. 738, 742 (Bankr. N.D.N.Y. 1997). As the results in *Pester*, make clear, whether the pre-petition creditor is over-secured or undersecured is irrelevant. *Pester*, 964 F.2d at 848.

Second, the relevant inquiry in determining the value of a reclamation claim is not the amount of the secured creditor's claim, but whether the secured creditor's claim is satisfied out of the goods to be reclaimed. *Pester*, 964 F.2d at 847-48; *Phar-Mor*, 301 B.R. at 496; *see also Hartz Foods*, 264 B.R. at 37-38; *In re McLouth Steel Products Corp.*, 213 B.R. 978, 989 (E.D. Mich. 1997); *In re Arlco, Inc.*, 239 B.R. 261, 276 (Bankr. S.D.N.Y. 1999). In order for a reclamation claim to be rendered valueless, the secured creditor must satisfy itself out of the proceeds from the goods to be reclaimed. *Phar-Mor*, 301 B.R. at 496.

Here, the pre-petition debt was grossly oversecured. The motions filed by the Defendant Debtor repeatedly acknowledge that there was collateral worth over $200 million securing indebtedness of approximately $41 million as of the Petition Date. The lenders admitted at the teleconference before this Court on this matter, that the amount of pre-petition indebtedness has already been paid down to $25 million and that the debtor-in-possession facility is projected to completely retire that amount. Thus, the pre-petition indebtedness is being satisfied without using the proceeds of Plaintiff's goods to be reclaimed. Not only does Plaintiff's reclamation claim have value, it will soon have priority.

B. The Debtors are Insolvent.

Section 101(32)(a) of the Bankruptcy Code defines insolvent as "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation." 11 U.S.C. § 101(32)(a). Based on the scant information provided by the Debtors to date, it is clear that the Debtors' debts approach the listed value of the Debtors' assets. Given that most debtors' estimates of their debts are optimistically low, it is reasonable to expect that the Debtors' actual debts exceed the stated value of their assets.

The Debtors are also incorrect that going concern is the proper method to value their assets. The Debtors rely on *Travellers Int'l AG v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.)*, 134 F.3d 188 (3d Cir. 1998) for their support. A close reading of the *TWA* case and the application of its principles to this case, though, leads to the conclusion that a liquidation value is the appropriate method to value the Debtors assets.

In *TWA*, the court was faced with the question of what is the appropriate method of valuation for purposes of a "fair valuation" of a debtors' assets in an insolvency inquiry under section 101(32). As the *TWA* court recognized, "valuation must be analyzed 'in a realistic framework' considering amounts that can be realized 'in a reasonable time' assuming a 'willing seller' and a 'willing buyer.'" Id. at 193-94 (citing *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 537 (1994); *Syracuse Engineering Co. v. Haight*, 110 F.2d 468, 471-72 (2d Cir. 1940)). As a result, valuation of an asset varies as a function of the time period afforded for a sale. *TWA*, 134 F.3d at 194. If a debtor has a lengthy period of time in which to sell its assets, such as 12-18 months, then the debtor is

entitled to a higher valuation. The converse is also true, if the circumstances of a debtors' bankruptcy case dictate an expedited sale process, then valuation will be depressed.

Here, the Debtors are in a firesale mode. Under the terms of their DIP financing, the Debtors have essentially 60 days from the Petition Date: (i) to sell their assets; or (ii) obtain replacement DIP financing. The latter option is highly doubtful, given that the Debtors have already stated they have been unable to locate alternative financing.

Nor should the Debtors be able to ascribe much value to a sale transaction. The Debtors have been shopping themselves for over six months with no takers. Instead, in order to comply with their financing, the Debtors have been forced to commence a sale process without the assurance of a stalking horse bidder. Such circumstances will hardly yield a sale premium for the Debtors. In the continuum of sale values, the Debtors are far closer to a forced liquidation firesale than a healthy going concern value that could be realized after 12-18 months of stabilized and restructured operations.

C. The Harm Alleged By Defendant Does Not Outweigh the Harm to Plaintiff.

Despite Defendant's recitation of the alleged harm that it may suffer if the requested TRO is granted, such speculative harm does not outweigh the irreparable harm to Plaintiff. As previously noted, any alleged harm that Defendant may suffer if the requested TRO is granted should not be given any weight by this Court in considering the request for a TRO because Plaintiffs' right of reclamation under section 546(c) of the Bankruptcy Code is not subject to or conditioned on the harm that such reclamation may cause Defendant. Defendant commenced this bankruptcy case and should not be allowed to eviscerate express statutory rights provided to Plaintiff on the grounds that the exercise of those rights by Plaintiff will decrease the value of Defendant's estate.

II. CONCLUSION

WHEREFORE, Plaintiff respectfully requests that the Court (I) enter an order, substantially in the form of the order attached to the Application, directing Defendant to (A) immediately stop selling the Goods until the Court orders otherwise; (B) segregate from its other inventory the Goods that remain in Defendant's possession and any Goods that are returned to Defendant's possession; (C) provide within 3 business days Plaintiff an accounting of the disposition of the Goods; and (D) provide Plaintiff within 4 business days access to inspect the Goods that are in Defendant's possession; and (II) grant such other and further relief as the Court deems just proper and equitable.

Dated: January 17, 2007

SAUL EWING LLP
Mark Minuti (No. 2659)
J. Kate Stickles (No. 2917)
Jeremy W. Ryan (No. 4057)
222 Delaware Avenue, Suite 1200
P.O. Box 1266
Wilmington, DE 19899
Tel.: (302) 421.6840
Fax: (302) 421.5873

-and-

KELLEY DRYE & WARREN LLP
Craig A. Wolfe
Robert L. LeHane
101 Park Avenue
New York, New York 10178
Tel: (212) 808-7800
Fax: (212) 808-7897

Co-Counsel to Plaintiff
Simon & Schuster, Inc.

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re: ADVANCED MARKETING SERVICES, INC., a Delaware corporation, *et al.*, Debtors.	Chapter 11 Case No. 06-11480 (CSS) Jointly Administered
SIMON & SCHUSTER, INC., a New York corporation, Plaintiff, - against - ADVANCED MARKETING SERVICES, INC., a Delaware corporation, Defendant.	Adv. Pro. No. 07-50004 (CSS)

CERTIFICATE OF SERVICE

I, Jeremy W. Ryan, Esquire of Saul Ewing LLP hereby certify that on January 17, 2007 service of the foregoing **Reply Brief in Support of Emergency Application of Simon & Schuster For Temporary Restraining Order Pursuant To Bankruptcy Rule 7065** was made by Electronic Mail on the following parties:

Mark D. Collins, Esquire
Russell C. Silberglied, Esquire
Paul N. Heath, Esquire
Richards, Layton & Finger
One Rodney Square
P.O. Box 1266
Wilmington, DE 19899

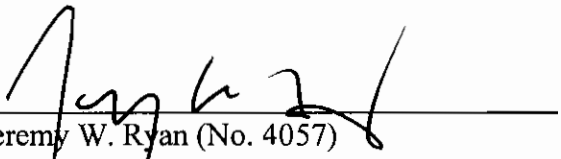
Sussanne S. Uhland, Esquire
Austin K. Barron, Esquire
Alexandra B. Feldman, Esquire
O'Melveny & Myers LLP
275 Battery Street
San Francisco, CA 94111

Advanced Marketing Services, Inc.
Attn: Gary Rautenstrauch
Chief Executive Officer
5880 Oberlin Drive
San Diego, CA 92121

Kurt F. Gwynne, Esquire
Reed Smith LLP
1201 Market Street, Suite 1500
Wilmington, DE 19899

Paul S. Arrow, Esquire
Buchalter Nemer
1000 Wilshire Blvd., 15th Floor
Los Angeles, CA 90017

Bruce Buechler, Esquire
Lowenstein Sandler PC
65 Livingston Avenue
Roseland, NJ 07068



Jeremy W. Ryan (No. 4057)
SAUL EWING LLP
222 Delaware Avenue, Suite 1200
P.O. Box 1266
Wilmington, DE 19899
(302) 421-6800