UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In re:

CASE NO. 97-22809

AUTO WORKS, INC.,

Debtors. **DECISION & ORDER**

MID-STATE AUTOMOTIVE WAREHOUSE, INC.,

Plaintiffs,

V. **AP #97-2238**

AUTO WORKS, INC.,

Defendants.

BACKGROUND

On July 24, 1997, the debtor, Auto Works, Inc. ("Auto Works") filed a petition initiating a Chapter 11 case. Auto Works is a wholly-owned subsidiary of Hahn Automotive Warehouse, Inc. ("Hahn") which acquired the stock of Auto Works in a November 1993 leveraged buy-out. Hahn is in the wholesale auto parts business and Auto Works operated a chain of approximately 150 retail auto parts stores. In the three years prior to its acquisition by Hahn, Auto Works lost in excess of $40,000,000.

Hahn acquired the stock of Auto Works with the proceeds of a loan from Fleet Bank ("Fleet"), the primary lender that financed Hahn's ongoing operations. As a part of the leveraged buy-out acquisition and the related financing transactions, Auto Works became a co-maker on a $13,000,000 term loan note and a $22,000,000 revolving line of credit facility. As security for this

indebtedness, Auto Works granted Fleet a security interest in all of its assets, including inventory. In addition, Auto Works granted Mass Mutual ("Mass Mutual") a security interest in all of its assets, including inventory, as security for a $15,000,000 loan that Mass Mutual made to Hahn in December 1989. During 1996 the Fleet obligations were refinanced. The revolving line of credit was increased, which resulted in a total credit facility of $47,500,000, the number of obligors expanded to include Fleet plus a number of participating financial institutions (the "Bank Group") and Meisenzahl Auto Parts, Inc., another wholly-owned subsidiary of Hahn, became an additional obligor.

By December 18, 1996, Hahn's board of directors determined that it must either sell Auto Works or liquidate its assets because it had continued to lose money. When Auto Works filed its Chapter 11 petition on July 24, 1997, the Bank Group asserted a claim in the approximate amount of $46,000,000, secured by all of the assets of Auto Works, including inventory. Mass Mutual also asserted a claim of approximately $4,250,000, secured by a security interest in all of Auto Work's assets, including inventory. In addition, Auto Works scheduled unsecured creditors with claims of in excess of $49,000,000.

On August 5, 1997, Auto Works filed a motion (the "Sale Motion") that requested an order approving the transfer of substantially all of its assets to a liquidator, free and clear of all liens and encumbrances, so that the assets could be sold at going out of business sales. After hearings conducted by the Court on August 15 and 19, 1997, the Court approved the proposed sale to Gordon Brothers Partners, Inc. ("Gordon Brothers"), free and clear of liens, pursuant to the terms of an agreement which provided that the estate's share of the proceeds of the liquidation of the assets was to be paid directly by Gordon Brothers to the Bank Group as a secured creditor.

The August 19, 1997 Order Approving the Sale (the "Sale Order") specifically provided that:

> 22. To the extent that any vendor has an allowed reclamation claim in the merchandise that is sold by the debtor or Gordon Brothers, such vendor shall be entitled to an administrative expense claim under Bankruptcy Code Section 546(c)(2)(A) to be paid pursuant to a Chapter 11 plan or further order of this Court; provided that nothing contained herein shall establish the validity or amount of any asserted reclamation claim.

On October 24, 1997, Mid-State Automotive Warehouse, Inc. ("Mid-State") commenced an adversary proceeding (the "Reclamation Proceeding") against Auto Works. The Complaint in the Reclamation Proceeding alleged that: (1) for several years prior to 1997, Auto Works had purchased automotive parts and related products from Mid-State; (2) prior to July 1997, Auto Works had placed average monthly orders with Mid-State in the $30,000-$40,000 range; (3) in July 1997, the same month that Auto Works filed its Chapter 11 petition, it placed orders with Mid-State for in excess of $193,000; (4) between July 14 and July 24, 1997, Auto Works was sent invoices in the amount of $146,552.14 for goods shipped during that time (the "Reclamation Goods"); (5) on July 29, 1997, Mid-State made a written demand pursuant to Section 546(c) (the "Reclamation Demand") to reclaim the Reclamation Goods; and (6) pursuant to Paragraph 22 of the Sale Order, if Mid-State had an allowed reclamation claim, it was entitled to an administrative expense claim under Section 546(c)(2)(A) in the amount of $146,522.14.

On December 18, 1997, Auto Works interposed an Amended Answer in the Reclamation Proceeding which alleged that: (1) it was Mid-State's burden to show what portion, if any, of the Reclamation Goods were still in the possession of Auto Works when the Reclamation Demand was made, since under applicable state law that would fix the maximum allowable administrative claim

under Section 546(c)(2)(A) if actual reclamation were denied; (2) Auto Works could not return any of the Reclamation Goods that may have been in its possession at the time the Reclamation Demand was made because those Goods had been transferred and resold by Gordon Brothers pursuant to the Sale Order; (3) the estate's interest in the proceeds of the liquidation by Gordon Brothers of the the assets, including inventory, of Auto Works, approximately $11,000,000, had been paid over to the Bank Group as a secured creditor; (4) in accordance with the decisions of the majority of the courts which had addressed the issue, including *In re Blinn Wholesale Drug Co., Inc.*, 164 B.R. 440 (Bankr. E.D.N.Y. 1994) ("*Blinn*"), the Reclamation Goods were subject to the valid perfected superior undersecured liens held by the Bank Group and Mass Mutual when the Reclamation Demand was made, and to the extent that Mid-State established a right to reclaim, and was granted an administrative expense claim under Section 546(c)(2)(A) and Paragraph 22 of the Sale Order if reclamation were denied, the Court should determine the value of that administrative claim to be zero.

On June 17, 1998, after the Court had conducted several pretrial conferences in connection with the Reclamation Proceeding, Auto Works filed a Motion for Summary Judgment (the "Summary Judgment Motion") which alleged that: (1) the liquidation of all of the assets of Auto Works, including inventory, which served as collateral for the secured claims of the Bank Group and Mass Mutual had generated approximately $11,000,000 for the estate, and was paid over to the Bank Group as a secured creditor; (2) the amount paid to the Bank Group was less than the allowed secured claim of the Bank Group; (3) the unsecured creditors committee (the "Committee") had commenced an adversary proceeding (the "Avoidance Proceeding") against Hahn, the Bank Group and Mass Mutual, which included causes of action to avoid: (a) as fraudulent transfers, all or a

portion of the liens of the Bank Group and Mass Mutual on the assets of Auto Works; and (b) as preferential transfers, certain prepetition payments made by Auto Works to these defendants; (4) the Court had approved a settlement of the Avoidance Proceeding (the "Committee Settlement") that required Hahn to pay the estate approximately $1.6 million over five years; (5) the Committee Settlement would allow Auto Works to fund a liquidation plan that would pay its administrative expense claimants in full as well as a partial distribution to its unsecured creditors; and (6) regardless of the fact that Hahn, as part of a refinancing with Fleet, had paid the outstanding balances due to the Bank Group after the payments to the Bank Group by Gordon Brothers and the commencement of the Reclamation Proceeding, at the time the Reclamation Demand was made, which is the point at which the relative rights of a reclaiming creditor and a prior perfected secured creditor are determined under state law, the Reclamation Goods were subject to the valid perfected superior undersecured liens of the Bank Group, so Mid-State, as a reclaiming creditor, could not benefit from that later payment.

On July 8, 1998, Mid-State interposed opposition to the Summary Judgment Motion (the "Mid-State Opposition") which asserted that: (1) based upon the facts learned by the Committee during discovery in its Avoidance Proceeding,[1] there were genuine material issues of disputed fact as to whether the liens of the Bank Group and Mass Mutual on the inventory of Auto Works, including the Reclamation Goods, were valid as against Mid-State when it made its Reclamation Demand; (2) there was case law authority contrary to the line of cases represented by *Blinn* which,

---

[1] Mid-State included as an exhibit in its opposition a copy of an Internal Committee Memorandum that comprehensively assessed the Committee's causes of action and was shared with the defendants in the negotiations which resulted in the Committee Settlement approved by the Court.

if followed by this Court, would permit it to disallow Mid-State's reclamation claim and grant it an administrative expense claim, pursuant to Section 546(c)(2)(A) and Paragraph 22 of the Sale Order, which would be required to be paid in full, up to the amount of the Reclamation Goods in the possession of Auto Works when Mid-State made the Reclamation Demand, even if there were valid perfected superior undersecured liens held by the Bank Group and Mass Mutual; (3) in the Sale Order, notwithstanding the existence of the apparently undersecured claims of the Bank Group and Mass Mutual, the Court determined that allowed reclamation claims would be entitled to an administrative expense priority claim which was to be paid pursuant to a Chapter 11 plan or subsequent Court order, not an administrative expense claim which could thereafter be valued by the Court at zero; (4) Mid-State believed that it was defrauded by Auto Works because it alleged that Auto Works had ordered the Reclamation Goods with knowledge that it would be filing a Chapter 11 liquidation proceeding that would not result in full payment to Mid-State for the Reclamation Goods; and (5) this alleged fraud was evidenced by the fact that the Reclamation Goods were ordered after July 10, 1997, the date when the Auto Works Chapter 11 petition was signed by a duly authorized officer and one of its attorneys, even though the petition was not filed with the Court until July 24, 1997.

DISCUSSION

I. Statute

Section 546(c) provides that:

> (c) Except as provided in subsection (d) of this section, the rights and powers of a trustee under sections 544(a), 545, 547, and 549 of 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 if the debtor has received such goods while insolvent, but—

(1) such a seller may not reclaim any such goods unless such seller demands in writing reclamation of such goods—

(A) before 10 days after receipt of such goods by the debtor; or

(B) if such 10-day period expires after the commencement of the case, before 20 days after receipt of such goods by the debtor; and

(2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court-

(A) grants the claim of such a seller priority as a claim of a kind specified in section 503(b) of this title; or

(B) secures such claim by a lien.

II. Mid-State's Right to Reclamation

There is no dispute that the required elements exist in this case which are necessary for Mid-State to establish a right under applicable state law, in this case The New York Uniform Commercial Code, to reclaim that portion of the Reclamation Goods which were in the possession of Auto Works at the time the Reclamation Demand was made. These elements are: (1) Auto Works was insolvent at the time the Reclamation Goods were sold to it; (2) there is a statutory right of reclamation, Section 2-702 of the New York Uniform Commercial Code; (3) the Reclamation Goods were sold to Auto Works in the ordinary course of Mid-State's business; and (4) the Reclamation Demand was timely. See *In re Victory Markets, Inc.*, 212 B.R. 738 (Bankr. N.D.N.Y. 1997) ("*Victory Markets"*)

and *In re Child World, Inc.*, 145 B.R. 5 (Bankr. S.D.N.Y. 1992); affirmed, 137 B.R. 323 (S.D.N.Y. 1992); affirmed 992 F.2d 321 (2nd Cir. 1993) ("*Child World*").

The primary question presented to this Court for decision by the parties in their submissions and in their oral arguments is whether this Court agrees with the line of cases represented by the decisions in *Victory Markets, Blinn* and *Child World.* These cases hold that a reclaiming creditors' rights under applicable state law, Section 2-702(3) of the New York Uniform Commercial Code, are subject to the rights of a buyer in the ordinary course of business or other good faith purchaser, which includes a creditor that holds a valid perfected superior floating lien on inventory and has not acted in bad faith. These cases further state that if a superior lienholder is undersecured when all of the debtor's assets which are collateral for the underlying loans, including inventory and the goods subject to a reclamation claim, are liquidated or properly valued, the reclamation creditor either has a valueless reclamation claim or, if pursuant to Section 546(c)(2)(A) actual reclamation is denied by the Court, the creditor is granted an administrative expense claim, that administrative expense claim must be valued at zero. In either case, the reclaiming creditor is left with a general unsecured claim.

I agree with the analysis of the Court in *Blinn* which comprehensively analyzed and integrated the statutory provisions, underlying policies and practical realities of the rights and remedies of a reclaiming creditor and a valid perfected superior undersecured creditor under both Section 2-702 of the New York Uniform Commercial Code and Section 546(c) of the Bankruptcy Code.

The *Blinn* Court held that in bankruptcy, the rights of a reclaiming creditor are subject to the rights of a valid perfected superior lienholder in after acquired inventory, including the goods to be reclaimed, and if that lienholder is determined to be undersecured, it is appropriate for the Court to:

(1) allow the reclamation claim, if all of the elements necessary to establish a basic right to reclamation exist; (2) deny any actual reclamation; (3) grant the reclaiming creditor an administrative expense claim, as required by Section 546(c); and (4) value that administrative expense claim at zero, leaving the reclaiming creditor with a general unsecured claim.

Necessary to the acceptance of the *Blinn* analysis and holding is my belief that: (1) Congress in enacting Section 546(c), intended to preserve, but not to enhance, state law reclamation rights; and (2) in order to facilitate the orderly administration of a Chapter 11 estate when the Court must address the competing rights of a good faith perfected superior undersecured creditor in inventory and a reclaiming creditor, the Court should deny a otherwise valid right to reclaim.

As discussed in *Blinn*, the practical questions to ask are: (1) what would be the point of allowing the reclaiming creditor to reclaim the goods; and (2) would the reclaiming creditor really liquidate them for the benefit of the undersecured creditor and pay over all of the proceeds of the liquidation to that secured creditor? At the same time, if actual reclamation must be denied, resulting in the reclaiming creditor being granted an administrative expense claim pursuant to the specific provisions of Section 546(c)(2), that claim should be valued at zero. This properly reflects the respective state law rights of those parties, and it implements one of the fundamental policies of the Bankruptcy Code, equality of distribution.[2]

---

[2] The Court is aware of the solution to this problem offered in *Victory Markets*. That analysis, which the Court was aware of at the time of the Sale Order was entered, did not have to specifically address a reclaiming creditor's request for reclamation, since that request had been withdrawn. However, the analysis achieved the same result as the Court in *Blinn*, in relegating the reclaiming creditor whose rights are subject to those of a perfected superior undersecured lienholder to general unsecured status.

Although it had not previously been asked to decide the issue, this Court was aware of and agreed with the analysis set forth in *Blinn* at the time it signed the Sale Order that was prepared by the attorneys for Auto Works and approved by the other parties that participated in the underlying hearings. In signing the Sale Order, the Court did not believe that its provisions, specifically Paragraph 22, required the payment in full of any administrative expense which might be granted to a reclaiming creditor who could establish a basic right to reclamation, if the secured liens of the Bank Group and Mass Mutual were ultimately found to valid and they exceeded the estate's portion of the proceeds of the sale of all of the assets of Auto Works, including inventory, which served as collateral for those obligations.[3]

III. Validity of the Liens of the Bank Group as Against Mid-State

There appear to be genuine material issues of disputed fact as to whether: (1) the liens of the Bank Group[4] in the inventory of Auto Works, including the Reclamation Goods, if any, that were on hand at the time the Reclamation Demand was made, were valid, in whole or in part, as against Mid-State; and (2) whether the Bank Group acted at all times in good faith, as required by Section 2-702(3) of the New York Uniform Commercial Code. The original financing transactions with Fleet in 1993 and the refinancing in 1996 are both within the six year statue of limitations under Article 10 of the New York Debtor and Creditor Law, the provisions of which might permit Mid-State, as a "future creditor", to avoid all or a portion of the liens of the Bank Group on the

---

[3] At the time the Sale Order was entered the Committee had specifically reserved the right to investigate and challenge the validity and avoidability of the liens of the Bank Group and Mass Mutual.

[4] There are also questions as to the avoidability and thus the validity of the liens of Mass Mutual as against Mid-State under Article 10 of the New York Debtor and Creditor Law.

Reclamation Goods. This might result in there being some value to Mid-State's administrative expense claim.

Auto Works has asserted that Mid-State's ability to establish that the liens of the Bank Group are not valid and superior to its reclamation rights because they may be avoidable as fraudulent conveyances or because the Bank Group somehow acted in bad faith, has been precluded by the Court's approval of the Committee Settlement. Although any causes of action against the Bank Group to avoid its liens and obtain a recovery for the estate under Section 550 may have been settled, and would preclude individual creditors such as Mid-State from pursuing and recovering such causes of action that they might otherwise hold but for the bankruptcy proceeding, that does not preclude Mid-State from establishing the invalidity of the liens of the Bank Group and Mass Mutual on the Reclamation Goods for purposes of establishing that Mid-State's administrative expense claim has some value.

As a result, Auto Works Summary Judgment Motion must be denied in order to afford Mid-State the opportunity to conduct discovery in connection with the validity of the liens of the Bank Group and Mass Mutual as against Mid-State as a reclaiming creditor.

IV. Miscellaneous

Mid-State has asserted that its administrative expense claim should be valued at $146,522.14 because subsequent to the Reclamation Demand, the Bank Group waived its security interest in inventory, including the Reclamation Goods, in connection with the sale to Gordon Brothers. The Court approved sale of the assets of Auto Works to Gordon Brothers was a sale free and clear of the liens of the Bank Group, but such liens were transferred to the estate's portion of the proceeds, which was to be paid to the Bank Group in partial satisfaction of its claims. The sale free and clear of liens

with the transfer of the liens of the Bank Group to the proceeds was not a waiver or release of those liens as against Mid-State as a reclaiming creditor whose rights had not been fully determined but who had rights of its own under Paragraph 22 of the Sale Order. Furthermore, the liquidation of all of the assets of Auto Works that were collateral for the obligations owed to the Bank Group did not result in the full payment of those obligations. As a result, the liquidation demonstrated that there was never excess value in those assets above the liens of the Bank Group that could result in a finding that there was value to the administrative claim of Mid-State. It is only if Mid-State can establish that the liens of the Bank Group and Mass Mutual were not valid against it, in whole or in part, at the time the Reclamation Demand was made that Mid-State can establish that there is value to the administrative expense claim that was granted to it by Section 546(c)(2) and Paragraph 22 of the Sale Order.

Although the attorneys for Auto Works are correct in asserting that the allegations by Mid-State that it was defrauded by Auto Works are immaterial and irrelevant to the Summary Judgment Motion, they are of concern to the Court. Mid-State has alleged that Auto Works ordered the Reclamation Goods knowing that Mid-State would never be fully paid for them because none of the alternatives it was exploring at the time it ordered the Goods, an asset sale or a Chapter 11 liquidation proceeding, would ever realistically have resulted in all of the unsecured creditors of Auto Works being paid in full, including Mid-State for the Reclamation Goods. Here the Reclamation Goods appear to have been ordered after the Chapter 11 petition was signed, and a response to these allegations of fraud by Auto Works failed to indicate that the alleged alternatives it was exploring at the times the petition was signed and the Reclamation Goods were ordered would

have paid Mid-State in full. These are issues that Mid-State is free to pursue in state court against the appropriate officers or directors of Auto Works.[5]

CONCLUSION

The Auto Work's Summary Judgment Motion is granted in part and denied in part. The right of Mid-State to reclaim the Reclamation Goods is denied, as it was by the Sale Order, and Mid-State is granted an administrative priority claim pursuant to Section 546(c)(2)(A) and Paragraph 22 of the Sale Order. However, that administrative expense claim is valued at zero unless Mid-State can establish at trial that: (1) the perfected superior undersecured liens of the Bank Group and Mass Mutual were either invalid as against it, presumably because they were avoidable as to Mid-State pursuant to Article 10 of the New York Debtor and Creditor Law; or (2) the Bank Group and Mass Mutual otherwise acted in bad faith. In either case those entities would not be good faith purchasers as to Mid-State within the meaning and intent of Section 2-702(3) of the New York Uniform Commercial Code.

This Reclamation Proceeding is adjourned to a telephonic pretrial to be conducted by the Court on December 10, 1998 at 10:00 a.m. That will afford Mid-State the opportunity to conduct discovery of the Bank Group and Mass Mutual.

---

[5] In a Chapter 11 case if it could be established that goods were fraudulently ordered prepetition, that would be inappropriate pre-bankruptcy planning and abusive. In such a case, it might be appropriate for the Court to review that issue in connection with its determination as to whether any plan which proposed to pay the unsecured creditors, including the supplier of those goods, less than the full amount due them, while shareholders retain an interest, could be in good faith within the meaning and intent of Section 1129(a)(3). A similar good faith issue is often analyzed by courts under Section 1325 when Chapter 13 debtors are seeking a superdischarge of one or more debts that would be nondischargeable in Chapter 7.

As stated by the Court at the oral argument on the Summary Judgment Motion, I do not expect that the attorneys for either Auto Works or the Committee will be involved in any way in that discovery. It is necessary to minimize the continuing cost of this Reclamation Proceeding to the estate and there is no apparent need for those attorneys to be involved in such discovery in order to protect the estate or the creditors of the estate.

IT IS SO ORDERED.

_____/s/_____
HON. JOHN C. NINFO, II
U.S. BANKRUPTCY JUDGE

Dated: August 31, 1998