

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

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In re : Chapter 11
Dana Corporation, *et al.*, : Case No. 06-10354 (BRL)
Debtors. : (Jointly Administered)
-----X

**REPLY BRIEF OF DEBTORS AND DEBTORS IN POSSESSION IN
SUPPORT OF PRIOR LIEN DEFENSE TO RECLAMATION CLAIMS**

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IN SUPPORT OF PRIOR LIEN DEFENSE TO RECLAMATION CLAIMS**

In accordance with the Court's *Order Pursuant to Section 105(a) of the Bankruptcy Code and Bankruptcy Rules 7042 and 9014: (I) Bifurcating Consideration of Issues Relating to Reclamation Claims; (II) Establishing a Briefing Schedule for Consideration of Certain Common Issues; and (III) Granting Certain Related Relief* (Docket No. 3865) (the "Reclamation Scheduling Order"), the above-captioned debtors and debtors in possession (collectively, the "Debtors") hereby submit this Reply Brief in support of the Debtors' Prior Lien Defense to the Remaining Reclamation Claims (as such terms are defined in the Debtor's Initial Brief).

I. INTRODUCTION

The twenty-four responses from creditors asserting reclamation rights (the "Reclamation Claimants") contain variations on a handful of common arguments. Their cornerstone is the

Debtors' stipulation that the prepetition secured debt was not paid with the proceeds of the Reclaimed Goods, but instead with proceeds of the DIP Loan.¹ While their articulations vary, the logic is consistent: (1) reclamation rights are subject only to a prior lien; (2) the prepetition debt was satisfied from a source other than the Reclaimed Goods; and thus (3) the Reclaimed Goods have been liberated from the prior lien and reclamation claims must now be valued in full. They contend that this result is compelled under the *Phar-Mor* interpretation of pre-BAPCPA law, or under the new BAPCPA-created federal common law of reclamation, as interpreted (or more accurately, promulgated) by the Reclamation Claimants. They acknowledge, mostly, that Judge Gonzalez' decision in *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. 128 (Bankr. S.D.N.Y. 2003) ("*Dairy Mart*") would compel the opposite result: on these facts, Reclamation Claims have no value.

Accordingly, the Reclamation Claimants argue in unison that Judge Gonzalez' decision in *Dairy Mart* is wrong and Judge Bodoh's decision in *In re Phar-Mor, Inc.*, 301 B.R. 482 (Bankr. N.D. Ohio 2003) ("*Phar-Mor*") is right. These cases squarely address the effect on reclamation rights when prepetition debt secured by a floating lien on inventory is paid from borrowings on a DIP loan that is secured by a new floating lien on the same inventory. Sensibly, *Dairy Mart* holds that reclamation rights do not sprout value when old senior debt is supplanted by new senior debt. Nothing about the replacement of one lien by another on Reclaimed Goods provides an economic rationale or equitable justification for revaluing reclamation rights. Rather, the use of the goods to collateralize the loan that retires the prior lien is effectively a disposition of the goods, because the release of the old lien and the creation of the new lien are a single, integrated transaction. Even *Phar-Mor* contemplates that reclamation rights may be

¹ Capitalized terms have the meaning assigned to them in the Debtors' Initial Brief in Support of the Prior Lien Defense to Reclamation Claims ("Initial Brief").

rendered valueless by a DIP lien, so long as the prepetition secured creditor assigns its lien rights to the DIP lender. In other words, under *Phar-Mor*, it is apparently the mechanics of the lien replacement – whether the DIP lender takes a new lien rather than an assignment of the prior lien – that determine whether reclamation rights have value or not. To the extent *Phar-Mor* is apposite, its formalistic and oversimplified approach is not law that should be adopted in this District.

Not a shred of legislative history supports the Reclamation Claimants' contention that the Prior Lien Defense was swept away by the Bankruptcy Abuse Protection and Consumer Protection Act of 2005 ("BAPCPA"). The Prior Lien Defense and the *Dairy Mart* decision predate BAPCPA. If Congress intended to eliminate them, amending section 546(c) to provide expressly that reclamation rights are subject to the rights of prior lienholders was a curious way to go about it. The opposite inference – that the amendment recognizes and incorporates the Prior Lien Defense – is far more reasonable. Regardless, the defense applies in this case post-BAPCPA. Under the express terms of the reworded statute, reclamation rights are still subject to a prior lien, and thus cannot be enforced if the reclaimed goods subject to the prior lien are disposed to satisfy that lien. Under *Dairy Mart*, that is the effect when the reclaimed goods are pledged in order to satisfy the prior lien. To argue otherwise disregards the substance of the transaction and the priority that the DIP Lien holds under section 364 of the Bankruptcy Code. There is no time at which the Reclaimed Goods have not been subject to senior liens.

What Congress did for suppliers of goods such as the Reclamation Claimants was far more significant: it enhanced their rights dramatically by enacting section 503(b)(9), which grants suppliers administrative claims for goods provided to the Debtor within twenty days of the petition date, *whether or not there are prior liens on the goods*, and whether or not they satisfied

the other requirements for reclamation. This right is not only sturdier than reclamation rights, but its twenty day window is double the reclamation period under pre-BAPCPA law. The Reclamation Claimants barely acknowledge this substantial change in the law for their benefit. Congress' intent can only be divined from the plain language and effect of these amendments. These suggest a legislative purpose to achieve a balance of substantive rights, not to reverse *Dairy Mart* or otherwise curtail the Prior Lien Defense.

A common refrain in the responses is that reclamation claims must be allowed because (a) reclamation rights are not extinguished by the existence of a prior lien, but only rendered subordinate to the prior lien, and (b) the Prepetition Lenders were oversecured, and thus the Reclamation Claimants should recover from any excess value. Under *Yenkin-Majestic Paint Corp. v. Wheeling-Pittsburgh Steel Corp. (In re Pittsburgh-Canfield Corp.)*, 309 B.R. 277 (B.A.P. 6th Cir. 2004) ("*Pittsburgh-Canfield*") and the other authorities cited in the Initial Brief, however, whether a prior lien is oversecured is irrelevant. Reclamation is an *in rem* remedy, and reclaiming sellers have no right to compel a lienholder to satisfy its claim from other collateral (such as *other* creditors' reclaimed goods). Cases from this District have made clear repeatedly that marshaling is inappropriate in the reclamation context. Hence if the value of any given reclaiming supplier's goods does not exceed the amount of debt secured by the prior lien, that reclamation claim is valueless. Furthermore, under *Dairy Mart*, oversecurity is also irrelevant because the reclaimed goods were effectively disposed in order to pay off the prepetition debt and release the prior lien.

Certain Reclamation Claimants argue that the lien securing the DIP Loan, by its terms, is subordinate to reclamation rights. The argument is inaccurate, and in several briefs rests on the selective omission of substantive language in the DIP financing orders. Some also argue that the

DIP Lien cannot take priority over reclamation rights because the lender was aware of the existence of the reclamation claims, and thus could not be a good faith purchaser to whose interests the reclamation rights are subject. Whether or not a lender is aware of reclamation demands, however, is not the *sine qua non* of good faith under the Uniform Commercial Code or the Bankruptcy Code. Furthermore, the Court made a good faith finding in connection with the DIP Loan and approved a priming lien that is superior to reclamation rights. The priority of that lien can hardly be challenged later by applying different criteria to facts that were known at the time.

Equitable estoppel is also inapplicable. The Reclamation Claimants' estoppel argument is based on the fact that the Reclamation Procedures were represented to be the sole and exclusive method for handling reclamation claims. The argument fails: not only is the assertion of the Debtors' legal defenses entirely within the "method" contemplated by the motion and order, but the procedures *expressly* reserved the Debtors' right to raise the "whether the demand is subordinate to the prior rights of a holder of a security interest in the applicable Goods or the proceeds thereof." On these facts, none of the requirements for estoppel are met.

Underlying the responses is the common theme that devaluing the Reclamation Claims based on the priority of the DIP Lien is inequitable, and represents an unexpected and undeserved windfall to the Debtors at the Reclamation Claimants' expense. This appeal to equity is unfounded. It has always been the case that reclamation is unavailable when the goods to be reclaimed are encumbered. Where that is so, suppliers have no greater rights than other unsecured creditors. In bankruptcy, the balance of equities is not between reclaiming sellers and the debtor, but between reclaiming sellers and other unsecured creditors, whose claims are leapfrogged if the Reclamation Claims are sustained. There is no economic rationale or

equitable reason why refinancing secured debt should have the effect of placing suppliers' claims ahead of other unsecured creditors when the Reclaimed Goods are just as encumbered after the refinance as before. Further, the Reclamation Claimants are now entitled to administrative priority for a substantial portion of their claims under section 503(b)(9). Congress already balanced the equities by enacting that provision, and there is no indication that it intended to eliminate the Prior Lien Defense. The motion should be granted and the Reclamation Claims valued at zero.

II. DAIRY MART IS GOOD LAW

The Reclamation Claimants are unanimous in their criticism of *Dairy Mart*. As most acknowledge, if the Court agrees with *Dairy Mart*, their reclamation rights have no value. That is because the Prepetition Indebtedness, which was secured in part by a first priority lien on the Reclaimed Goods, was paid from proceeds of the DIP Loan, which was also secured in part by a first priority lien on the Reclaimed Goods. On such facts, Judge Gonzalez held that reclamation rights continued to be valueless after the release of the prior lien, because the release of the prior lien and the creation of the new lien were part of an integrated transaction, and the pledge of the reclaimed goods as collateral for the new loans that paid the old debt constituted the disposition of such goods for reclamation purposes.

Instead, the Reclamation Claimants urge the Court to adopt the reasoning of *Phar-Mor*. In *Phar-Mor*, the prepetition secured debt was paid upon approval of the DIP financing and the prepetition lien was released. Approximately ten months later, the DIP loan of \$135,000,000 was repaid from going-out-of-business sale proceeds, and approximately six months later, the debtors proposed a plan that provided for the payment of reclamation claims as administrative expenses and reserved \$10,000,000 for that purpose. Shortly thereafter, the debtors moved to reclassify reclamation claims as general unsecured claims on the basis that the reclaimed goods had been

sold in the going-out-of-business sale and applied to repayment of the DIP loan. Judge Bodoh sided with the reclamation claimants, on the basis that the prepetition lenders had released their lien on the reclaimed goods. *Id.* at 497. The release of the prior lien distinguished that case from a prior decision of the same court, in which reclamation rights were deemed subject to the rights of a DIP lender that had taken an assignment of the prepetition lien. *Id.* at 497 n.7 (referencing *Pittsburgh-Canfield*, 309 B.R. 277).

Given the great weight assigned by the Reclamation Claimants to *Phar-Mor*, and the variety of interpretations of reclamation law asserted in response to the Prior Lien Defense, it is worth noting the extent to which the *Phar-Mor* and *Dairy Mart* opinions have a common legal foundation. Each articulates the same well-established principles governing the treatment of reclamation claims in bankruptcy:

- A seller's right to reclaim is subject to the rights of a buyer in the ordinary course or a good faith purchaser. *Phar-Mor*, 301 B.R. at 494; *Dairy Mart*, 302 B.R. at 133.
- A secured creditor qualifies as a good faith purchaser. *Id.*
- A reclaiming seller is not automatically entitled to an administrative expense priority or a replacement lien equal to the full value of the claim if reclamation is denied. *Phar-Mor*, 301 B.R. at 496; *Dairy Mart*, 302 B.R. at 134.
- When a secured claim is paid out of the goods to be reclaimed, the seller's reclamation right is rendered valueless. *Phar-Mor*, 301 B.R. at 496; *Dairy Mart*, 302 B.R. at 135.
- A reclaiming seller is not entitled to receive more than what it would have received outside bankruptcy. *Phar-Mor*, 301 B.R. at 496; *Dairy Mart*, 302 B.R. at 134.
- The secured creditor's decisions concerning what collateral to liquidate determine the value of the seller's right to reclaim. *Phar-Mor*, 301 B.R. at 497; *Dairy Mart*, 302 B.R. at 134.

The facts of *Phar-Mor* did not involve, and thus the decision did not address, certain other fundamental principles applicable to this case:

- "A right to reclamation is . . . an *in rem* right." *Action Indus., Inc. (Dollarama) v. Dixie Enters., Inc. (In re Dixie Enters., Inc.)*, 22 B.R. 855, 859 (Bankr. S.D. Ohio 1982). Thus

a seller's reclamation rights are limited to the goods it sold or their proceeds. *Pittsburgh-Canfield*, 309 B.R. at 287-88.

- A reclaiming seller has no right to marshaling. *Simon & Schuster, Inc. v. Advanced Marketing Servs., Inc. (In re Advanced Marketing Servs., Inc.)*, ___ B.R. ___, 2007 WL 162685, at *4 (Bankr. D. Del. January 22, 2007); *Pittsburgh-Canfield*, 309 B.R. at 291-292; *Dairy Mart*, 302 B.R. at 135-136; *Galey & Lord, Inc. v. Arley Corp. (In re Arlco, Inc.)*, 239 B.R. 261, 274 (Bankr. S.D.N.Y. 1999).
- Because a reclaiming seller's rights are limited to the goods it sold, and it has no right to compel a lienholder to resort to someone else's goods, a reclamation claim has value only if the specific goods to be reclaimed have value in excess of the amount of secured debt, whether or not the secured creditor is oversecured. *Pittsburgh-Canfield*, 309 B.R. at 287 (reclamation claim was entitled to recovery "only to the extent that the value of the specific inventory in which the reclaiming seller asserts an interest exceeds the amount of the floating lien in the debtor's inventory" and finding no abuse of discretion in holding that seller's reclamation claims were valueless where the secured creditor was substantially oversecured); *Dairy Mart*, 302 B.R. at 133-134 ("it is only when the reclaiming seller's goods or traceable proceeds from those goods are in excess of the value of the superior claimant's claim that the reclaiming seller will be allowed either to reclaim the goods or receive an administrative claim or lien in an amount equal to the goods that remain after the superior claim has been paid.") (citations omitted).

A common theme in the responses is that reclamation claims are not automatically extinguished by the existence of a prior lien, but are subject to the decision of the secured creditors when it comes to liquidating their collateral. This proposition is usually the complement of the argument that, since the Prepetition Lenders were oversecured, value must be assigned to the Reclamation Claims. The Debtors do not argue — and have never argued — that the Reclamation Claims were extinguished by virtue of the existence of the prior lien. *Dairy Mart* and *Phar-Mor*, among others, hold that they are not extinguished but rendered valueless because they were disposed of in satisfaction of the Prepetition Indebtedness.

Where *Phar-Mor* diverges from *Dairy Mart* is in its mechanical approach to determining the legal consequence of retiring prepetition secured debt through a DIP loan. The *Phar-Mor* rationale could not be simpler: the prepetition debt was paid and the prior lien was released, not preserved for the benefit of the DIP lender, and thus reclamation claims are no longer subject to

the prior lien. *Phar-Mor*, 301 B.R. at 497 (“Since Pre-Petition Lenders’ liens were released, Vendors’ right to reclaim is not affected by the interests of Pre-Petition Lenders.”).²

Judge Bodoh justified this conclusion in *Phar-Mor* by invoking the maxim that “[n]o action on the part of a debtor should be permitted to defeat a seller’s right to reclamation,” citing cases holding that a debtor’s sale of reclaimed goods after the assertion of a valid reclamation demand does not defeat the claim. *Id.* That is followed, without further citation, by the statements that a “debtor’s decision to grant a security interest in inventory to a subsequent secured lender cannot defeat a seller’s reclamation rights if the seller asserted its rights before the security interest is granted. Moreover, the Interim and Final DIP Orders explicitly prohibit Debtors from returning the goods constituting collateral under § 546(c) of the Bankruptcy Code. Therefore, having notice of the Reclamation Demands, DIP Lenders cannot qualify as good faith purchasers under § 2-702(C).” *Id.*

Dissecting this superficial logic confirms the sound reasoning of *Dairy Mart*. The cash to retire the prior lien could have been raised by selling the Reclaimed Goods, thereby extinguishing any reclamation rights. Instead, the prior lien was retired with borrowed cash raised by pledging the Reclaimed Goods as collateral for *another* first priority lien, conferred under subsections (c) and (d) of section 364 of the Bankruptcy Code. Nothing about the replacement of one lien by another on Reclaimed Goods provides an economic rationale or equitable justification for revaluing reclamation rights. As the *Dairy Mart* court found, the use

² Setting aside its holding concerning the effect of the DIP lien, *Phar-Mor* simply falls into line with those cases that stand for the uncontroversial proposition that reclamation claims are not extinguished by a prepetition lien, and thus are no longer subject to such a lien after the lien is released. *In re Pester Refining Co.*, 964 F.2d 842, 848 (8th Cir. 1992) (“Because the secured creditors released their superior liens and satisfied their claims from unrelated assets and income sources, the bankruptcy court properly valued Ethyl’s right to reclaim at the full invoice price”); *In re Georgetown Steel Co., LLC*, 318 B.R. 340, 348 (Bankr. D.S.C. 2004) (allowing a seller’s administrative claim where the prior secured creditor had been paid in full and implicitly released its lien on the seller’s goods).

of the goods to collateralize the loan that pays off the prepetition secured debt is effectively the disposition of the goods, because the release of the old lien and the creation of the new lien are an integrated transaction.

The only way the [Dairy Mart] Debtors could get a post-petition loan was if they afforded the debtor-in-possession lender a lien on all the pre-petition lender's collateral. *In effect, that was the disposition of the collateral* — the lien was given to the new lender in exchange for payment to Citizens or in effect 'sold' to the new lender. The transaction of releasing Citizens' lien and simultaneously granting the lien to the post-petition lender, Foothill, must be viewed as an integrated transaction There was a direct nexus between the release of the liens on the pre-petition collateral and the payment on the pre-petition secured loan *Thus, at the time that Citizens' secured claim was paid . . . , all of the goods or proceeds of those goods were disposed of to 'pay' Citizens' secured claim.* In this context, the reclamation goods or the proceeds from those goods have been used to satisfy the secured creditor's claim. As such the goods or their proceeds have effectively been 'paid' to the secured creditor, and the Reclamation Claims in those goods is valued at zero.

Dairy Mart, 302 B.R. at 135-36 (emphasis added).³

To argue that reclamation rights gained value simply because the prior lien was released, without taking into account the new loan, disregards the economic substance of the transaction. It was a stated purpose of the DIP Loan to refinance the Prepetition Indebtedness, such relief was expressly authorized, and the payoff was accomplished the day after the Final DIP Order was entered.⁴ The argument also disregards the primacy of the DIP Lien that was authorized under

³ Some Reclamation Claimants seek to distinguish *Dairy Mart* factually on the basis that the prior lienholder was paid from its own collateral during the time period between approval of the DIP loan and the payoff of the prepetition secured debt, either directly by cash sweeps or via sweeps by the postpetition lender while the prepetition lien was still in effect. *Id.* at 135. They conclude that the *Dairy Mart* holding — that reclaimed goods were effectively disposed by being pledged to obtain the funds to pay off the prepetition lien — is therefore "only" an alternative holding. That is inaccurate. Unless the *Dairy Mart* prepetition lender was paid entirely from sales of its collateral and not by the DIP lender, the holding was necessary to the decision. The decision implies that was not the case. Indeed, if no reclaimed goods remained on hand, the court's "integrated transaction" analysis would have been superfluous.

⁴ The Final DIP Order was entered on March 29, 2006 (Docket No. 721), approving the DIP Facility on a final basis and authorizing the Debtors to refinance the Prepetition Indebtedness with the proceeds of the DIP Facility.

sections 364(c) and (d). That lien unequivocally had priority not just over reclamation rights, but over the prior lien that had priority over the reclamation rights! Section 546(c) cannot be read to preclude the authority under section 364 to approve first priority liens. The Reclaimed Goods were equally encumbered before and after the transaction.⁵ The use of the Reclaimed Goods to collateralize a loan that paid off the Prepetition Indebtedness did not alter the capital structure of the Debtors in any manner that freed the Reclaimed Goods from liens with priority over reclamation rights.

In the first post-BAPCPA bankruptcy court decision involving the Prior Lien Defense, a Delaware bankruptcy court has held that reclamation rights were subject to both pre- *and* post-petition liens. *In re Advanced Marketing Servs. Inc.*, 2007 WL 162685, *3 (Bankr. D.Del. Jan. 22, 2007). Although cross-collateralization had been authorized there, the operative principle is the same: because there was never a time at which the Reclaimed Goods were not encumbered by a lien with priority over reclamation rights, there was never a time at which the reclamation rights had value. *Phar-Mor* holds that this outcome is purely dependent upon whether the DIP lender took a new lien or was assigned the prior lien. Such elevation of form over substance is not sound and should be rejected by this Court.

The cursory justification in *Phar-Mor* that a “debtor’s decision to grant a security interest in inventory to a *subsequent* secured lender cannot defeat a seller’s reclamation rights if the seller asserted its rights before the security interest is granted” is legally inaccurate. The

(continued...)

On March 30, 2006 (the “Payoff Date”), pursuant to the terms and conditions of the DIP Facility and the Final DIP Order, the Debtors repaid the Prepetition Indebtedness in full using funds borrowed under the DIP Facility.

⁵ Another attempt to distinguish *Dairy Mart* is that the DIP lenders required a lien on all collateral before they would lend, whereas the Dana DIP Lenders did not require a lien on all collateral. That is false. As set forth in the Initial Brief, the Court made findings that the DIP Lenders would not lend without the security they were given, including the lien on inventory. Regardless, the collateral packages did not differ with respect to inventory, which is all that is relevant here.

ostensible support for the statement is Judge Bodoh's preceding observation that debtors cannot defeat reclamation by their actions. But that maxim and its supporting citations relate to the legal effect of a debtor's unilateral acts in selling reclaimed goods. That is different than the legal effect of a court-approved priming lien. There is no logic or authority that supports the application of that maxim to credit agreements that are subject to notice and approval by the Court under section 364 of the Bankruptcy Code. In that context, it is not a debtor's actions that defeat reclamation rights, but the substantive provisions of the Bankruptcy Code.

Moreover, the stated rationale of *Phar-Mor* is flatly inconsistent with this purported justification. Under the *Phar-Mor* holding, a subsequent lender certainly *can* be given a security interest superior to reclamation rights – so long as the transaction is structured as an assignment of the prior lien. No principled distinction exists to justify giving such a lien a different legal effect than that of a DIP lien that is created as part of an integrated transaction that refinances the prepetition debt. In each case the reclaimed goods are used as collateral to obtain the funds to release the prior lien. They are functionally identical.

The other stated justification in *Phar-Mor* is equally flawed. Judge Bodoh states that, “having notice of the Reclamation Demands, DIP Lenders cannot qualify as good faith purchasers under § 2-702(C).” *Phar-Mor*, 301 B.R. at 497. But that is not the prevailing law. Under the Uniform Commercial Code, “good faith” means honesty in fact and the observance of reasonable commercial standards of fair dealing.⁶ Refusing even to permit discovery on the issue, the court in *Pittsburgh-Canfield* stated:

Although several of the Objecting Vendors argued that they should be allowed to take discovery as to the “good faith” of the Prepetition Lenders and the lenders under the DIP Facility, they did not identify any question as to such “good faith” that would

⁶ The definition is codified in § 2-103 or § 1-201 of the Uniform Commercial Code, depending on jurisdiction.

warrant such discovery. *See e.g. In re Steinberg's, Inc.*, 226 B.R. 8, 11-12 (secured creditor who enforces security agreement "in a manner consistent with the clear terms thereof" acts in good faith; discovery not proper unless reclaiming seller shows "some basis on which to question" the secured creditor's good faith); *In re Wathen's Elevators, Inc.*, 32 B.R. 912, 920-21 (Bankr.W.D.Ky.1983) ("good faith" only requires honesty and reasonable commercial standards; secured creditor's alleged "knowledge" of reclamation demands is irrelevant to good faith); *In re Arlco, Inc.*, 239 B.R. 261, 271-72 (Bankr. S.D.N.Y. 1999).

Pittsburgh-Canfield, 309 B.R. at 289-290. Moreover, section 546(c), as amended, does not contain a good faith requirement, which is likely due to the uniform acceptance of this authority with respect to holders of security interests. Finally, the Interim DIP Order and Final DIP Order contain explicit findings that the transaction was negotiated and entered at arms-length and in good faith. Lienholders and other interested parties received actual notice and had approximately three weeks to object. The DIP Orders were not appealed, and are final and conclusive. It is inconceivable that the DIP Lender could find itself behind millions of dollars of reclamation claims on the basis of a challenge to its good faith made months or years after the fact and under different criteria than those that it relied upon in extending credit.⁷

The Debtors submit that *Dairy Mart* is the better reasoned of these two decisions. The Reclaimed Goods were encumbered at all times, and the DIP Lien not only replaced the prior lien in an integrated transaction, but had priority over the prior lien under section 364. In holding that reclaimed goods are subject to a prior lien, but not to a subsequent lien on the same collateral that secures a loan that pays off the prior lien (except where the new lender takes an assignment of the prior lien), *Phar-Mor* utilizes a mechanical, formalistic approach that

⁷ The citation by Parker Hannifin Corporation to Hesse, *Reclamation Rights v. DIP Financiers*, 23-2 ABIJ 20 (March 2004) for further support of the notion that DIP Lenders are not good-faith purchasers is redundant. The article is simply summarizing the *Phar-Mor* opinion where cited.

disregards both the economic substance and practical equities of refinancing, and that should not find acceptance in this District.

III. BAPCPA DOES NOT PREEMPT THE PRIOR LIEN DEFENSE OR REVERSE DAIRY MART

According to the Reclamation Claimants, the 2005 Bankruptcy Code amendments enacted in BAPCPA represent a sea change in the law of reclamation. They urge in essence that weaker state law reclamation rights and adverse judicial interpretations such as *Dairy Mart*, *Arlco*, *Victory Markets Inc.*, 212 B.R. 738 (Bankr. N.D.N.Y. 1997), and *Pittsburgh-Canfield* that have weakened them further, all gave way to a new and stronger and exclusively federal common law of reclamation. Critically, the Reclamation Claimants assert that the “New 546(c)” eliminated the Prior Lien Defense. They argue that the revised statute provides only that reclamation rights are subject to a prior lien – a defense that was eliminated in this case when the Prepetition Indebtedness was refinanced. Apparently, although it purportedly swept away most other cases interpreting UCC § 2-702 and the Prior Lien Defense, the Reclamation Claimants believe (conveniently) that Congress’ intent was to codify *Phar-Mor*. These arguments are specious. BAPCPA does not preempt the Prior Lien Defense or the considerable body of existing law interpreting it and would not change the outcome of this case in any event.

The chief problem with the argument that BAPCPA preempts existing law on the Prior Lien Defense is that it has no support in the statute or its legislative history, and has already been rejected in *Advanced Marketing*. As with so many of the BAPCPA business-related amendments, the record is devoid of legislative history that would corroborate that Congress intended to override existing law on the effect of prior liens on reclamation rights, or that would provide my guidance to the courts as to the development of a new federal common law to replace it. Any such intent must be divined from the text of the revisions. Not only do those revisions

fail to evince any preemptive intent, their plain language supports a strong inference that the Prior Lien Defense was incorporated into the Bankruptcy Code, and that by enacting section 503(b)(9), Congress intended to take a different approach to balancing creditors' substantive rights.

Prior to BAPCPA's effective date, section 546(c) of the Bankruptcy Code provided that "the rights and powers of a trustee under ... this title are subject to *any statutory or common law* right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods" (emphasis added). As the Reclamation Claimants note, the express reference to "any statutory or common law" reclamation right was dropped, a 45 day reclamation period was specified, and the preexisting deadline for submitting demands was increased. One key phrase – "subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof" – was added.⁸

The Reclamation Claimants contend that the consequence of this amendment is the creation of a stand-alone federal reclamation right that preempts state law, and which renders irrelevant all existing authority interpreting reclamation rights under the Uniform Commercial Code, including the Prior Lien Defense under UCC § 2-702. *Collier* makes the short comment that the amendment "suggests" that reclamation rights are now derived exclusively from the

⁸ Section 546(c) of the Bankruptcy Code provides that:

(c) (1) ... ***subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof***, the rights and powers of the trustee under sections 544(a), 545, 547 and 549 are subject to the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days before the date of the commencement of a case under this title but such a seller may not reclaim any such goods unless such seller demands in writing reclamation of such goods —

(A) not later than 45 days after the date of receipt of such goods by the debtor; or (B) not later than 20 days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.

(2) If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9).

11 U.S.C. § 546(c) (emphasis added).

Bankruptcy Code. 5 *Collier on Bankruptcy* ¶ 546.04[1] (Lawrence P. King, et al. eds., 15th ed. rev. 2005). What the Reclamation Claimants fail to note is that when it comes to the Prior Lien Defense, however, *Collier* suggests exactly the opposite: “Using prior versions of section 546(c)(1) as a guide, this provision appears intended to state that the seller’s reclamation rights remain ‘subject to’ the secured creditor’s rights.” *Id.* at ¶ 546.04[2][a][vii].

If Congress had intended its amendment of section 546(c) to preempt the existing body of law on reclamation generally and the Prior Lien Defense specifically, it would have expressed its purpose (but did not). “The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. *Edmonds v. Compagnie Generale Transatlantique*, 443 U.S. 256, 266-267 (1979). The Court has followed this rule with particular care in construing the scope of bankruptcy codifications.” *Midlantic Nat’l. Bank v. New Jersey Dept. of Env’tl. Protection*, 474 U.S. 494, 501, 88 L. Ed. 2d 859, 106 S. Ct. 755 (1986) (emphasis added).

When Congress amends the bankruptcy laws, it does not write “on a clean slate.” See *Emil v. Hanley*, 318 U.S. 515, 521, 87 L. Ed. 954, 63 S. Ct. 687 (1943). Furthermore, this Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history. See *United Savings Assn. of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 380, 98 L. Ed. 2d 740, 108 S. Ct. 626 (1988). See also *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 563, 109 L. Ed. 2d 588, 110 S. Ct. 2126 (1990); *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 244-245, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989).

Dewsnup v. Timm, 502 U.S. 410, 419, 112 S.Ct. 773 (1992).⁹ No legislative history exists evincing an intent to eliminate the Prior Lien Defense or reverse its interpretation in *Dairy Mart* or any other decision.¹⁰

The text of the statute confirms that no sweeping override of existing authority was intended. The “subject to prior rights” proviso in section 546(c), as amended, is remarkably similar in concept, wording and level of detail to the UCC language that has necessarily given rise to the considerable judicial authority on the subject.¹¹ Whatever impact the new language may have on *other* good faith purchasers, it changes nothing in respect to holders of security interests. To the contrary, it codifies the Prior Lien Defense.¹²

Further, the amended statute cannot possibly be applied without reference to existing law. It does *not* say “junior to liens created by an agreement prior to the bankruptcy filing,” as one response hopefully suggests. Brief of the Timken Company, et al., at 9. It says “subject to the prior rights of the holder of a security interest in such goods or the proceeds thereof.” What prior rights? What if the lienholder is oversecured? Is marshaling required? The Reclamation Claimants contend elsewhere that reclamation claims must be deemed to have value if the prior lien is oversecured. Is that purported right eliminated under their strict construction of post-BAPCPA section 546(c)? Are reclamation rights junior to the prior lien if it is assigned, as in

⁹ See also *Desiano v. Warner-Lambert & Co.*, 467 F.3d 85, 95 (2d Cir. 2006) (“[W]ere we to conclude that Appellants’ claims were preempted, we would be holding that Congress, without any explicit expression of intent, should nonetheless be taken to have modified (and, in effect, gutted) traditional state law duties between pharmaceutical companies and their consumers. We see no reason, nor can we identify any precedent, to justify such a result.”).

¹⁰ It bears noting that “[t]he reference to *Collier* is not part of the Code’s “‘legislative history’ in any meaningful sense of the term.” *Midlantic Nat’l. Bank v. New Jersey Dept. of Environmental Protection*, 474 U.S. at 512 (Rehnquist, J., dissenting) (internal citation omitted).

¹¹ UCC § 2-702(3) provides: “The seller’s right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course of business or other good faith purchaser for value under Section 2-403.”

¹² The reworded statute also eliminates the good faith requirement, presumably due to the unanimity of authority that holders of security interests are good faith purchasers.

Phar-Mor? What if the goods have been disposed? Does pledging the goods to release the prior lien constitute a disposition, as in *Dairy Mart*? If Congress intended to replace existing law with a new, more restrictive, federal “Prior Lien Defense Lite,” it did so obliquely and incompletely. As it relates to the legal effect of prior liens, the statute requires judicial interpretation and substance, and there is simply no indication that Congress intended it to come from anywhere other than existing interpretations and substantive law on the subject. Restated, there is no Congressional intent to wipe the slate clean and none should be inferred.

In *Advanced Marketing*, the only post-BAPCPA decision involving the Prior Lien Defense, the Delaware bankruptcy court rejected any construction of the amended section 546(c) that would limit its application to “junior to liens created by an agreement prior to the bankruptcy filing.” *In re Advanced Marketing, supra*. After quoting the “prior rights” clause, Judge Sontchi ruled: “Accordingly, under the express language of §546(c)(1) of the Bankruptcy Code, as amended, the Senior Lenders’ pre-petition **and post-petition liens** on the Debtors’ inventory are superior to S&S’s reclamation claim.” 2007 WL 162685, at *3 (emphasis added). Such a result would be untenable under the Reclamation Claimants’ strict construction of section 546(c) as amended. Under their narrow interpretation, a postpetition lien cannot trump reclamation rights for purposes of the Prior Lien Defense if it was not created “prior” to the assertion of such rights, no matter how closely it is tied to a prepetition lien.¹³ While the postpetition lien in *Advanced Marketing* was cross-collateralized with the prepetition loan, it was nonetheless created after the assertion of such rights. Underscoring that BAPCPA was not revolutionary is the Delaware court’s further notation that the “Court would reach the same result under section 546(c) as it

¹³ Certain of the Reclamation Claimants suggest that BAPCPA confers lien status on reclamation claims. This cannot possibly be squared with their position that the amended section 546(c) is so restrictive. Moreover, there is absolutely no indication that new section 546(c) creates “lien” rights in reclamation claimants. “Lien” is a defined term in the Code. 11 U.S.C. § 101(37). If Congress had wanted reclamation claimants to be granted liens on account of their reclamation claims, it could have said so.

