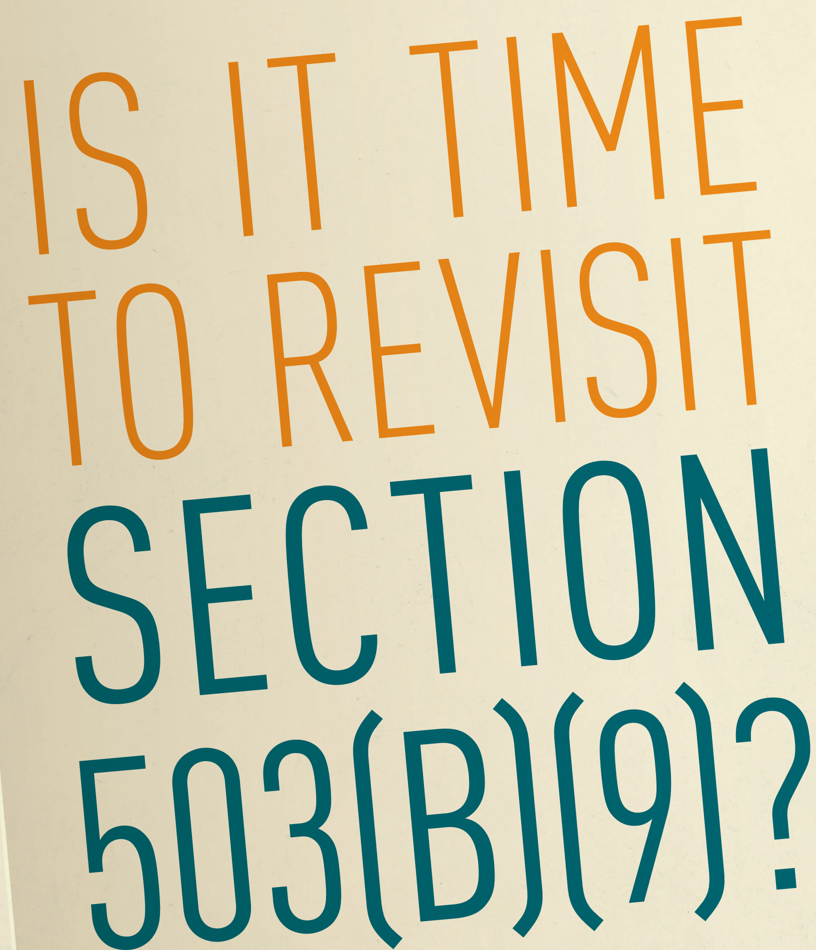

IS IT TIME TO REVISIT SECTION 503(B)(9)?

BY JOSEPH H. HUSTON JR., SHAREHOLDER, STEVENS & LEE, P.C.

Section 503(b)(9) of the U.S. Bankruptcy Code is either loved or hated, and sometimes both by the same constituency, depending on who wins or loses regarding administrative claims of suppliers whose claims arose in the 20 days before a bankruptcy filing. The section often yields anomalous or inconsistent results based on only slight variation in facts, some of which are often just the result of good or bad luck. Many commentators have called for the provision's amendment or outright repeal.

Through a hypothetical scenario, this article illustrates some curious outcomes that section 503(b)(9) can produce and discusses why it might be time to give section 503(b)(9) a long, hard look.

Fashions, Inc., a U.S. retail clothing chain, is having a tough time, has been behind on hundreds of thousands, if not millions, of dollars in payments to suppliers and landlords during the first five months of the year, and is preparing to file Chapter 11 sometime in July after the close of the second quarter. The petition and supporting documents and declarations are already in the works. Fashions' secured lender has a blanket lien, is playing ball for the time being, and has expressed a cautious willingness to consider doing the required post-petition lending.

The retailer has ordered imported products from various suppliers whose sources are in China and will deliver them to Fashions' freight consolidator Kontainer in Hong Kong. Kontainer, in turn, will assemble them with goods going to a variety of purchasers, load them into a container, and deliver them to Fashions' third-party shipping company in the U.S., Quick Drop. On Friday, June 13, Auspicious Jeans from Shanghai ships to Kontainer 100 pairs of its wildly popular jeans, invoice price $10 each, which are featured "door buster" offerings at Fashions and draw much of its traffic. The jeans arrive June 17 and are to be shipped from port to be delivered to Fashions' warehouse by Wednesday, July 2. They arrive in the U.S. on time, but Quick Drop has not been paid on some recent invoices. The shipping company holds up delivery until it gets paid. It delivers the jeans on Monday, July 7.

Acqua Pura delivers 100 bottles of mineral water marked with the Fashions logo to the retailer every day to be handed out *gratis* to employees and customers. There are almost never any left at the end of a day. Having not gotten paid for some time, however, Acqua Pura is owed $1,000 and stops delivering June 24. There are no bottles left after a day or two.

Shopping bag supplier Sacco has a standing order to deliver 10,000 bags to Fashions every week on Fridays at a cost of 10 cents a bag, or $1,000 per order. It delivers 10,000 bags to its common carrier on July 2 for that week's order, ordinarily to be delivered Friday, July 4. The carrier gives its employees a day off for the Fourth of July, however, so the delivery isn't made until Monday, July 7. That week's standing order of 10,000 bags is scheduled to go to the carrier July 9 to be delivered Friday, July 11. Sacco is owed $1,000.

Fashions' point-of-sale computer system crashes late afternoon on Saturday, July 5, so with sales essentially at a dead stop, the stores close early and will most likely have to stay closed until the system is fixed. Forza Elettronica, a leading point-of-sale tech and information recovery service, is called out for a rescue and works through the night Saturday and all day Sunday, July 6, to repair the system. The firm saves the day by getting the system back up and running and by identifying and fixing a defect in the software, guaranteeing no more crashes for the time being. Forza leaves its bill for $1,000, but news of the crash has hit the airways, and local media question the already-shaky Fashions' ability to open its doors any time soon. Fashions calls its lawyers in a panic, and it's agreed that the company will file for bankruptcy as soon as possible on Monday once the papers are completed.

Fashions opens for business on Monday and issues a series of press releases to reassure the consuming public: "Don't believe everything you hear and only half of what you see. It will be business as usual, thanks to our loyal suppliers, the heroic efforts of our tech support staff, and especially the world-class performance by Forza Elettronica. Bravo, Forza, we couldn't have done it without you." The Chapter 11 petition is filed Monday afternoon. It turns out that Fashions ordered a large volume of inventory in anticipation of robust July 4th weekend sales and had taken delivery of merchandise invoiced at several million dollars from mid-June on, much of it within the 20 days immediately preceding the filing.

The section often yields anomalous or inconsistent results based on only slight variation in facts, some of which are often just the result of good or bad luck.

Unequal Treatment

Section 503(b)(9) of the Bankruptcy Code, enacted in 2005 largely under the radar as part of the long-anticipated Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA)[(Pub.L. 109–8, 119 Stat. 23, April 20, 2005]—which was anything but—provides:

> After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—
> ......
> ....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.
> 11 U.S.C. 503(b)(9) (emphasis added)

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The provision (along with many other important changes for business bankruptcies) was largely overshadowed in the legislative debate, the press, and even in bankruptcy commentary by the controversial "means testing," mandatory credit counseling, limitations on discharge, and other consumer provisions in BAPCPA. It significantly changed the landscape for unsecured creditors, administrative creditors, debtors, and DIP financers in Chapter 11 because i) qualifying sellers of goods (not providers of services), who previously were general unsecured creditors and might expect just pennies on the dollar and to be paid near the end of the food chain, were bumped up to administrative priority; and ii) as required by section 1129 of the code, a plan of reorganization cannot be confirmed unless *all* administrative claims allowed under section 503(b) are paid in full, in cash, on the effective date of the plan, unless the holder of such a claim agrees to a different treatment. 11 U.S.C. § 1129(a)(9)(A).

In *In re Fashions, Inc.,* as of the petition date Auspicious Jeans, Acqua Pura, Sacco, and Forza Elettronica each is owed $1,000 and before the passage of BAPCPA would have been general unsecured creditors, treated equally. The existence of the lender's blanket lien removes the two sellers' prospects of having reclamation claims. 11 U.S.C. § 546(c)(1). By virtue of the operation of section 503 of the Bankruptcy Code, and particularly section 503(b)(9), however, each of these similarly situated prepetition creditors almost certainly will be treated differently, arguably irrationally so, because each of them, save one, was of signal importance in producing benefit for Fashions' post-petition estate: Auspicious Jeans delivered the door-buster jeans to draw traffic; Forza Elettronica literally saved the day for stable post-petition operations; and it's hard to imagine a retailer doing business for long without offering customers Sacco's bags for their purchases. In contrast, Acqua Pura's waters are all gone and have been for two weeks, and thus it contributes absolutely nothing to the bankruptcy estate.

As recited earlier, section 503(b)(9) creates administrative priority only for i) sellers of "goods" that are ii) "received by the debtor" iii) "within 20 days before the date of commencement of a case" under Title 11. Why is that? And why are only sellers of goods covered, when prepetition service providers also often benefit the post-petition estate?

> The legislative history for § 503(b)(9) is virtually nonexistent. Its apparent purpose was to provide additional protection for vendors and reduce the challenges they face when asserting their state law reclamation rights under § 546(c). In addressing those burdens, Congress effectively ignored one of the principal tenets underlying the [c]ode: namely, that claims accorded administrative-expense priority should be narrowly limited to those that provide a benefit to the bankruptcy estate.... The actual result was the creation of a new class of administrative creditors that a debtor must pay in full as a condition to confirmation of a chapter 11 plan, regardless of whether those creditors actually provided a benefit to the debtor's estate.... [R]etail debtors—particularly those that have a relatively quick inventory turnover rate—have struggled to satisfy § 503(b)(9) claims...." M. Wilson & H. Long, "Section 503(b)(9)'s Impact: A Proposal to Make Chapter 11 Viable Again for Retail Debtors," *ABI Journal,* Vol. XXX, No. 1, February 2011, at 21.

In Fashions' case, Forza Elettronica, as a service provider, clearly is out of the money, even though the post-petition estate would not have gotten its first and every subsequent dollar of revenue without a functioning, stabilized point-of-sale system.

Auspicious Jeans also clearly benefitted the post-petition estate but is in an unclear position: 503(b)(9) requires that goods be "received by the debtor ... within 20 days before *the date of commencement*" of the case (emphasis added). Through no fault of its own—in fact, due only to Fashions' tight cash and the self-serving leverage exercised by Quick Drop—Auspicious' jeans weren't delivered to Fashions until the day of the commencement. But was delivery to Kontainer equivalent to delivery to the debtor? If so, there should be a 503(b)(9) claim. If not, Auspicious is just an unsecured creditor, as most cases hold that post-petition delivery of goods sold prepetition results in a prepetition general unsecured claim, even though the goods clearly are sold or used for the benefit of the post-petition estate. *E.g., In re Montgomery Ward, LLC,* 292 B.R. 49, 54-55 (Bankr. D. Del. 2003) (Delivery to the debtor's freight consolidator prepetition was delivery to the debtor. Whether the debtor actually took possession of the goods post-petition is irrelevant to whether seller has a pre- or post-petition claim).

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Acqua Pura added no benefit to the bankruptcy estate because all the water bottles were gone by the time the petition was filed, but it will have a 503(b)(9) claim for what it delivered from June 17 to June 24.

The issue of when goods are "received" is not addressed in the Bankruptcy Code, and thus the courts have determined the issue by reference to the Uniform Commercial Code's Article 2 on the Sale of Goods. Since the right to a 503(b)(9) claim is viewed as somewhat akin to a replacement for reclamation rights, although not limited to reclamation claimants, the courts focus on a seller's rights under sections 2-702 and 2-705. *See, e.g., In re Circuit City Stores, Inc.,* 416 B.R. 531, 536 (Bankr. E.D. Va. 2009). In that context, Article 2 defines "receipt" as "taking physical possession of them," UCC § 2-705(2)(b), which has been interpreted to require more than passage of title or risk of loss, and to include a buyer's agent or bailee having appropriate authority. *E.g., Cargill Inc. v. Trico Steel Co. LLC (In re Trico Steel Co. LLC)*, 282 B.R. 318 (Bankr. D. Del. 2002), aff'd sub nom. *JPMorgan Chase Bank v. Cargill Inc. (In re Trico Steel Co. LLC)*, 302 B.R. 489, 494 (D. Del. 2003)(right of stoppage of goods). Delivery to a common carrier without duties other than carriage, however, is not delivery to the buyer as contemplated by section 2-705. *Cargill*, 282 B.R. at 324, citing *In re Marin Motor Oil,* 740 F.2d 220, 225 (3d Cir. 1984).

What does all this mean for Auspicious Jeans and Sacco? If Kontainer was a properly authorized agent or bailee—and the fact that goods destined for others were in the container clouds the issue—Auspicious Jeans should have a 503(b)(9) claim. Otherwise, it most likely does not, because the goods were not delivered to Fashions within the 20 days before the petition date. *Cf. In re Goody's Family Clothing, Inc., 401 B.R. 131 (Bankr. D. Del. 2009)* ("The language of the statute provides for the allowance of an administrative claim provided the claimant establishes: ... (2) the goods were received by the debtor within twenty days prior to filing."). Sacco appears to be out of luck regardless. Although it delivered its bags to the common carrier on time for delivery three days before the petition was filed—and again, through no fault of its own—they were not "received by the debtor" until the date of the commencement of the case, though they clearly benefited the post-petition estate and only the post-petition estate.

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The adoption of section 503(b)(9) also has had an obvious effect on retailers' ability to reorganize and on post-petition lenders' appetite to lend, because now there is a new class of claims entitled to payment in full, in cash, on the effective date of any confirmed plan. They must be reserved for and paid out of any of the cash available, so many lenders factor that *into* their budgets and *out of* the debtor's borrowing availability.

Initially, given the nature of the remedy, 503(b)(9) claimants asserted that, like all other suppliers of goods benefitting the post-petition estate, they were entitled to immediate payment. That caused a panic among practitioners because of its potential effect on liquidity. Section 503(b) is silent as to timing of payment of administrative claims. Under §507(a)(2), an administrative expense under §503(b) is treated as a first priority expense in a business bankruptcy case. As noted earlier, a plan may only be confirmed if it provides for payment of §507(a)(2) priority claims no later than the effective date of the plan. Other than this confirmation requirement, however, the timing is left to the discretion of the court.

The first written opinion on the topic was *In re Global Home Prods. LLC,* Case No. 06-10340 (Bankr. D. Del. Dec. 21, 2006) (Gross, J.). In *Global Home Products,* a creditor whose goods were delivered to the debtors within the 20-day period moved for allowance and immediate payment under section 503(b)(9). The expense had not been anticipated in the DIP budget. The court therefore allowed the claim but denied the request for immediate payment, finding that the harm to the debtor would be material and that so holding would encourage other parties to do the same, which could effectively end the reorganization proceeding. Since that time, virtually all courts have agreed, relying on section 1129(a)(9). But that simply defers the problem.

In addition, in many "skinny" cases, there will never be enough to pay all the 503(b)(9) claims and provide for meaningful, if any, distributions to unsecured creditors. In many of them, the 503(b)(9) class is approached to take something less than 100 percent with the assurance of fairly prompt payment. *See* S. Bernstein & R. Rich, *Claims for Goods Delivered on the Eve of a Bankruptcy Filing: What Every Business Lawyer Needs to Know,* 14 N.Y Bus. L.J., No. 2, 26, 30 (2010). This approach often succeeds because otherwise, the case most likely would be forced to convert to a Chapter 7, and allowed pre-conversion administrative claims: a) will be subordinated to Chapter 7 administrative claims, *e.g., In re Energy Coop., Inc.* 55 B.R. 957, 969 (Bankr. N.D. Ill. 1985); b) will not be paid until the Chapter 7 liquidation is complete and distributions commence, *i.e.,* perhaps for years; and c) will almost certainly yield materially less and may never be paid at all due to the cost of Chapter 7 administration. See, *e.g.,* First Amended Disclosure Statement at 21-22, *In re PPI Holdings, Inc.,* Case No. 08-13289 (KG) (Bkcy. D. Del.)(Docket No. 1430; July 17, 2011).

A Second Look

Some commentators have suggested tweaks ("a few minor changes") to make section 503(b)(9) less painful; see, *e.g.,* M. Wilson & H. Long, *supra*, suggesting that the statute be changed to provide that "the goods were in the possession of the debtor on the date of commencement of a case under this title" and changing the burdens of proof. *Am. Bankr. Inst. Journal,* Vol. XXX, No. 1, February 2011, at 21, 57. Others have suggested major surgery or outright repeal, including codifying modifications to "critical vendor" status or eliminating it altogether, including services, adding to 503(b)(9) a scienter element or rebuttable presumption for purchases in anticipation of a filing to deal with stockpiling, or returning to reliance on some form of modified reclamation rights. B. Gage, Student Note, *Should Congress Repeal Bankruptcy Code Section 503(B)(9)?,* 19 Am. Bankr. Inst. L. Rev. 215, 280-85 (2011).

The website of ABI's Commission to Study the Reform of Chapter 11 (commission.abi.org) contains links to both articles, but the commission, so far, has not taken a position on what to do. While interesting, the proposed fixes, apart from the suggestion to include services (limited to operational as opposed to, perhaps, professional services), seem to add complexity without necessarily being silver bullets.

It would appear clear, however, that the answer to the question posed in the title of this article is "yes," that it is time to revisit section 503(b)(9). It is with the next question—"Okay, precisely how?"—where things bog down. One view with the appeal of simplicity is that there wasn't a "503(b)(9) problem" before it was enacted. Perhaps a return to those days is in order.

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