

Bankruptcy, Financial Reorganization & Creditors' Rights

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Receipt of Goods Means Physical Possession in Determining Whether a Trade Vendor Has a Section 503(b)(9) Claim

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A recent decision by the United States Court of Appeals for the Third Circuit in *In re World Imports, Ltd.* ruled on a hotly contested issue of bankruptcy law that has significant ramifications for trade creditors selling goods to a debtor just prior to the debtor filing for bankruptcy. Section 503(b)(9) of the Bankruptcy Code provides that a creditor is entitled to a priority administrative expense claim for the value of goods sold to and "received by the debtor within 20 days before" the bankruptcy petition is filed if sold within the ordinary course of business.

The Third Circuit court (which covers bankruptcy courts in Delaware, New Jersey, and Pennsylvania) resolved the growing split among lower courts regarding when "receipt" occurs: when the buyer (or its agent) takes physical possession of the goods, or when the goods are shipped and title passes to the debtor (even if the debtor never takes physical possession of the goods, such as in a drop-shipping scenario). The Third Circuit held that receipt requires physical possession by either the debtor or the debtor's agent.

In *World Imports*, certain Chinese trade vendors sold furniture and similar goods to World Imports (the debtor) in the ordinary course of business. The goods were shipped via common carrier from China to the United States "free on board" (FOB) at the port of origin, meaning that risk of loss or damage and title passed to World Imports upon transfer at the port in China to a common carrier.

The goods left China more than 20 days before the bankruptcy, but the debtor (or its agent) took physical possession of the goods in the United States within 20 days of the date when World Imports filed for Chapter 11. The bankruptcy court's decision noted that "some of the goods were shipped directly to the Debtor's customers (i.e., drop-shipped) while the remainder went directly to the Debtor." *In re World Imports, Inc.*, 511 B.R. 738, 741 (Bankr. E.D. Pa. 2014). The trade creditors filed motions to compel allowance and payment of administrative claims under section 503(b)(9) of the Bankruptcy Code. The debtor opposed those motions.

The bankruptcy court held that the goods were "constructively received" by the debtor when shipped from China and, therefore, did not qualify for the section 503(b)(9) 20-day claim and the creditors' motions for payment of administrative claims were denied. The district court affirmed the decision of the bankruptcy court. The rationale of the bankruptcy and district courts in denying the creditors 20-day administrative priority claim treatment was based in part on the Convention on Contracts for the International Sale of Goods (CISG) and trade terms, here FOB the common carrier vessel. On appeal by the creditors, the Third Circuit Court of Appeals reversed.

The Third Circuit held "that goods are 'received' when the debtor or its agent takes physical possession of them." Slip op. at 5. The court began its analysis by looking at the language of the statute, and noted that Congress did not define the word "received" in the Bankruptcy Code so that the court should construe it according to its ordinary or natural meaning. The court noted that both the legal and dictionary definitions of "received" with respect to goods is "taking physical possession of them."

The court further noted that Bankruptcy Code section 546(c) references the similar word "receipt." Based on a prior decision of the Third Circuit Court of Appeals in which the court held that "receipt" within the meaning of section 546(c) has the same definition as in the Uniform Commercial Code, namely taking physical possession, the court then reasoned that different but similar terms in the Bankruptcy Code should be read to "mean ... the same thing."

Having defined "received" within the meaning of section 503(b)(9) as the debtor taking physical possession, the court turned to the facts of the case. The court noted that the debtor argued the goods were constructively received upon delivery to the common carrier vessel at the port in China because they were delivered "FOB." The court noted that delivery and receipt of goods can occur at different times. The court found that under the Uniform Commercial Code, and thus Chapter 11, receipt does not occur until after a seller's ability to stop delivery ends, which is upon

the buyer's physical possession of the goods. The court noted that the transfer of risk is not identical to receipt. Following prior decisions, the court then ruled that common carriers can never qualify as agents. Therefore, receipt by the common carrier in China did not operate as constructive receipt by the debtor's agent. The court therefore determined that the debtor took possession of the goods when the goods were received in the U.S. within 20 days of the debtor's bankruptcy petition and, accordingly, reversed the lower courts' decisions and granted the creditors' motions for allowance of section 503(b)(9) 20-day claims.

The *World Imports* decision is important given the Third Circuit's prominent role in bankruptcy cases, being the Court of Appeals whose decisions bind Delaware bankruptcy courts. The court issued a decision favorable to trade creditors by holding that "receipt" within the meaning of section 503(b)(9) can be through an agent and occurs when the ability of the seller to stop the goods ceases. This ruling will allow trade vendors a more expansive ability to assert that their claims for goods received by the debtor or its agents will be covered under section 503(b)(9) and thus entitled to administrative priority status, which increases the likelihood that such claims will be paid 100 cents on the dollar.

An example is in the context of drop-shipping where a debtor orders goods from a trade vendor and directs that the goods be shipped directly to the debtor's customer at a third party location. A number of lower courts have held that when the goods are received by the third party customer, even within

the 20 days prior to bankruptcy, that is not deemed receipt by the debtor and they have, therefore, denied the trade vendor's request for administrative priority status under section 503(b)(9) because the debtor did not physically receive the goods.

Since the *World Imports* decision holds that receipt can occur through a debtor's agent, it opens the door to a court ruling that drop-shipped goods are entitled to administrative priority under section 503(b)(9). To date, a number of court decisions have held that drop-shipped goods are not entitled to administrative priority. The Official Comment 2 to section 2-705 of the Uniform Commercial Code states, "[r]eceipt by the buyer includes receipt by the buyer's designated representative, the sub-purchaser, when shipment is made direct to him and the buyer himself never receives the goods." *World Imports* makes clear that physical possession by the buyer or its agent within the meaning of U.C.C. section 2-705, not the passing of title, is how one determines when a debtor "received" goods for purposes of section 503(b)(9). The Official Comment to U.C.C. 2-705 makes clear drop-shipping is receipt by the buyer and, therefore, should come within the ambit of section 503(b)(9) entitling the claim to administrative priority.

The *World Imports* decision is therefore an important decision for trade vendors dealing with financially distressed companies in the short period of time before the bankruptcy and will enhance their likelihood of payment.

Contact

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