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UNITED STATES BANKRUPTCY COURT  
SOUTHERN DISTRICT OF NEW YORK

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In re	Chapter 11
Dana Corporation, <i>et al.</i> ,	Case No. 06-10354 (BRL)
Debtors	Jointly Administered.

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**BRIEF OF RECLAMATION CLAIMANT, COLOR BOX, LLC, IN  
OPPOSITION TO PRIOR LIEN DEFENSE TO RECLAMATION CLAIMS**

Color Box, LLC (“Color Box”) submits the following brief in opposition to the prior lien defense to reclamation claims:

**I. FACTS:**

On March 16, 2006, Color Box sent its reclamation demand letter to the Debtors in accordance with the Court’s March 6, 2006 order and March 29, 2006 amended order

establishing procedures for resolving reclamation claims, etc. Color Box asserted a reclamation claim in the amount of \$47,707.33. The Debtors' Notice of Reconciled Reclamation Claims, which the Debtors filed with the Court on June 30, 2006, proposed to disallow completely Color Box' reclamation claim as well as the reclamation claims of all the other creditors that asserted reclamation claims. The Debtors propose to disallow Color Box' reclamation claim under various grounds, including, as relevant to this brief, that all reclamation claims should be disallowed solely because the Debtors granted a lien on all their inventory to postpetition lenders to secure over \$377 million of postpetition financing that was used to pay the claims of prepetition secured creditors with liens on the Debtors' inventory.

The Debtors have stipulated that none of the inventory sought to be reclaimed was liquidated for the purposes of paying the prepetition creditors, and the prepetition creditors were not paid from the proceeds of the inventory sought to be reclaimed, but rather from the proceeds of the Debtors' postpetition secured financing.

## **II. ARGUMENT:**

The Debtors' argument that the postpetition DIP loan transaction extinguished all reclamation claims should be rejected because it is not based on the proper application of the law to the facts of the case. Bankruptcy Code § 546(c)(1), as amended in 2005, provides in general terms that the rights of unsecured vendors to reclaim goods from the insolvent debtor are "subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof." This provision merely confirms what is said in Uniform

Commercial Code § 2-702, that “The seller’s right to reclaim . . . is subject to the rights of a buyer in the ordinary course of business or other good-faith purchaser for value under Section 2-403.” Being “subject to” the claims of prior secured creditors, does not, however, mean that a prior security interest in inventory automatically extinguishes reclamation claims. *In re Pester Refining Co.*, 964 F.2d 842, 846 (8th Cir. 1992). “This contention does obvious violence to the statutory language. In the UCC context, when the right to reclaim is ‘subject to’ the rights of secured creditors, that means the right is subordinate or inferior to the security interests, not that it is automatically and totally extinguished.” *Id.*

The facts alleged by the Debtors are simply that there was a prepetition secured lender owed \$377 million whose claim was secured by a security interest in the Debtors’ inventory, and this lender’s claim was paid by postpetition financing secured by a postpetition security interest in the same inventory. Under these facts, the prepetition lender has been paid from a source other than the inventory Color Box seeks to reclaim—i.e., the proceeds from the prepetition loans. The reclamation claims are therefore no longer “subject to” the secured claims of the prepetition lender. *In re Phar-Mor, Inc.*, 301 B.R. 482, 497 (Bankr.N.D. Ohio 2003), *amended on rehearing*, 2003 Bankr. LEXIS 2009 (Bankr.N.D. Ohio Dec. 18, 2003). The reclamation claims may now be “subject to” the security interests of the postpetition DIP lender, but only if the lender acquired its security interest in the reclaimed inventory in good faith, *id.*, a fact question that will become relevant only if the Court mistakenly equates reclamation claims’ being “subject to” the liens of the postpetition DIP lenders with their being “extinguished by” the liens

of the postpetition DIP lenders. As argued by Color Box here, the mere fact that the postpetition DIP lenders were granted a security interest in goods sought to be reclaimed by Color Box (even if the lenders acted in good faith), and the fact that the DIP lenders' loans were used to pay the claims of prepetition creditors who also claimed security interests in the reclaimed goods does not alone constitute grounds to disallow the reclamation claims.

Even if the reclamation claims are "subject to" the rights of a secured lender, Color Box' reclamation claim will be entitled to payment as administrative expenses and will not be extinguished by the interests of the secured creditors, no matter what the value of the reclaimed goods may presently be in relation to the amount of the secured DIP financing, if the secured lender satisfies its claim from sources other than the reclaimed goods or releases its security interest in the reclaimed goods. *In re Georgetown Steel Co. LLC*, 318 B.R. 340, 348 (D.S.C. 2004).

The Court in the *Dairy Mart* case, *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. 128 (Bankr.S.D.N.Y. 2003), held to the contrary only because it did not recognize the difference between the defeasible interests of a secured creditor in collateral and the indefeasible rights of an outright purchaser of inventory from the debtor. The courts appear to be in general agreement that the debtor's outright sale of reclaimed goods to a buyer in the ordinary course of business defeats the reclamation rights of the vendor that initially sold the goods to the debtor. *See, e.g., In re Coast Trading Co.*, 744 F.2d 686, 690 (9th Cir. 1984). When the debtor sells the goods outright to a purchaser in the ordinary course of business, the debtor retains no legal or equitable rights in the goods

sold nor any right to get the goods back, no matter whether the debtor tenders any amount of money to the purchaser in the ordinary course of business.

In contrast, when the debtor grants its creditor a security interest in its inventory, the debtor still retains its ownership interest in the inventory and is entitled to remove the security interest from its inventory by paying what is owed to the secured creditor. *See, e.g.* Uniform Commercial Code § 9-513(c) (secured creditor is required to file termination statement upon demand by the debtor if no obligation is secured and no commitment to make further secured advances remains).

Because the grant of a security interest in inventory is not the same as the outright sale of the inventory to a buyer in the ordinary course of business, the debtor's grant of a security interest in inventory to a secured creditor takes priority over the rights of reclaiming sellers of inventory to the debtor, but does not extinguish the sellers' reclamation rights. *In re Pester Refining Co.*, 964 F.2d 842, 846 (8th Cir. 1992); *In re Victory Markets*, 212 B.R. 738, 743 (Bankr.N.D.N.Y. 1997). Instead, the reclaiming seller retains a priority interest in any goods remaining and in any surplus proceeds remaining after the superior secured creditor's interests have been satisfied or released. *Victory Markets*, 212 B.R. at 743.

The court in the *Dairy Mart* case incorrectly concluded that the reclamation claims of prepetition sellers were automatically extinguished when a postpetition security interest in all the debtor's inventory was granted to a DIP lender, and the proceeds from the DIP loan were used to pay the claims of the debtor's prepetition secured lenders (which also had a security interest in all the debtor's inventory). *See Dairy Mart, supra*,

302 B.R. at 135. In that case, the court reasoned that the prepetition lender “could have sought Court approval to foreclose on all its collateral,” and that the reclaimed inventory or its proceeds “were used to satisfy [the prepetition lender’s] secured claim.” *Id.* This last conclusion is erroneous. The inventory was used as collateral for postpetition loans, but it was not disposed of. As in the present case, in *Dairy Mart*, it was the proceeds from the postpetition loans—not the proceeds from the inventory—that was used to pay the prepetition lenders. It was incorrect for the *Dairy Mart* court to conclude that granting the postpetition lender a security interest in the inventory constituted a “disposition” of the inventory. *See id.* The inventory remained with the *Dairy Mart* debtors for use in their business, just as the reclaimed inventory remained with the Debtors in the present case. It was as much an error for the *Dairy Mart* court to conclude that the grant of a security interest to the postpetition lender extinguished the sellers’ reclamation rights as it would have been for the court to have concluded that the grant of a security interest to prepetition lenders extinguished the reclamation rights. In both cases, and in the present case, after the loan transactions, the inventory still remained with the debtor for further disposition (e.g., sale to its customers) in the course of its business.

In short, the facts of this case are insufficient to deny Color Box’ reclamation claim, and the Court should therefore not enter an order denying Color Box’ reclamation claim.

**III. CONCLUSION:**

For the reasons stated herein, Color Box requests that the Court find and conclude that the prior lien defense, under the facts presented, does not render Color Box' reclamation claim valueless or provide grounds to deny Color Box' reclamation claim.

Respectfully submitted,

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