



## Section 503(b)(9) Priority Claims Under Attack

**B**ankruptcy Code Section 503(b)(9) grants trade creditors an administrative priority claim for goods sold to a debtor in the ordinary course of the debtor's business that the debtor had received within twenty (20) days of the commencement of its bankruptcy case ("20-day goods"). This protection encourages creditors to continue selling to their financially distressed customers by providing a "step-up" in the priority of creditors' 20-day goods claims over other pre-petition unsecured claims.

Debtors and secured creditors have raised many defenses and arguments as roadblocks to minimize the amounts paid to Section 503(b)(9) claimants. Trade creditors asserting Section 503(b)(9) priority claims were recently dealt a blow by a ruling of the Delaware Bankruptcy Court in *In re ADI Liquidation, Inc.* The court held that the debtors could apply various pre-petition credits, discounts, allowances, rebates, chargebacks and similar claims that the creditors owed the debtors

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prior to the bankruptcy to reduce the creditors' Section 503(b)(9) priority claims (where creditors anticipated full recovery of their claims), instead of the creditors' far less valuable general unsecured claims (where the prospects for any recovery are speculative at best). This raises the risk of reduced recoveries to Section 503(b)(9) priority claimants if other courts follow the holding of the *ADI* court. Are there contractual fixes to address the adverse impact of the *ADI* court decision on the collectability of Section 503(b)(9) priority claims? Read on for the answer!

### Factual Background

The debtors filed their Chapter 11 petitions on Sept. 9, 2014. They were a cooperative food distributor that



provided distribution and retail services to retailer members. They serviced 800 supermarkets, specialty stores and convenience stores with grocery, meat, produce, dairy, frozen foods and other merchandise.

Numerous trade creditors of the debtors, including Kraft, Kellogg, Dannon, Kimberly-Clark, Pepsi and others, had asserted administrative priority claims under Section 503(b)(9) for goods they sold that the debtors had received within twenty (20) days of the bankruptcy filing. In addition, prior to the bankruptcy, the debtors had earned certain credits owing by the creditors and had additional claims against the creditors based on: (i) overpayments; (ii) various promotions, volume discounts, advertising and warehousing allowances, rebates and similar refunds owing under supply agreements and other arrangements between the debtors and the creditors; and (iii) other amounts the creditors owed the debtors (collectively, the "credits").

The debtors and the creditors' committee (the "committee") that was appointed in the Chapter 11 case jointly filed a motion (the "motion") seeking authorization from the bankruptcy court to setoff or recoup the credits to first reduce, and thereby limit recoveries on, the trade creditors' more valuable Section 503(b)(9) priority claims. The balance of the credits would then reduce the creditors' far less valuable general unsecured claims. The trade creditors opposed this relief and invoked their state law setoff and recoupment rights to apply their obligations on account of the credits first towards their less valuable general unsecured claims, thereby

allowing them to maximize recoveries on their Section 503(b)(9) priority claims.

### The Parties' Arguments

The debtors and the committee primarily relied upon Bankruptcy Code Section 558. This is a little known and little used provision that grants a debtor the benefit of any defense, including personal defenses, available to the debtor against any other entity. A debtor's right of setoff or recoupment, which is a state law right<sup>1</sup>, is one of the debtor's personal defenses that Section 558 preserves. The debtors and committee argued that a debtor can assert very broad setoff rights against a creditor, as though no bankruptcy case was filed, as a defense under Section 558. That would allow the debtors the option of setting off their pre-petition claims against the creditors in a manner most advantageous to the debtors by first reducing the creditors' Section 503(b)(9) priority claims, which have the potential for a full recovery. This is contrary to the creditors' position that the debtors' pre-petition claims first be applied to reduce the debtors' pre-petition obligations to the creditors, which have little or no real prospects for recovery.

The debtors and the committee also argued that no provision of the Bankruptcy Code or case law supports the creditors' argument that their exercise of setoff and recoupment rights to apply the credits to first reduce their less valuable general unsecured claims against the debtors trumps the debtors' assertion of their setoff and recoupment rights to apply the credits to reduce the creditors' far more valuable Section 503(b)(9) priority claims. The debtors further justified the priority of their setoff and recoupment rights as promoting a fairer distribution to all unsecured creditors.

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The trade creditors contended that it was unfair to prefer the debtors' setoff and recoupment rights. This disregards the creditors' rights under Bankruptcy Code Section 553, which recognizes a creditor's state law setoff rights against a debtor. The creditors also argued that the relief sought by the motion: (a) undermines the legislative history of Section 503(b)(9); (b) infringes on their state law setoff rights; (c) allows the debtors to use Section 558 as a sword, not as a defensive shield; and (d) fails to recognize that the debtors' setoff rights might be limited by the debtors' and creditors' contract and prior course of dealing.

### The Bankruptcy Court's Holding

The bankruptcy court sided with the debtors and the committee. The court held that the Bankruptcy Code favors a debtor's exercise of setoff and recoupment rights over a creditor's exercise of these rights. The debtors could invoke their broad set-

off rights under Section 558 to setoff their pre-petition credits claims against the creditors to reduce the creditors' post-petition claims (including their Section 503(b)(9) priority claims) against the debtors.

The court contrasted the debtors' broader setoff rights under Section 558 with the creditors' more limited setoff rights under Section 553. Section 558 grants the debtors broad setoff rights to apply their pre-petition credits claims against trade creditors as a reduction first to the creditors' Section 503(b)(9) administrative priority claims for 20-day goods. This contrasts with the creditors' more limited setoff rights under Section 553 that only permit setoff of their pre-petition claims to reduce their pre-petition obligations to the debtors.<sup>2</sup>

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After concluding that the debtors had a preferred right of setoff that trumped the creditors' setoff and recoupment rights, the *ADI* court then adopted the equity based rationale of the Bankruptcy Court for the Eastern District of Virginia in its 2009 decision in *In re Circuit City Stores, Inc.* The *Circuit City* court held that the debtors could invoke their rights under Section 558 to obtain preferred treatment of their setoff rights compared to the creditors' setoff rights. The *Circuit City* case involved a similar circumstance where the debtor had sought to setoff the debtors' pre-petition claims first against trade creditors' Section 503(b)(9) priority claims and then in reduction of their general unsecured claims. That court held that "[t]he Court, in evaluating setoff, should favor an application that is most likely to result in equal distributions to the Debtors' creditors as a whole."

The *ADI* court rejected the trade creditors' argument that allowing the debtors to setoff their pre-petition credits claims first to reduce the creditors' Section 503(b)(9) priority claims and then to reduce their general unsecured claims deprived the creditors of the benefit of their Section 503(b)(9) priority claims; was contrary to the purpose of Section 503(b)(9); and provided a disincentive for creditors to continue to sell to financially distressed customers. The court relied on Section 558's preservation of the debtors' defenses, including the debtors' ability to assert broad setoff and recoupment rights, to justify the preferential treatment of the debtors' setoff and recoupment rights to reduce the allowed amount of the creditors' Section 503(b)(9) priority claims.

Several creditors also argued that their setoff rights are a property interest that requires the debtors to provide the creditors adequate protection to the extent that the creditors' exercise of their setoff and recoupment rights reduces the creditors' setoff and recoupment rights. The creditors relied on Bankruptcy Code Section 506(a), which treats the portion of a creditor's

claim that is subject to setoff as a secured claim up to the amount of the setoff. The court expressed doubts about whether adequate protection rights are ever implicated in the context of a creditor's assertion of setoff rights. The court also quoted the *Circuit City* court's ruling, that any adequate protection requirements were satisfied because the claimant "gets the benefit of the extinguishment of the debt it owes the Debtors dollar for dollar" when the Section 503(b)(9) claim is setoff against the obligations owed to the debtors.<sup>3</sup>

The court did consider the creditors' final argument, that the parties' contracts and/or prior course of dealing might limit the debtors' setoff and recoupment rights. The court adopted a rebuttable presumption that the contracts between the debtors and creditors, the creditors' prior course of dealing with the debtors, and industry practice do not operate as a waiver of the debtors' equitable setoff remedies under Section 558. However, the court left the door open, allowing creditors to rebut this presumption by proving that the debtors had waived their setoff and recoupment remedies as a result of their agreements or course of dealing with the creditors.

### Conclusion

The *ADI* decision risks reduced trade creditor recoveries on their higher priority Section 503(b)(9) claims where the debtor has setoff or recoupment rights based on its pre-petition claim against the creditors. This holding, and the holding in *Circuit City*, deprive creditors of the option of deciding how to setoff mutual indebtedness to and claims against a debtor. Instead, creditors will be subject to the debtor's assertion of its setoff rights in a manner most favorable to the debtor, such as first reducing the amount of the creditor's administrative claim (including Section 503(b)(9) priority claim), instead of first reducing a creditor's less valuable general unsecured claim.

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The issue left unresolved by the *ADI* decision, which may be addressed during the substantive claim objection process in the *ADI* case, is the impact a creditor's contract and prior course of dealing with a debtor will have on the debtor's ability to exercise setoff rights to reduce the creditor's Section 503(b)(9) priority claim. A creditor's contract with a debtor might contain very specific provisions regarding when a debtor is permitted to setoff its claims. These provisions may include a debtor's full waiver of its setoff rights regarding its credits claims against the creditor, or a partial waiver of such setoff rights if the debtor is in default, out of business, or past due amounts are owing. Similarly, the contract may provide that the creditor has sole and absolute discretion to determine the application of its setoff rights in reduction of its claim.

Interestingly, the *ADI* decision held that such provisions are presumed to be an invalid waiver of the debtor's setoff remedy, subject to the creditor's right to challenge and rebut the presumption. Since Section 558 is intended to preserve an existing debtor's "personal defenses," which include setoff, it seems odd that Section 558 could be a basis to authorize a debtor's setoff in bankruptcy when such rights were specifically waived by a debtor through contract or course of dealing prior to the bankruptcy filing. In such an instance, exactly what personal defenses of the debtor would Section 558 be preserving?

Further development through case law will be needed to determine whether other courts will follow the holdings in *ADI* and *Circuit City*. And those courts following the *ADI* and *Circuit City* decisions will need to determine what factual circumstances will overcome the presumption enunciated by the *ADI* court that a creditor cannot enforce any restriction on setoff contained in a contract or through prior course of dealings with a debtor. ■

1. Setoff is a state law remedy that is available to any party with a claim against and an obligation owing to another party. Setoff enables the party asserting a claim to cancel out or apply its claim in reduction of its obligations to the other party. Recoupment is a special category of setoff rights where, by way of example, a creditor's claim against the debtor that gives rise to the creditor's setoff rights arose from the same transaction as the debtor's claim against the creditor.

2. Section 553 recognizes a creditor's right to setoff only mutual debts (i.e., setting off pre-petition claims against the debtor to reduce pre-petition obligations to the debtor). The court never addressed whether the creditors' recoupment rights, which are not limited by any mutuality requirement under the Bankruptcy Code, justified trumping the debtors' broad Section 558 setoff rights.

3. The court similarly rejected the creditors' arguments based on cases where the IRS was permitted to apply setoff first against general unsecured claims against the debtor before setting off against priority tax claims. The court distinguished those cases, finding that a federal statute existed that specifically grants the IRS the discretion to apply a refund against "any liability" of the debtor taxpayer. By comparison, the court found that the creditors were unable to assert any non-bankruptcy or equitable basis that would allow them to direct how the credits should be applied.

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