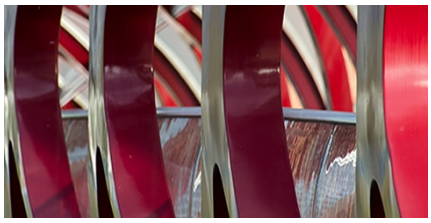
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News & Types: Commercial, Competition & Trade Update

Supplier Reclaiming Shipments to Bankrupt Retailer Loses to Secured Super-Priority Lender

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Practices: Commercial, Competition & Trade, Corporate, Finance & Acquisitions, Litigation

Executive Summary

In any bankruptcy, there are inevitably winners and losers. The winners do not always do virtuous acts to win and the losers are not necessarily evil. Rather, dividing up a limited pie, the bankruptcy courts must leave some creditors short-changed. A good example is the recent 7th Circuit case involving a supplier and a lender. (*hhgregg, Inc. et al. (Debtor). Whirlpool Corporation v. Wells Fargo Bank, National Association, and GACP Finance Co., LLC*, 7th Circuit Court of Appeals, No. 18-3363, February 11, 2020)

hhgregg (with a lower case name) was a retailer of electronics and appliances. It filed for bankruptcy on March 6, 2017 in the Southern District of Indiana. Prior to the bankruptcy, Wells Fargo, as administrative and collateral agent for a consortium of financial institutions, had been providing hhgregg with operating credit. The security agreement gave Wells Fargo a first-priority, floating lien on nearly all of hhgregg's assets, including existing and after-acquired inventory and proceeds.

On the date of the bankruptcy filing, hhgregg entered into an agreement with Wells Fargo to provide hhgregg with debtor in possession (DIP) financing. Wells Fargo, on behalf of itself and a group of lenders, agreed to provide $80 million in DIP financing in exchange for a priming, first-priority security interest in hhgregg's assets, including existing and after-acquired inventory and proceeds. (The court found the interests of GACP Finance, another defendant, to align with those of Wells Fargo, so referred to the lenders together as "Wells Fargo.")

Judge Sykes, writing for the court, acknowledged that lenders to a distressed debtor, especially one in bankruptcy, are taking a major risk and require special security. So judges frequently give this type of lender "super-priority." Such was true in this case when the bankruptcy judge granted super-priority to Wells Fargo.

In the meantime, Whirlpool, a key supplier to hhgregg, had continued to supply hhgregg with home appliances. On March 10, 2017 (three days after entry of the bankruptcy court's order granting the financing and giving Wells Fargo super-priority), Whirlpool sent a reclamation demand seeking return of approximately $16.3 million of unpaid inventory delivered to hhgregg in the 45 day period before the March 6, 2017 bankruptcy filing. This reclamation demand was timely as both Uniform Commercial Code Article 2 and the Bankruptcy Code permit a supplier to a bankrupt customer to reclaim shipments made within a certain period before the bankruptcy filing, if the supplier complies with the strict time limits under the law, which Whirlpool did.

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hhgregg's attempts to restructure were not successful and the bankruptcy court authorized hhgregg to liquidate its inventory, including the Whirlpool appliances, and pay Wells Fargo, with the proceeds subject to Whirlpool's reclamation claim. On May 18, 2017 the bankruptcy judge decided Whirlpool's reclamation claim. The judge granted summary judgment to Wells Fargo, effectively denying Whirlpool's reclamation claim. The 7th Circuit affirmed.

From Judge Sykes' opinion, the result was not very close. The result was dictated by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). Under BAPCPA, the rights of a reclaiming seller are "… *subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof* …" (11 U.S.C. Section 546(c)) (court's italics). As a result, said Judge Sykes,

> "To the extent that priority was uncertain under the old version of [Section] 546(c), after the 2005 amendments, it's crystal clear that a seller's reclamation claim is subordinate to 'the prior rights of a holder of a security interest.' [Section] 546(c)(1) What this means as a practical matter is that '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.'"

So, concluded Judge Sykes, Whirlpool's shipments were subject to Wells Fargo's pre-bankruptcy petition and DIP liens. To Whirlpool's undoubted annoyance and frustration, effectively, Wells Fargo was using Whirlpool's shipments to finance the struggling retailer, hhgregg.

The result in *hhgregg* is certainly a lesson to all suppliers to distressed customers. Deciding winning and losing creditors in a bankruptcy can be very difficult. But, under BAPCPA, Congress made the winners and losers clear. The winner is the DIP lender and secured lender with a prior security interest. The loser is the unsecured supplier to the distressed customer.

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