

BANKRUPTCY**RECENT CASE LAW DEVELOPMENTS IMPACT CLAIMS OF UNPAID SUPPLIERS FOR GOODS DELIVERED IMMEDIATELY PRIOR TO CUSTOMER BANKRUPTCY.**

by Daniel F. Gosch

Section 503(b)(9) of the Bankruptcy Code (11 U.S.C. §503(b)(9)) provides a special administrative priority claim for someone that supplies goods to a debtor in the 20 day period before the bankruptcy filing, but is unpaid as of the date of the filing. This is a meaningful priority. Administrative priority claims, which are on par with the claims of other post-petition service providers, like the debtor's professionals, must be paid in full at the time of the confirmation of a plan, in order for a plan to be confirmed. Reliance on the priority provided by Section 503(b)(9) of the Bankruptcy Code can serve as an important alternative to suppliers who might otherwise be forced to seek to exercise state law rights of reclamation under the Uniform Commercial Code after a customer receives their goods—claims which can clash, often unsuccessfully for the supplier, with the rights of secured lenders.

Claims arising under Section 503(b)(9), are, at their essence, relatively uncomplicated on first blush. An unpaid claim for “the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor’s business” is entitled to the priority. Notwithstanding what looks to be pretty straightforward language, however, a recent set of decisions from the Third Circuit Court of Appeals, and from the Bankruptcy Court for the District of Delaware provide some detail on what it means for goods to be “received by the debtor” for purposes of Section 503(b)(9).

In *In re World Imports, Ltd.*, 16-1357 (3rd. Circuit, July 10, 2017), two Chinese suppliers sold goods to the debtor which were loaded onto ships in China, “FOB at the port of origin”. As a result, the risk of loss with respect to the goods passed to the debtor at the time the goods were transferred to the shipper for carriage to the United States. Although the debtor accepted the goods in the United States within 20 days of the date it filed its chapter 11 petition, the date the goods were transferred to the shipper in China was more than 20 days prior to the filing date. The debtor objected to the suppliers’ subsequent 503(b)(9) claim, arguing that the goods were “received” when the risk of loss transferred—outside the 20 day period. The Bankruptcy Court agreed with the debtor and denied 503(b)(9) priority to the suppliers’ claims. On appeal, the District Court affirmed. However, on appeal to the Third Circuit Court of Appeals the lower courts were reversed, as the Court of Appeals determined that the term “received by the debtor” as used in Section 503(b)(9) meant the time “the debtor or its agent takes physical possession of [the goods].” Because the goods were actually in the possession of the debtor within the 20 day period preceding the filing date, the suppliers were entitled to 503(b)(9) priority.

Shortly after the decision in *World Imports*, the Bankruptcy Court for the District of Delaware was faced with a slightly different problem in a Section 503(b)(9) context. In *In re SRC Liquidation, LLC*, No. 15-10541 (Bankr. D. Del. July 13, 2017), the debtor had arranged for one of its suppliers to “drop ship” certain goods ordered by the debtor so that they would be shipped by the supplier directly to the debtor’s customers, with the debtor never taking actual physical possession of the goods. The supplier claimed that it was entitled to an administrative expense claim under Section 503(b)(9) for the value of the goods shipped directly to the debtor’s customers, but in ruling on an objection to that claim the Bankruptcy Court disagreed. Relying in significant measure on the Third Circuit’s determination in *World Imports*, the Court found that under the drop shipment arrangement, the goods were never “received by the debtor” because neither the debtor nor its agent (and, as the Court pointed out, a common carrier/shipper does not qualify as an “agent” of a debtor for these purposes) ever had physical possession of them. As a result, the supplier was not entitled to a priority claim under Section 503(b)(9).

In reaching their respective decisions, both courts above made specific reference to the provisions of Section 2-705 of the UCC to support the conclusion that goods are “received” by the buyer’s physical possession of the goods or the buyer’s “constructive receipt” of the goods, in each case as outlined in 2-705. Thus, the phrase “received by the debtor” in Section 503(b)(9) turns out to mean pretty much exactly what common sense would suggest it means—the goods must have been physically received by the debtor or its agent (such as a bailee who holds the goods for the debtor) within the 20 day period.

Finally, one other recent case suggests vitality for a supplier remedy under the UCC that has been somewhat overshadowed by 503(b)(9) and post-delivery reclamation demands—the right to seek to stop delivery of goods in transit.

In *O2Cool, LLC v. TSA Stores, Inc.*, No. 16-10527 (Bankr. D. Del. March 1, 2017) a supplier found itself in a fight with a debtor’s secured lenders over the value of goods that were shipped to the debtor pre-petition. Here, there was no dispute about the debtor’s receipt of the goods. However, in this case, the supplier alleged that prior to the time the goods had been received by the debtor it had served a timely notice to stop delivery under Section 2-705 of the UCC upon the carrier of the goods. According to the supplier’s complaint, that notice had been actually received by the carrier before the debtor took possession of the goods, but the debtors had instructed the carrier to disregard the notice. The debtor subsequently sold the goods, and turned over the proceeds of the sale to the secured lenders. The supplier sought a judicial determination that its rights to the value of the goods and their proceeds were senior to those of the secured lenders.

The lenders sought to dismiss the complaint, arguing that there was no timely reclamation demand made by the supplier, and that even if there had been, the supplier’s claim would be junior to the lenders’ liens. The supplier admittedly never made a reclamation demand of the debtor, and never filed a timely claim under 503(b)(9), notwithstanding

the debtor's receipt of the goods. Instead, the supplier asserted that the effect of the stoppage notice was that the debtor never acquired any rights in the goods whatsoever—hence there was no need for any such claims. Rather, it argued, because the debtor never acquired rights in the goods, the debtor never had any right to sell the goods, and the liens of the secured lenders never attached to them at all. As a result, the supplier contended it was entitled to the full value of the goods.

This claim survived the lenders' motion to dismiss as the Bankruptcy Court found that if the allegations of the complaint were in fact true, no reclamation claim would have been required of the supplier, and the disputed goods would never have become property of the bankruptcy estate. Thus, the supplier had a colorable argument that any subsequent sale of the goods after the notice to stop delivery would have required full payment in cash to the supplier—which never occurred, as the proceeds were instead paid to the lenders.

While clearly at a preliminary stage of the proceeding, this case suggests an alternative for suppliers other than simply taking action after delivery of the goods to the debtor—the giving of notice to a carrier to stop delivery before delivery to the debtor, when permitted to do so under Section 2-705 of the UCC. Clearly, there are a great number of details associated with taking this sort of action in any particular case (for example, the supplier in O2Cool had utilized a freight forwarder, and initially gave the stop shipment order to the wrong entity), but if done timely, and correctly, and in compliance with 2-705 of the UCC, another arrow may reside in the quiver of the supplier.

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