

Bruce Nathan, Esq.



Section 503(b)(9) Goods Supplier Priority—Beware of the Debtor's Setoff Rights

Section 503(b)(9) of the Bankruptcy Code was added by the 2005 Bankruptcy Code amendments to grant an administrative priority claim in favor of trade creditors that sell goods to the debtor in the ordinary course of the debtor's business, which the debtor had received within 20 days of its bankruptcy filing (the "20-Day Goods"). Section 503(b)(9) enables a trade creditor to step up the priority of its pre-petition claim for 20-Day Goods and thereby increase the likelihood of a larger and faster payment of this claim. A trade creditor's Section 503(b)(9) priority claim is also not saddled with all of the issues and defenses that have made reclamation rights a nearly meaningless remedy. By way of example, the Section 503(b)(9) priority is not lost where the 20-Day Goods are no longer in the debtor's possession, are not identifiable and/or are subject to a prior perfected security interest in the debtor's inventory when the debtor files bankruptcy.

Debtors and secured lenders have more frequently sought to limit the amount of trade creditors' 20-Day Goods priority claims by litigating many questions left unanswered by Section 503(b)(9). Among the litigated issues is the debtor's invocation of its setoff rights against the creditor to disallow or reduce the creditor's Section 503(b)(9) priority claim. That is precisely what recently happened in Circuit City's Chapter 11 case pending in the United States Bankruptcy Court for the Eastern District of Virginia. The *Circuit City* court ruled that Circuit City could setoff its pre-petition chargeback, returns, credits, rebates, deductions, allow-

NACM's 114th

**CREDIT CONGRESS
& EXPOSITION**

MAY 16-19, 2010 • RIO HOTEL LAS VEGAS

CATCH BRUCE IN SESSIONS:

Executive Exchange

- 18021.** Bankruptcy
- 18042.** Creditors' Committees
- 18054.** Hot & Emerging Legal Issues
- 18079.** The Legal Clinic: Ask an Attorney

ances and other similar claims (the "Pre-petition Credits Claims") in reduction of trade creditors' Section 503(b)(9) priority claims, instead of first reducing trade creditors' lower priority pre-petition general unsecured claims. This ruling could severely limit trade creditors' recovery on their Section 503(b)(9) priority claims in cases where debtors have pre-petition claims against the creditors.

Prior Court Decision Where Debtor Invoked Setoff Rights to Defeat Creditor's Section 503(b)(9) Claim

Circuit City is not the first case to deal with a debtor's attempt to assert its setoff rights in opposition to a Section 503(b)(9) priority claim. In *Brown & Cole Stores*,

LLC, the United States Ninth Circuit Bankruptcy Appellate Panel, the equivalent of a United States District Court, ruled that a debtor could exercise its setoff rights arising from its pre-petition breach of contract claim against the creditor to reduce a Section 503(b)(9) priority claim. The debtor, Brown & Cole Stores, LLC (“Brown & Cole”), was a large privately held grocery store chain that operated 27 stores in the state of Washington. Associated Grocers, Inc. (“Associated”) was Brown & Cole’s principal supplier. Associated’s claim against Brown & Cole included a claim of \$6,379,879.51 for 20-Day Goods that Associated had sold to Brown & Cole prior to the latter’s bankruptcy filing.

Brown & Cole and Associated were also parties to a supply agreement. The agreement contained a “most favored nations” pricing clause that required Associated to sell goods to Brown & Cole on no less favorable terms than the terms offered to Associated’s other customers. Brown & Cole claimed that prior to its Chapter 11 filing, Associated had breached the agreement by selling goods to Brown & Cole at higher prices than Associated had charged its other customers. Brown & Cole sought recovery of a “seven figure” damage claim from Associated based upon Associated’s improper pre-bankruptcy termination of a rebate program.

Brown & Cole filed Chapter 11 on November 7, 2006. Associated moved for allowance and payment of its \$6,379,879.51 priority claim for 20-Day Goods. Brown & Cole asserted its setoff rights attributable to its pre-petition damage claims against Associated as grounds for disallowing Associated’s 20-Day Goods priority claim.

The Bankruptcy Court allowed Associated’s Section 503(b)(9) priority claim. The court rejected Brown & Cole’s setoff defense because it was based on a lower priority pre-petition breach of contract unsecured claim that lacked the necessary mutuality, as a prerequisite for setoff, to justify challenging Associated’s higher priority administrative expense claim. Associated appealed the Bankruptcy Court’s decision to the Ninth Circuit Bankruptcy Appellate Panel.

The Ninth Circuit Bankruptcy Appellate Panel ended up reversing the Bankruptcy Court’s allowance of Associated’s Section 503(b)(9) priority claim. The court ruled that Brown & Cole could setoff its pre-petition breach of contract claim against Associated in reduction of Associated’s Section 503(b)(9) priority claim against Brown & Cole. The court noted that Associated’s priority claim for 20-Day Goods was a pre-petition claim that possessed the requisite mutuality, for setoff purposes, with Brown & Cole’s pre-petition breach of contract claims against Associated to justify Brown & Cole’s invocation of setoff rights as a defense to Associated’s Section 503(b)(9) priority claim.

The court noted that setoff is an equitable state law remedy, allowing entities that owe money to each other to cancel out or apply their mutual debts against each other. This avoids the absurd and unfair result of making A pay B when B owes A. As

a general rule, setoff rights arise under state law when two parties owe each other mutual debts under either the same or different contracts. The obligations must be between the same parties acting in the same capacity.

The *Brown & Cole* court relied on Bankruptcy Code Section 553 which preserves, but does limit, state law setoff rights. Based on Section 553, a creditor can setoff a pre-petition claim against the debtor against only the creditor’s pre-petition indebtedness (and not its post-petition indebtedness) owing to the debtor. The court concluded that Associated’s Section 503(b)(9) priority claim against Brown & Cole was a pre-petition claim, and, therefore, subject to setoff by Brown & Cole to the extent of its pre-petition damage claims against Associated. It is interesting that the *Brown & Cole* court never

The *Brown & Cole* court relied on Bankruptcy Code Section 553 which preserves, but does limit, state law setoff rights.

addressed the merits of Brown & Cole’s pre-petition damage claim against Associated, and therefore did not determine whether Brown & Cole had valid setoff rights. As a result, the court was not called upon to allocate Brown & Cole’s setoff rights between Associated’s more valuable Section 503(b)(9) priority claim and less valuable lower priority pre-petition general unsecured claim.

Circuit City Stores

On November 10, 2008, Circuit City, a specialty retailer of consumer electronics, filed Chapter 11. On the filing date, Circuit City operated 712 retail stores and nine outlet stores throughout the United States and Puerto Rico and employed approximately 39,600 employees. On January 16, 2009, the Bankruptcy Court pulled the plug on Circuit City, authorizing going-out-of-business sales at Circuit City’s remaining 567 stores. Circuit City completed their going-out-of-business sales on March 8, 2009.

On October 13, 2009, Circuit City filed objections to numerous Section 503(b)(9) claims. In their objections, Circuit City sought to setoff the Pre-petition Credits Claims in reduction of the creditors’ Section 503(b)(9) priority claims, even though these creditors also had less valuable nonpriority general unsecured claims against Circuit City that could have been reduced by the setoff.

Circuit City relied on Bankruptcy Code Section 558, which preserves all of a debtor’s personal defenses, including setoff rights. Section 558 states as follows:

“The estate shall have the benefit of any defense available to the debtor as against any entity other than the estate, including statutes of limitations, statutes of frauds, usury

and other personal defenses. A waiver of any such defense by the debtor after commencement of the case does not bind the estate.”

Circuit City invoked its state law setoff rights under Virginia law, which Section 558 makes applicable to Circuit City’s bankruptcy case, to justify applying the Pre-petition Credits Claims in reduction of trade creditors’ Section 503(b)(9) priority claims. Circuit City argued that the Pre-petition Credits Claims are debts owed by each Section 503(b)(9) claimant to Circuit City. Likewise, each trade creditor’s Section 503(b)(9) priority claim is a debt owing by Circuit City to the claimant. Circuit City, therefore, asserts the requisite mutuality of obligation to satisfy its burden of proof for setoff. Circuit City then asserted the right to setoff the Pre-petition Credits Claims in reduction of the trade creditors’ Section 503(b)(9) priority claims, instead of reducing the trade creditors’ less valuable lower priority pre-petition general unsecured claims.

Circuit City argued that the bankruptcy court has the discretion to first allocate Circuit City’s setoff rights to reduce priority claims in furtherance of the objectives of the Bankruptcy Code to provide the greatest possible recovery to unsecured creditors. Circuit City stated that if it could not setoff the Pre-petition Credits Claims in reduction of Section 503(b)(9) priority claims, Section 503(b)(9) claimants would receive a windfall of full payment of both their Section 503(b)(9) claims and a portion of their pre-petition general unsecured claims equal to the amount of the Pre-petition Credits Claims applied in reduction of their general unsecured claims. That would reduce the recovery to Circuit City’s pre-petition general unsecured creditors.

The Section 503(b)(9) claimants opposed Circuit City’s invocation of setoff rights to reduce their priority claims. Some claimants argued that Circuit City should be required to first use its Pre-petition Credits Claims to reduce Section 503(b)(9) claimants’ pre-petition general unsecured claims that enjoy lower priority status, instead of first reducing their Section 503(b)(9) priority claims. Otherwise, Circuit City would defeat Congress’ determination in enacting Section 503(b)(9) to grant trade creditors priority status for their 20-Day Goods claims.

Other Section 503(b)(9) claimants argued that their recoupment rights against Circuit City trumped Circuit City’s setoff rights against them. These Section 503(b)(9) claimants asserted their recoupment rights to apply their lower priority pre-petition general unsecured claims against Circuit City in reduction of Circuit City’s Pre-petition Credits Claims against them to the extent all these claims arose under the same contract or transaction. This would amount to using the Pre-petition Credits Claims to reduce the purchase price of goods the claimants had previously sold to them to which these credits relate. This would prevent Circuit City from reaping the benefits of its contracts with these creditors (by exercising setoff rights) without regard to Circuit City’s own unpaid pre-petition obligations to the creditors. The Section 503(b)(9) claimants also argued that their recoupment rights had to be first

taken into account before Circuit City could assert any setoff rights under Section 558.

The *Circuit City* court allowed Circuit City to invoke its setoff rights to apply the Pre-petition Credits Claims against the Section 503(b)(9) claimants’ 20-Day Goods priority claims. The court found the requisite mutuality for setoff by Circuit City based on the Section 503(b)(9) claims asserted by the claimants against Circuit City and the Pre-petition Credits Claims owing by the claimants to Circuit City. And, relying on Bankruptcy Code Section 558, the court allowed Circuit City to exercise its setoff rights any way it chose. The court went as far as to suggest that Circuit City’s setoff rights under Section 558 were not conditioned on the mutual debts between Circuit City and the Section 503(b)(9) claimant both being pre-petition obligations—Circuit City could setoff pre-petition claims against post-petition obligations it owes. As a result, the court allowed Circuit City to setoff the Pre-petition Credits Claims in reduction of the claimants’ more valuable Section 503(b)(9) priority claims, rather than their less valuable lower priority pre-petition general unsecured claims.

The court also noted that Section 558 does not require Circuit City to exercise its setoff rights to first reduce creditors’ lower priority pre-petition general unsecured claims before reducing the priority portion of their claims. That left it to the *Circuit City* court to allow Circuit City to offset the Pre-petition Credits Claims in reduction of trade creditors’ more valuable Section 503(b)(9) priority claims. The court concluded that would further the Bankruptcy Code’s goal of equitable treatment for all creditors by maximizing the distribution to all creditors in the case.

Conclusion

The *Circuit City* court’s decision to allow Circuit City to setoff its pre-petition claims against trade creditors in reduction of their more valuable Section 503(b)(9) priority claims, instead of their less valuable lower priority pre-petition unsecured claims, is not good news for trade creditors. The court’s holding threatens to dilute the effectiveness of the Section 503(b)(9) 20-Day Goods priority claim as an effective trade creditor remedy! The holding may also discourage trade creditors from extending post-petition credit to Chapter 11 debtors because it states that a debtor could setoff its pre-petition claims against a creditor in reduction of the creditor’s post-petition administrative priority claims against the debtor. ●

Bruce Nathan, Esq. is a partner in the New York City office of the law firm of Lowenstein Sandler PC. He is a member of NACM and is on the Board of Directors of the American Bankruptcy Institute and is a former co-chair of ABI’s Unsecured Trade Creditors Committee. He can be reached via email at bnathan@lowenstein.com.

This is reprinted from Business Credit magazine, a publication of the National Association of Credit Management. This article may not be forwarded electronically or reproduced in any way without written permission from the Editor of Business Credit magazine.