

NEW PRECEDENT RELATED TO 503(B)(9) CHANGES LANDSCAPE FOR CREDITORS SEEKING ADMINISTRATIVE EXPENSE CLAIMS

Perspective by CRF

When a debtor files for bankruptcy, its creditors are forced to line up to receive payment in order of priority, as established by the Bankruptcy Code. While the claims of vendors and trade creditors would typically be last in line as general unsecured creditors, often receiving pennies on the dollar, Congress provided special incentives for creditors who provide necessary goods and services to the debtor, within a specified timeframe, by giving these creditors administrative expense claims. An administrative expense claim can be extremely valuable because it typically moves the creditor up in line in order of priority of payment and, for solvent bankruptcy estates, often entitles these claimholders to full payment of their claims.

A 503(b)(9) claim is a specific type of administrative claim awarded to a creditor 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.” 11 U.S.C. § 503(b)(9). To receive an administrative expense claim under Section 503(b)(9), a creditor must demonstrate that: (1) the goods in question were received by the debtor within 20 days before the filing of the bankruptcy (i.e., the petition date), (2) the goods were sold to the debtor, and (3) the goods were sold in the ordinary course of business. Recent cases interpreting the text of Section 503(b)(9) have clarified (and perhaps narrowed) the class of creditors that will qualify for this golden ticket claim.

COURTS CLARIFY THE MEANING OF “RECEIVED BY THE DEBTOR”

In order to qualify for an administrative expense claim under Section 503(b)(9), the goods that a creditor sold

to the debtor must be received by the debtor within 20 days before the bankruptcy petition date. Under recent Third Circuit precedent, “received by

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the debtor” has a more stringent standard.

In *In re World Imports, Ltd.*, the Third Circuit examined a case in which differing interpretations of the term “received” determined whether two vendors would receive administrative expense claims, or be relegated to the back of the priority line as general unsecured creditors.¹ In this case, two vendors shipped goods from China “free on board” (FOB) using a common carrier and the debtor accepted the goods about a month later in the United States. The debtor argued that the goods were “received” when the vendor delivered them to the common carrier for shipment because, under the United Nations Convention on Contracts for the International Sale of Goods (CISG) and its incorporated Incoterms², “FOB” meant that risk of loss passed to the debtor at that time. Under the debtor’s interpretation, it “received” the goods pre-shipment, more than 20 days before the petition date, and thus the vendors would not receive administrative expense claims. The vendors argued that the Court should, consistent with precedent related to a different section of the Bankruptcy Code³, apply the framework of the Uniform Commercial Code (UCC) and find that the debtor “received” the goods when it received physical possession, regardless of when title or risk of loss passed. Under the vendors’ interpretation, the debtor “received” the goods when it accepted them in the United States, which was within the 20-day period prior to the petition date and thus the vendors would receive administrative expense claims.

The Third Circuit agreed with the vendors. The Court relied on the UCC to find that the meaning of “received” in Section 503(b)(9) required physical possession by the buyer or the buyer’s agent. The Court found that delivery to a common carrier, regardless of FOB status, was not equivalent to constructive receipt of the goods because the common carrier was not the buyer’s agent. Specifically, the Court found that “receipt does not occur until after the seller’s ability to stop delivery ends – namely, upon the buyer’s physical possession.” Based on the Court’s finding, the vendors received the sought-after administrative expense claims.

While the vendors in *In re World Imports, Ltd.*, succeeded in obtaining their administrative expense claims based on the Court’s definition of “received,” the vendors in two subsequent cases were denied administrative expense claims because they utilized a “drop-shipping” fulfillment method. Often associated with e-commerce, “drop-shipping” is a fulfillment method where, typically, a retailer receives an order from their customer, transfers that order to a supplier (such as a manufacturer or wholesaler), and that supplier ships the order directly to the retailer’s customer. Retailers like Macy’s, Nordstrom, Chewy and Wayfair all utilize drop-shipping, which continues to rise in popularity.⁴ However, use of drop-shipping may include additional risks for vendors under the precedent established by *In re World Imports*.

In *In re SRC Liquidation, LLC*, a drop-shipping relationship cost a vendor its

administrative expense claim.⁵ In this case, the vendor delivered goods to UPS for shipping directly to the debtor's customer, using the debtor's UPS account. The Court, following *In re World Imports*, found that, because the debtor never physically possessed the goods (as they were sent directly to the debtor's customer), the goods were never "received" by the debtor within the meaning of Section 503(b)(9), and thus the creditor could not meet the requirements of the statute. In so ruling, the Court rejected the vendor's argument that passing of title was a better measure because requiring physical possession by the debtor failed to consider current commercial realities. The Court also did not find the fact that the debtor was intimately involved in the transaction, such that the vendor used the buyer's UPS account to arrange for shipment to the buyer's customer, to be persuasive.

In another drop-shipping case, *In re ADI Liquidation, Inc.*, the Court, using similar logic, found that a vendor who drop-shipped goods directly to the debtor's customers could not establish a Section 503(b)(9) administrative expense claim because neither the debtor nor its agent ever took physical possession of the goods.⁶ In this instance the vendor, a commercial bakery, participated in the debtor's "Bill Thru" program under which it would ship goods directly to the debtor's customers in exchange for an additional 2% fee. The vendor argued that denying its administrative expense claim would undermine the dual objectives of Section 503(b)(9), which are to encourage trade creditors to continue to extend credit to debtors moving toward bankruptcy and discourage abuse by debtors who acquire goods just before bankruptcy knowing that they will not have to pay. The Court rejected the vendor's equitable arguments, finding that Congress spoke clearly with regard to the requirements of the statute and that the vendor had failed to satisfy such requirements based on lack of physical possession of the goods by the debtor.

Examining the cases above, the Court in *In re O.W. Bunker Holding North America Inc.* clarified that "received by the debtor" continued to include constructive possession, such as when a debtor's agent or bailee physically receives the goods.⁷ In this case, the only dispute was whether the bunker fuel delivered to certain vessels by a vendor was "received by the debtor," such that the vendor was entitled to a Section 503(b)(9) administrative expense claim. Through a series of contracts, the vessels ordered bunker fuel from the debtor. The debtor then submitted a purchase order to the vendor, and the vendor delivered the bunker fuel to the vessels. Relying on the terms of the contracts between the parties, which stipulated that the vessel-buyers were merely bailees of the debtor until full payment was made, the Court found that the vessels were bailees in physical possession of the bunker fuel and thus the debtor "received" the goods under a constructive possession theory. Therefore, the vendor was entitled to an administrative expense claim.

The holding in *In re O.W. Bunker Holding North America Inc.* is consistent with the holdings in *In re World Imports*, *In re SRC Liquidation* and *In re ADI Liquidation* because it found that “received by the debtor” requires either (1) actual possession by the debtor by physically possessing the goods, or (2) constructive possession by the debtor by physical possession of the goods by a bailee or agent of the debtor. In *In re World Imports*, the Court found that because the common carrier was not the debtor’s agent, the debtor did not “receive” the goods until a later date, when the debtor physically possessed them. Similarly, in *In re SRC Liquidation* and *In re ADI Liquidation*, the Courts found that the debtor’s buyer, who received the goods directly from the vendor via a drop-shipping arrangement, was not the debtors’ agent and thus the debtors never “received” the goods.

However, in *In re O.W. Bunker*, the distinguishing fact was that, under the terms of the contracts between the parties, the vessel-buyers acted as a bailee for the debtor, and thus the debtor was in constructive possession of the goods when its bailee was in physical possession of such goods. Had the vessel-buyers not been considered a bailee, the case would have likely seen the same result as in *In re World Imports*, *In re SRC Liquidation* and *In re ADI Liquidation*, and the vendor likely would not have been eligible for an administrative expense claim.

Most recently, a court applied *In re World Imports* to award a vendor an administrative expense claim under Section 503(b)(1)(A) for goods shipped pre-petition but received post-petition, further expanding the impact of the *In re World Imports* decision. Under Section 503(b)(1)(A), claims for “the actual, necessary costs and expense of preserving the estate” can be deemed administrative claims. In *In re Bluestem Brands*, vendors shipped goods to the debtor pre-petition.⁸ However, the goods were not received by the debtor under after the bankruptcy petition had been filed and thus the vendors were ineligible for a claim under Section 503(b) (9), which requires that the goods are received by the debtor in the 20 days *before* the petition. The plan administrator argued that vendors could not meet requirements of Section 503(b) (1)(A), which requires a claim that arises during the post-petition period, because the contracts were completed pre-petition when the goods were delivered to the shipper. In rejecting the plan administrator’s arguments, the Court found that the statute required the vendors to provide a benefit to the estate post-petition, which they had when the debtor received physical possession of the goods post-petition. Following the cases above, the Court found it was necessary to rely on physical possession, as opposed to delivery to a carrier or passing of title, because the vendors still retained the right to stop delivery or reclaim the goods up until the point at which the buyer physically received them. Based on this holding, it appears that courts will continue to use the date on which the debtor (or its agent or bailee) physically possesses the goods at issue to determine issues under the Bankruptcy Code related to goods

received by the debtor.

The above cases interpreting Section 503(b)(9) and related provisions governing administrative expense claims illustrate how mere days, or even hours, can impact whether or not a vendor is eligible to receive full payment for goods shipped to a debtor, or, whether its claim falls to the bottom of the payment pecking order. It's important to keep these considerations in mind when conducting business with an entity that is a known credit risk or on the brink of default, and weigh the benefits and potential costs of continued business with that entity.

1 862 F.3d 338 (3d Cir. 2017).

2 The United Nations Convention on Contracts for the International Sale of Goods (CISG) is a treaty that governs cross-border sales of goods.

3 Vendors relied on previous 3rd Cir. precedent from *In re Marin Motor Oil, Inc.*, which applied the framework of UCC to reclamation rights under Section 546(c) of the Bankruptcy Code and found that goods were “received” by the debtor when the debtor’s bailee physically received them. 740 F.2d 220, 224-26 (3d Cir. 1984). In 2005, Congress added Section 503(b)(9) to the Bankruptcy Code as an exemption from Section 546(c)’s reclamation conditions, offering an alternative remedy to reclamation. In its holding, the *In re World Imports* Court noted this relationship between Section 546(c) and Section 503(b)(9).

4 <https://www.retailwire.com/discussion/will-drop-shipping-become-a-major-catalyst-of-online-growth/>

5 573 B.R. 537 (Bankr. D. Del. 2017).

6 No. BR 14-12092 (KJC), 2019 WL 211528 (D. Del. Jan. 16, 2019).

7 607 B.R. 32 (Bankr. D. Conn. 2019).

8 No. 20-10566 (MFW), 2021 WL 3174911 (Bankr. D. Del. July 27, 2021).