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Alert

Third and Seventh Circuits Preserve Secured Lenders' Rights

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A creditor's "later-in-time reclamation demand is 'subject to' [a lender's] prior rights as a secured creditor," held the U.S. Court of Appeals for the Seventh Circuit on Feb. 11, 2020. *In re HHGregg, Inc.*, 2020 WL 628268 (7th Cir. Feb. 11, 2020). And "[w]hen a lender insists on collateral, it expects the collateral to be worth something," said the U.S. Court of Appeals for the Third Circuit on Feb. 11, 2020, when rejecting a guarantor's "novel reading" of his security agreement. *In re Somerset Regional Water Resources, LLC*, 2020 WL 628542 (3d Cir. Feb. 11, 2020).

Reclamation Creditor Subordinate to Prior Secured Lender

The reclamation creditor ("W") in *HHGregg,* "a longtime supplier" to the corporate debtor, had delivered goods to it "during the period just before the bankruptcy filing." *HHGregg*, 2020 WL 628268, at *1. Under a pre-bankruptcy credit agreement, though, the lender had a "first-priority floating lien on nearly all of" the debtor's assets, "including existing and after-acquired inventory and its proceeds." *Id.*

Within one day of the debtor's Chapter 11 filing, the lender entered into a debtor-in-possession ("DIP") financing agreement with the debtor, obtaining a "first-priority security interest on substantially all of" the debtor's assets, "including existing and after-acquired inventory and its proceeds." W sent a "reclamation demand seeking the return of" goods it had delivered in the 45-day period "before the [bankruptcy] petition date" three days after the bankruptcy court had approved the DIP financing. *Id.* at *3. The Seventh Circuit affirmed the granting of the lender's motion for summary judgment dismissing W's reclamation complaint that sought priority as to the goods subject to its reclamation demand.

The Seventh Circuit relied on Bankruptcy Code ("Code") § 546(c), as amended in 2005, to subordinate W's reclamation claim to the lender's floating lien on the debtor's inventory. Under Code § 546(c), it reasoned, a seller's right to reclaim goods is "subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof." *Id.* at *1–*2.

The Seventh Circuit easily rejected W's arguments that (a) its reclamation claim was "in effect" on the date of bankruptcy, (b) there was a purported "gap" in the lender's "lien chain" and that (c) the lender was not a good faith purchaser under applicable state law. According to the court, "a reclamation right is not a security interest." Nor is the "reclamation remedy self-executing, either within or outside bankruptcy." W served its reclamation demand after the lender's post-bankruptcy DIP financing lien attached pursuant to a bankruptcy court order. *Id.* at *8.

Nor was there any "gap" in the lender's "lien chain." Prior to bankruptcy, the lender held "a first-priority, perfected lien on" the debtor's assets, including the inventory sold by W. The lender later "obtained a court-approved, priming, first-priority, perfected lien on" the debtor's assets, including

inventory. *Id.* at *8. Thus, W's goods "were continuously encumbered by one or both of" the lender's liens. "The lien chain remained unbroken." *Id.*

Finally, reasoned the court, because of the 2005 amendment to Code § 546(c), "the rationale for examining the lienholder's status as a good-faith purchaser has evaporated." The statutory text "expressly subordinates a seller's reclamation claim to the prior rights of a lienholder," removing the need for any "state law good-faith purchaser inquiry." *Id.* (emphasis in original).

Ambiguous Security Agreement

The lender in *Somerset* was the corporate debtor's largest creditor with a "blanket lien on most of the Debtor's assets" and a personal guaranty by "M," the debtor's principal. *Somerset*, 2020 WL 628542, at *1. After sustaining losses in 2015, the debtor filed a Chapter 11 petition and sought DIP financing from its preexisting secured lender. Because the debtor had already "pledged most of its assets to" the lender, "it had little left to offer." "To entice" the lender to make the DIP loan, M agreed to "pledge" his anticipated net tax refund of $1 million "as collateral." *Id.* at *2. In "hasty negotiations that followed," M signed an agreement pledging as collateral "any rights or interests in the 2015 federal tax refund due to him individually, but attributable to the operating losses of the Debtor." According to trial testimony, the lender would not have made the new loan "[w]ithout that valuable collateral." *Id.* Unfortunately, "the agreement left open the details about executing the tax filings needed to trigger the expected refund," but the bankruptcy court had approved the agreement as part of a consent order. The debtor later defaulted on the DIP financing and a Chapter 7 bankruptcy liquidation ensued.

M then tried to "keep" for himself the entire refund "that he had pledged." *Id.* at *2–3. When the lender and M filed cross motions seeking a determination as to ownership of the refund, the bankruptcy court held an evidentiary hearing. It accepted the lender's testimony and the "overwhelming evidence" of the parties' intent, holding that "the deal was to pledge the entirety of the refund generated by the [Debtor's] 2015 operating losses." *Id.* at 3.

The Third Circuit affirmed the bankruptcy court and the district court, interpreting the DIP financing order "as a contract." *Id.* at *5. Although the security agreement was "ambiguous because it [was] 'subject to multiple reasonable interpretations,'" the Third Circuit accepted the lender's interpretation of that agreement: the 2015 federal tax refund attributable to debtor's operating losses referred to "any refund paid because of losses that the Debtor incurred in 2015." *Id.* at *5 (emphasis in original).

The court relied on parol evidence — "statements between the parties or the circumstances surrounding the agreement." *Id.* at *6. That evidence showed not only the parties' intent, but also the circumstances of the parties' agreement. *Id.*

Not only would the lender have not advanced more funds, but the parties also expected M to "pledge close to $1 million of his tax refund as collateral." The parties never specified "the details of how they would execute new and amended tax returns because the negotiations were moving so fast." *Id.* In any event, "the parties understood that the '2015 refund' referred generally to any refund generated by the Debtor's 2015 losses." *Id.*

M admitted that under his distorted interpretation (excluding refunds from 2013 and 2014), "the agreed-upon refund 'would be valueless.'" *Id.* at *7. The court therefore rejected "this commercially

unreasonable reading" because "worthless collateral would [not] have enticed the [lender] to make so risky a loan." *Id.*

Finally, representatives of the debtor and the lender told M during negotiations that they had read the security agreement "as requiring [M] to pledge around $1 million of the tax refund as collateral for the emergency loan." M never "told them of his contrary reading at the time," but "kept them in the dark until after the [lender] had relied on the collateral to extend a risky loan." *Id.* at 8. The court therefore rejected M's unexpressed reading in order to "prevent a silent party from later ambushing his unwitting opponents." *Id.* at *8.

Comment

These two sensible opinions show resistance by appellate courts to baseless attacks on secured creditors. The lenders here not only bargained for collateral, but also advanced new funds to enable their borrowers' survival.

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If you have any questions concerning this *Alert,* please contact your attorney at Schulte Roth & Zabel or the author.

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