

BANKRUPTCY & CORPORATE RESTRUCTURING

Vendors and the Bankruptcy Reform Act

BY THOMAS D. HAYS AND MICHAEL B. SCHAEDEL

Thomas D. Hays, III, CTP is a Principal at NachmanHays Brownstein. He can be contacted on +1 (610) 660 0060 or by e-mail: thays@nhbteam.com

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 has amended the US Bankruptcy Code elevating the status of vendors in bankruptcy, better protecting sellers of goods in the vulnerable position of shipping distressed companies just prior to bankruptcy.

Before Bankruptcy Code §546(c) was amended, sellers could reclaim goods that purchasers/debtors received while insolvent, provided that a seller complied with the state reclamation law and made a written demand “[b]efore ten days after receipt of such goods by the debtor; or... if such ten day period expires after the commencement of the case, before 20 days after receipt of such goods by the debtor...” (11 U. S. C. §546(c)(1).) The Act amends §546(c) of the Bankruptcy Code extending the time frame for the assertion of reclamation rights from 20 days after case commencement to 45 days.

The new law, as opposed to old §546, does not expressly incorporate state reclamation law (UCC §2-702), but seems to create a new federal reclamation right for vendors. Under formerly incorporated state law, reclamation is subject to the rights of a purchaser, a holder in due course or other good faith purchaser of goods (which has been generally held to include a security interest holder). Further, in order to assert state law reclamation, the purchaser/debtor had to have possession of the goods at the time the demand was made and the goods had to be identifiable in the case of any timely reclamation demand. The court under old §546(c) also had discretion to compel the return of the goods to the seller or to deny reclamation and grant seller either an administrative claim in the amount of the invoice(s) for the unpaid goods or to secure that same claim with a lien on property—all subject in the rights of a good faith purchaser of goods, including a secured creditor.

The Act by deleting references to “statutory and common law [reclamation] right[s] has arguably expanded a seller’s right to reclaim goods if the

seller satisfies Bankruptcy Code §546(c)(1) and (2) notice of demand provisions, subject to the rights of a secured creditor in relevant goods. Also, the ability of the court to substitute administrative claims or liens for reclamation rights has been eliminated. Perhaps most importantly in terms of the costing of bankruptcy presently, even ‘under water’ (as to secured claims) reclamation claim holders can benefit from the administrative claim priority provided for vendors under bankruptcy Code §503(b)(9).

Bankruptcy Code §503(b)(9) is a new provision in the bankruptcy law, which allows an administrative expense for “the value of any goods received by debtor within 20 days before the date or commencement of a case under this title, in which the goods have been sold to the debtor in an ordinary course of such debtor’s business.” (11 U. S. C. §503(b)(9) (emphasis added).) This section appears to apply irrespective of whether a creditor might have equity in goods within the 45 day reclamation period or even if the goods have been reclaimed. The rule does not specify when payment is to be made on these claims, but at the same time elevates vendor claims for the value of sold goods, as a particular species of unsecured priority claims, above the priority given to, for example, employee wages and benefits.

Practical scenarios

Specialty retailer

A specialty retailer had 40 different locations, about half of which were unprofitable. The company had a working capital line, which covered only a portion of its inventory. The retailer over ordered close to the end of the season, based upon substantial sales of a particular product line earlier in the season. It took the latest product shipments in just as sales were falling off.

Seeking bankruptcy relief to cleanse unprofitable leases, the retailer waited beyond the 45 day reclamation period to file, because the un-

sold products might have been reclaimed due to seasonality, and their unique and identifiable nature (through serial numbering). Additionally, the retailer minimized other inventory purchases within 20 days of the filing. The value represented by this inventory could have created administrative expense, increasing cash needs for reorganization.

Heavy construction equipment distributor

A company is in default to a secured creditor with a blanket lien on all corporate assets. In anything other than a consensual workout, the secured creditor would have a substantial deficiency. During the forbearance period, the secured lender sold its debt to a hedge fund—a fund with a ‘loan to own’ agenda.

The company’s business involved purchasing heavy equipment and leasing it with the expectation of selling it shortly after purchase. Equipment purchases were made subject to purchase money liens. The company also sold and leased movable, unaffixed attachments such as shovels or air hammers. The attachments were purchased on open account from trade vendors and not identified by serial number. Purchased on open account, the attachments were subject to the secured lender’s blanket lien.

Under the new law as applicable, attachment reclamation would not be available to the trade due to the blanket lien and because of problems in pairing attachments to the claims of vendors. To the extent attachments were shipped the company within 20 days of case commencement, however, vendors would have Bankruptcy Code §503(b)(9) administrative expense claims for the value of the attachments.

Thus, in this Chapter 11 context, certain important vendors have substantial bargaining power with the company and the hedge fund. Vendors may refuse to go along with anything less than a full payout, demanding current payment in full or the purchase of claims. Ignoring

vendor claims in an 11 may lead to administrative insolvency, decreasing the chances of case success. This change in possible administrative leverage may influence the fund's decision-making in respect of realizing on its claims.

The hedge fund prolonged negotiations with the company while limiting funding for new attachment buys so as to minimise possible administrative leverage if an 11 proved to be necessary.

Plastic film processor

This company was purchased in a highly leveraged transaction by managers. The acquisition was financed by a secured lender with excess coverage as well as second lien financing. The company's performance has been below expectation.

The primary secured lender has gone through eight forbearance agreements and is looking to exit the loan from its portfolio as the company has never made a profit since its purchase for a variety of reasons. In any liquidation, the secured creditors are paid out, but returns to unsecured creditors would range anywhere between 20 and 90 percent.

The company is negotiating with a new secured creditor to 'take out' the existing debt in exchange for accommodations that include warrants. The new secured lender would like a bankruptcy to insure its position.

As to reclamation, the company's inventory is in the form of resin and finished goods, which

under state reclamation principles (albeit not necessarily under the new federal reclamation regime), likely would not be subject to reclamation as they are no longer in their original form. If the company were to file, there would be potential reclamation claims covering a 45 day period prior to case commencement. This creates an opportunity for material vendors to leverage recoveries that would have been unavailable under prior law—perhaps reducing the attractiveness of the deal from the new lender's standpoint.

Claims purchase

A claims investor purchases a block of sub-debt in a \$500m grocery chain, with the hopes that the investment will become the leverage security in a bankruptcy. This acquisition was made after a review of public information. The investor did not take into account the company's even flow of purchases prior to bankruptcy. The pre-bankruptcy purchases amounted to \$30m dollars being treated as an administrative claim, which upon reorganization reduced the value of the sub-debt.

The new environment

As we see above, the Bankruptcy Reform Act importantly elevates the rights of vendors in bankruptcy process. Former reclamation requirements created narrower windows and grounds for vendors to assert rights against inventory that competed with the rights of account debt-

ors and their secured creditors. State law also conditioned the old Bankruptcy Code §546(c) with express possessory and/or inventory identification requirements at the time of demand. Revised Bankruptcy Code §546(c) substantially broadens reclamation rights, which may negatively effect the availability and pricing of DIP financing. Bankruptcy Code §503(b)(9) should land some 'under water' reclamation claims in a plan context or, arguably, in the context of a cash-flowing, equity solvent case. There is a possible pricing effect in that trade credit may be more easily obtainable by distressed companies, which may create a countervailing pressure on funding an 11, mitigating additional lending costs.

Risk has been shifted from vendors to debtors and their distressed operations and finances. Congress' very broad view of reclamation rights has and will create uncertainty in the law, which will result in litigation on the basic requirements for reclamation after bankruptcy, the interaction between Bankruptcy Code §546(c) and §503(b)(9), and valuation battles to determine Bankruptcy Code §503(b)(9) claims. Generally, in managing inventory and obtaining trade credit, new leverages and new pricing have been created and careful planning around new risks is required. ■

This article was co-written by Michael B. Schaedle, a partner at Blank Rome LLP. He can be contacted on +1 (215) 569 5762 or by email: schaedle@blankrome.com