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Limits on Foreign Goods Sellers' § 503(b)(9) Priority Rights



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Section 503(b)(9) of the Bankruptcy Code grants goods sellers with an administrative-priority claim for the value of goods that have been sold to a debtor and received within 20 days of a bankruptcy filing. In the nine years since its enactment, there has been significant litigation concerning the scope of the rights afforded to good sellers under § 503(b)(9). Several of these disputes arise from the Code's failure to define the term "received," leaving courts to borrow from alternative sources of law to fill in the gap.

Most of the handful of courts that have addressed the meaning of "received" have relied on the Uniform Commercial Code (UCC). However, in a recent decision, the bankruptcy court in *In re World Imports Ltd.* refused to apply the UCC in a case involving foreign-based goods suppliers selling and shipping goods to a U.S. customer. The court ruled that a federal trade treaty, to which the U.S. and the sellers' country were parties, pre-empted the UCC, and that the treaty and international trade usages governed the meaning of "received." The decision raises a host of important legal and policy questions concerning whether non-UCC law should be applied when adjudicating the § 503(b)(9) rights asserted by foreign goods sellers.

Section 503(b)(9) Rights

At first glance, the text of § 503(b)(9) appears to be relatively straightforward. It affords an administrative-priority 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."² This priority status frequently entitles the holder of

an allowed § 503(b)(9) claim to the full payment of its claim prior to any recovery by general unsecured creditors.

The Meaning of "Received"

The key to determining the extent of a seller's recovery on its § 503(b)(9) claim is when the debtor "received" the goods. Only the value of goods that the debtor receives within 20 days prior to its bankruptcy filing is afforded administrative-priority status.

The Bankruptcy Code does not define the term "received," and there have been few opinions that have considered the meaning of the terms "received" or "receipt." However, most courts that have considered the issue have adopted the UCC's definition of receipt of goods as "taking physical possession of them."³

In 1984, the Third Circuit Court of Appeals in *In re Marin Oil Inc.* addressed the question of when a buyer was deemed to have received the goods to determine the seller's deadline for making a timely reclamation demand under § 546(c).⁴ The version of § 546(c) in effect at that time required a seller to make a written reclamation demand within 10 days after the buyer's "receipt" of the goods. Although the Bankruptcy Code did not define "receipt," the Third Circuit held that it was appropriate to rely on the UCC's definition of "receipt" because when enacting § 546(c), Congress essentially borrowed the UCC's reclamation provision and the UCC's definition of "receipt."⁵

In 2010, the U.S. Bankruptcy Court for the Eastern District of Virginia in *In re Circuit City Stores Inc.* considered the meaning of the term

¹ The views expressed in this article do not necessarily represent the views of Lowenstein Sandler LLP, its attorneys or its clients.

² 11 U.S.C. § 503(b)(9) (emphasis added).

³ U.C.C. § 2-103(1)(c).

⁴ *Montello Oil Corp. v. Marin Motor Oil Inc.* (*In re Marin Motor Oil Inc.*), 740 F.2d 220 (3d Cir. 1984).

⁵ *Id.* at 225 n.9.

“received” as it appears in § 503(b)(9).⁶ The court cited to authority for the proposition that when the undefined terms that appear in a statute have well-known meanings in common law or otherwise, the drafters intended for those well-known meanings to apply to the undefined terms.⁷ The court rejected the approach of analyzing the law of each state with an interest in the sale-of-goods transaction and applying the state law definition on an individualized basis.⁸ The court held that Congress contemplated a consistent, uniform approach to the interpretation of “received” and concluded that applying the state law definition on a case-by-case basis was impractical in large bankruptcy cases and “could lead to inconsistent treatment for otherwise similar claims.”⁹

While acknowledging that the term “received” is not defined in the UCC, the *Circuit City* court ruled that “received” as used in § 503(b)(9) was the “functional equivalent” of “receipt” as used in the UCC, and that the terms should be interpreted identically.¹⁰ The court ruled that “received” means “having taken into physical possession” the goods and should be applied as a “federal definition” for purposes of interpreting § 503(b)(9).¹¹

Applying this definition of “received,” the *Circuit City* court ruled that for purposes of determining when goods sold to the debtor on consignment are “received” under § 503(b)(9), the operative date is when the debtor physically received possession of the goods, not the subsequent date when the debtor sells the consigned goods to a customer and the title passes to the debtor and the debtor’s customer pursuant to the terms of the consignment agreement.¹² In other words, the date when title and risk of loss passes to the buyer is irrelevant as to when goods are received for purposes of § 503(b)(9).

In *In re Momenta Inc.*, the U.S. Bankruptcy Court for the District of New Hampshire, agreeing with the *Circuit City* court’s analysis, similarly applied the UCC’s definition of “receipt” to the term “received” contained in § 503(b)(9).¹³ The *Momenta* court then considered whether “received” could encompass a situation whereby goods were drop-shipped to the debtor’s customer. The court explained that under the UCC, a seller may stop delivery of goods in transit until the buyer receives the goods.¹⁴ The UCC lists four events that terminate a seller’s right to stop the delivery of goods;¹⁵ however, only one of these events requires the buyer to take physical possession of the goods.¹⁶ Accordingly, the court found that under the UCC — and by extension, § 503(b)(9) — a seller can stop delivery until the buyer receives the goods either by having physical or constructive possession (such as when the buyer’s agent or a carrier

acknowledges that it is holding the goods for the buyer).¹⁷ However, the court held that the seller was unable to prove that the debtor had even constructive possession of the goods, and therefore denied the creditor’s motion for allowance of its § 503(b)(9) priority claim.¹⁸

While *World Imports* could be championed for its application of international trade terms, it could be questioned for promoting the “inconsistent treatment” of similar bankruptcy claims by making the meaning of “received” dependent on ... whether goods were shipped from a CISG signatory country or shipped domestically in the U.S.

World Imports Rejects Application of the UCC

On June 18, 2014, the U.S. Bankruptcy Court for the Eastern District of Pennsylvania denied the motions of two foreign suppliers, Funjian Zhangzhou Foreign Trade Co. Ltd. and Haining Wansheng Sofa Co. Ltd., for the allowance and payment of administrative-priority claims pursuant to § 503(b)(9).¹⁹ The Haining claim was for goods that were shipped from a port in Shanghai, China; the debtor took physical possession of the goods in the U.S.²⁰ The Funjian claim was for goods that were shipped from a port in Xiamen, China, and physically received in the U.S.²¹ The terms of both the Fujian and Haining contracts were “free on board” (FOB) the country of origin.²² The parties stipulated that the goods were shipped from China more than 20 days prior to the debtor’s bankruptcy filing and that the debtor (or its customer in the case of drop-shipped goods) took physical possession of the goods within 20 days of the bankruptcy filing.

The claimants argued that they were entitled to priority because the goods were “received” within the meaning of § 503(b)(9) when the debtor took physical possession of the goods in the U.S. The debtor and the creditors’ committee opposed the motions, arguing that the debtor had “received” the goods when they were loaded onto the ships in the Chinese ports, which was more than 20 days prior to the bankruptcy filing.²³ Notably, the court permitted the parties to argue their positions in open court in lieu of filing briefs.²⁴

The court rejected the claimants’ implicit argument that state law, such as the UCC, “may provide a rule of

6 *In re Circuit City Stores Inc.*, 432 B.R. 225 (Bankr. E.D. Va. 2010).

7 *Id.* at 228 (citing *Standard Oil Co. of N.J. v. United States*, 221 U.S. 1, 59 (1911)).

8 *See Circuit City*, 432 B.R. at 228.

9 *Id.*

10 *Id.* at 229.

11 *Id.* at 230. Utilizing similar arguments, the *Circuit City* court had previously ruled that the UCC’s definition of “goods” should be applied in determining whether a creditor has a valid priority claim under § 503(b)(9). *See In re Circuit City Stores Inc.*, 416 B.R. 531, 537 (Bankr. E.D. Va. 2009). Other courts have similarly applied the UCC’s definition of “goods” when adjudicating § 503(b)(9) claims. *See In re Plastech Engineered Prods. Inc.*, 397 B.R. 828, 836 (Bankr. E.D. Mich. 2008); *In re Pilgrim’s Pride Corp.*, 421 B.R. 231, 237 (Bankr. N.D. Tex. 2009); *In re SemCrude LLP*, 416 B.R. 399, 405 (Bankr. D. Del. 2009).

12 *See Circuit City*, 432 B.R. at 230.

13 *See In re Momenta Inc.*, 455 B.R. 353, 358–59 (Bankr. D.N.H. 2011), *aff’d*, *Ningbo Chenglu Paper Prods. Manf. Co. Ltd. v. Momenta Inc.*, 2012 WL 3765171 (D.N.H. Aug. 29, 2012).

14 *See Momenta*, 455 B.R. at 359; *see also* U.C.C. § 2-705.

15 *See Momenta*, 455 B.R. at 359; *see also* U.C.C. § 2-702(2).

16 *See Momenta*, 455 B.R. at 360; *see also* U.C.C. § 2-705(2)(a).

17 *See Momenta*, 455 B.R. at 360; *see also In re Trico Steel Co. LLC*, 282 B.R. 318, 324 (Bankr. D. Del. 2002) (stating that “‘delivery’ of the goods, where risk of loss and transfer of title pass to the buyer, does not necessarily constitute ‘receipt’ of goods, which requires transfer of actual physical possession”), *aff’d*, 302 B.R. 489 (D. Del. 2003).

18 *See Momenta*, 455 B.R. at 360–61.

19 *In re World Imports Ltd.*, 511 B.R. 738 (Bankr. E.D. Pa. 2014).

20 *Id.* at 740.

21 Shipments comprising the Fujian claim were drop-shipped directly to the debtor’s customer in the U.S. and received within 20 days of the commencement of the bankruptcy case. *Id.*

22 *Id.* at 745.

23 *Id.* at 741.

24 *Id.*

decision for gaps in federal statutes.”²⁵ The court ruled that the UCC was inapplicable because a trade treaty, the Convention on Contracts for the International Sale of Goods (CISG), to which the U.S. and China are parties, applied to contracts for the sale of goods among sellers and buyers in those countries.²⁶ The CISG provided a uniform federal law that displaced state law for matters involving international sales transactions.²⁷

The court acknowledged that like the Bankruptcy Code, the CISG does not define “received.” However, the CISG requires that disputes not expressly covered by the treaty be resolved in conformity with applicable rules of private international law.²⁸ Under the CISG, parties are deemed to have incorporated into their agreements usages of trade that are widely known and regularly observed in international law.²⁹ These usages of trade include commercial terms compiled by the International Commerce Commission, known as “Incoterms.”³⁰ Among these Incoterms is the term “FOB,” which means “that the seller delivers the goods on board the vessel nominated by the buyer at the named port of shipment. . . . The risk of loss of or damage to the goods passes when the goods are on board the vessel.”³¹ If a seller’s goods have been delivered in accordance with the FOB’s requirements, the buyer must take delivery of the goods.³²

Although the Incoterms’ definition of FOB does not include a definition of either “received” or “receipt,” the court noted that the definition of FOB “aids in interpretation” and ruled that once the goods are loaded onto a ship in a foreign port and the risk of loss or damage passes to the buyer, the goods “are perforce constructively received by the Debtor.”³³ Accordingly, the debtor received the goods more than 20 days prior to the bankruptcy filing, so the court denied the claimants’ motions for allowance and payment of their § 503(b)(9) administrative-priority claims.³⁴

Issues Raised by *World Imports*

The *World Imports* decision is currently on appeal to the district court. If affirmed, it has the potential to add another layer of complexity in analyzing the rights of § 503(b)(9) claimants. The decision places great emphasis upon respecting the supremacy of U.S. treaties and ensuring that, as envisioned by the CISG, international trade terms and usages are consistently applied to private contracts. However, noticeably absent from the court’s decision and the record is any testimony (expert or otherwise) or citation to Chinese or international law concerning when a buyer is deemed to have received the goods. Such an analysis would have been helpful to understand the reasonable expectations of the parties, especially since neither the CISG nor the Incoterms even use the term “received.”

The decision is a break from the body of case law that has adopted the UCC in order to interpret undefined

terms in § 503(b)(9), especially where such cases rely on decades of old precedent concerning reclamation and stoppage of delivery rights. The *World Imports* court appears to reject the *Circuit City* view that the UCC definition of “received” is a “federal definition” that is incorporated into the Bankruptcy Code.

The *World Imports* court acknowledged that § 503(b)(9) works in conjunction with § 546(c), yet refused to apply the UCC’s definition of “received.”³⁵ While Congress enacted § 503(b)(9) as a supplemental remedy to a seller’s reclamation rights at a time when courts addressing this issue had adopted the UCC’s definition of “receipt,” it is possible that the *World Imports* court distinguished those cases as involving domestic sales and not international transactions.

While *World Imports* could be championed for its application of international trade terms, it could be questioned for promoting the “inconsistent treatment”³⁶ of similar bankruptcy claims by making the meaning of “received” dependent on the happenstance of whether goods were shipped from a CISG signatory country or shipped domestically in the U.S. In either case, it raises important questions concerning the interpretation of § 503(b)(9) that will benefit from an appellate court’s careful review. It should also prompt vendors shipping goods from abroad to consider making U.S. law (such as the UCC), rather than the CISG, the governing law of the transaction, or to explicitly define “received” or “receipt” in their agreements. **abi**

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²⁵ *Id.*

²⁶ *Id.* at 743-44.

²⁷ *Id.* at 744.

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.* at 745.

³² *Id.*

³³ *Id.*

³⁴ *Id.* The court also denied § 503(b)(9) priority status for the drop-shipped goods, which were a component of the Fujian claim, because the debtor had never received them. *Id.* at n.2.

³⁵ *Id.* at 740.

³⁶ See *Circuit City*, 432 B.R. at 228.