

# 'Goods' News for the Trade: Section 503(b)(9) Priority Applies to Sales of Goods Under Service Contracts



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Section 503(b)(9) of the U.S. Bankruptcy Code has been a boon to creditors dealing with financially distressed customers that ultimately file for bankruptcy. Section 503(b)(9) grants trade creditors an administrative expense priority claim for the value of goods sold to and received by the debtor in the ordinary course of business within 20 days of the debtor's bankruptcy filing. Therefore, trade creditors successfully invoking Section 503(b)(9)'s priority status have increased their recoveries because administrative expense priority claims must be paid ahead of lower priority unsecured claims and as a condition to confirmation of a Chapter 11 plan.

Section 503(b)(9)'s administrative expense priority status applies only to claims for the sale of *goods*—not *services*. While the distinction may seem clear on the surface, many transactions include both a sale of goods and provision of services. In these hybrid transactions, debtors, trustees and secured lenders may object to a creditor's assertion of a Section 503(b)(9) priority claim on the basis that the claim is not actually for the sale of goods—particularly where the sale of goods was merely incidental to the provision of services.

This is precisely what occurred in *Sklar Exploration Company, LLC (Sklar Exploration)*, a Chapter 11 case pending in the United States Bankruptcy Court for the District of Colorado (Court). In *Sklar Exploration*, the Court handed down a win for trade creditors by granting a claim for goods, provided in connection with services rendered under a service contract, administrative expense priority status under Section 503(b)(9).

## Background Regarding Priority Claims

Section 503(b)(9) grants an administrative expense 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."

Section 503(b)(9) provides a significant advantage to trade creditors that sold goods on credit terms to a debtor that were received within 20 days of its bankruptcy filing. Section 503(b)(9) grants these

creditors an administrative expense priority claim, which generally must be paid in order for the debtor to confirm a Chapter 11 plan, elevating what would otherwise have been a general unsecured claim near the bottom of the Bankruptcy Code's claims priority scheme. Therefore, Section 503(b)(9) significantly increases the likelihood of collecting claims for goods sold to and received by the debtor in the 20 days prior to the debtor's bankruptcy filing.

The concept and language of Section 503(b)(9) surely seem straightforward enough. But, as with all legal matters, there is always room for differing interpretations and analyses. In *Sklar Exploration*, the Debtor sought to limit the scope of Section 503(b)(9) by objecting to the allowance of a trade creditor's asserted administrative expense priority claim for goods provided under a services contract because the predominant purpose of the transaction was to provide services (not goods) to the Debtor. The Court ended up overruling the Debtor's objection and granting priority status to the portion of the creditor's claim attributed to the goods the creditor had provided in connection with the services rendered under its contract with the Debtor.

### **Background Regarding the Sklar Exploration Decision**

Sklar Exploration Company, LLC (Debtor) filed a voluntary Chapter 11 bankruptcy petition on April 1, 2020 (Petition Date). NexTier Completion Solutions, Inc. (NexTier) had provided acidizing services on the Debtor's oil and gas wells in the year leading up to the Debtor's bankruptcy filing, including during the 20 days immediately prior to the Petition Date. NexTier had to use certain chemicals, primarily nitrogen and acid, in connection with these services. On each invoice, NexTier included a separate charge for the chemicals used and the services provided to the Debtor.

As of the Petition Date, the Debtor owed NexTier \$643,512.55, of which \$62,693.34 was on account of the chemicals NexTier had provided to the Debtor within 20 days of the Petition Date. On October 21, 2021, NexTier filed an application for allowance of an administrative expense priority claim under Section 503(b)(9) in the amount of \$62,693.34 for the chemicals NexTier had

used as part of its provision of services to the Debtor during the 20 days prior to the Petition Date.

On November 12, 2021, the Debtor filed an objection to NexTier's Section 503(b)(9) priority claim, arguing that NexTier had never sold any goods to the Debtor as Section 503(b)(9) requires because any additional charges for the chemicals NexTier had used were merely ancillary to the services NexTier had provided under its contract with the Debtor.<sup>1</sup> Thereafter, in supplemental briefing seeking summary judgment, the Debtor argued that the *predominant purpose test* governs whether NexTier had sold goods to the Debtor for purposes of satisfying the requirements of Section 503(b)(9). Courts have relied on the predominant purpose test to determine whether Article 2 of the Uniform Commercial Code (UCC) applies to a hybrid goods and services contract because UCC Article 2 only applies to *transactions in goods* as a whole. According to the predominant purpose test, if a transaction is predominantly for the provision of services and the goods provided were merely incidental to the services provided, then the transaction is not considered a transaction in goods and UCC Article 2 does not apply.

The Debtor argued that by limiting Section 503(b)(9) to the sale of goods, Congress must have intended for Section 503(b)(9) to apply only to transactions in goods as a whole; and therefore, it is appropriate for courts to rely on the UCC's predominant purpose test to determine whether Section 503(b)(9) applies to a hybrid goods and services transaction. Against this backdrop, the Debtor relied on the predominant purpose test to assert that NexTier's claim should not be entitled to priority status under Section 503(b)(9). The Debtor noted that NexTier was engaged to provide acidizing services, not goods, to the Debtor. The chemicals NexTier had used—including the quantity, nature, and types of chemicals—were not ordered by the Debtor or within the Debtor's control. NexTier itself determined the chemicals that were required and used them in connection with the services NexTier had provided. As the Debtor argued, allowing NexTier an administrative expense priority claim under Section 503(b)(9) would "invite all [service

providers] to attempt to assert an administrative priority claim, even when the debtor had solely contracted for services." This, the Debtor asserted, would be an impermissibly expansive view of Section 503(b)(9).

NexTier argued that the predominant purpose test is irrelevant to and should not determine the applicability of Section 503(b)(9). NexTier asserted that Section 503(b)(9) provides an administrative expense priority claim for the value of goods sold regardless of the nature of the transaction as a whole. NexTier's invoices included separate charges for the services and chemicals provided to the Debtor. As a result, NexTier was entitled to an administrative expense priority claim for the value of the chemicals (i.e., goods) NexTier had provided to the Debtor, regardless of whether the parties' contract was primarily for services, so long as the requirements of Section 503(b)(9) were otherwise satisfied.

### **The Bankruptcy Court's Decision**

The Bankruptcy Court overruled the Debtor's objection and granted NexTier's application for allowance of an administrative expense priority claim in the amount of \$62,693.34 under Section 503(b)(9). The Court acknowledged that the Debtor had "advanced excellent arguments" and that the decision was a "close call," but ultimately held that nothing in the language of Section 503(b)(9) supports the application of the predominant purpose test to deny priority status in favor of NexTier.

First, the Court rejected the Debtor's argument that NexTier did not sell any goods to the Debtor for purposes of Section 503(b)(9). The Court relied on the UCC's definition of goods: "All things (including specially manufactured goods) [that] are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action." Applying this definition, the Court concluded that the chemicals NexTier had provided were goods for purposes of determining the applicability of Section 503(b)(9).

The Court then rejected the Debtor's argument that the predominant purpose test determines whether a creditor is entitled to an administrative expense priority claim

under Section 503(b)(9) where goods are provided in connection with a services contract. Joining a majority<sup>2</sup> of courts and specifically quoting the U.S. Bankruptcy Court for the Eastern District of Michigan's opinion in *In re Plastech Eng'rd Prod., Inc.*, the Court stated:

The only relevant determination under § 503(b)(9) is the value of the goods that were delivered, irrespective of whether the contract also called for the delivery and sale of services. The predominant purpose test does not inform the Court as to whether a particular thing that has been sold is or is not goods. Therefore, the predominant purpose test is unnecessary. There is nothing in § 503(b)(9) that dictates the use of a *winner take all* approach.

The Court concluded that nothing in Section 503(b)(9) requires a creditor to prove its contract with the debtor falls within UCC Article 2's *transaction in goods* limitation on which the predominant purpose test is based. If Congress had intended to limit the scope of Section 503(b)(9) in the same manner to *transactions in goods* as a whole, Section 503(b)(9) would have also used that same phrase. It did not. Instead, Section 503(b)(9)'s administrative expense priority claim applies more broadly to the value of any goods sold to the debtor in the ordinary course of the debtor's business and received by the debtor during the 20 days prior to the bankruptcy filing, regardless of the context in which those goods were sold and delivered (e.g., in connection with a services contract). In the hybrid scenario, the creditor simply carries the burden of proving the portion of the claim that relates to the sale of goods that would be entitled to priority status.<sup>3</sup>

The Court also rejected the Debtor's argument that its transaction with NexTier was not a sale of goods because NexTier, and not the Debtor, had controlled the quantity, nature and types of chemicals NexTier used in performing services for the Debtor. The Court noted that "nothing in the plain language of § 503(b)(9) requires proof that the Debtor placed an order for a specific amount or type of goods prior to those goods being provided." The Debtor entered

into a contract with NexTier for services that necessarily required the sale of goods (e.g., the chemicals), which NexTier had provided at the prices listed in the invoices, and justified NexTier's assertion of priority status under Section 503(b)(9).

The Court also was unpersuaded that allowing an administrative expense priority claim for the goods NexTier had provided would improperly encourage other service providers to attempt to assert administrative expense claims in connection with their service contracts. The Court noted that a service provider could conceivably provide goods to a debtor in connection with the services the debtor had contracted for, and concluded that so long as a service provider is able to separately identify the charges for the goods and services provided during the twenty days prior to the bankruptcy filing (as NexTier had done), then the service provider is entitled to an administrative expense priority claim under Section 503(b)(9) for the charges attributed to the goods.

### Conclusion

The *Sklar Exploration* decision that Section 503(b)(9)'s administrative expense priority status applies to goods provided in connection with what is predominantly a services contract is a clear win for trade creditors. In these hybrid circumstances, best practice would be for a creditor to ensure that its invoices separately identify the charges for the goods and services provided to assist in satisfying the requirements for an allowed administrative expense priority claim under Section 503(b)(9) for the goods portion of the claim.

- 1 The Debtor also argued that NexTier had failed to timely file its Section 503(b)(9) priority claim by the general bar date established in the chapter 11 case. However, the parties thereafter agreed that because the order establishing the general bar date did not specifically indicate a deadline to file Section 503(b)(9) claims, the general bar date did not apply to NexTier's 503(b)(9) Claim (rather, the deadline to file administrative expense claims under Section 503(b)(9) was the same as the deadline to file all other administrative expense priority claims that was established pursuant to the Debtor's chapter 11 plan—by which NexTier had timely filed its application for allowance of its Section 503(b)(9) claim).
- 2 The Court explicitly rejected a 2009

decision by the U.S. Bankruptcy Court for the Eastern District of Virginia, in *In re Circuit City Stores, Inc.*, in which the bankruptcy court held that the predominant purpose test is relevant to claims asserted under Section 503(b)(9) since Section 503(b)(9) grants an administrative expense priority claim "only for transactions in which goods have been sold to the debtor in the ordinary course of such debtor's business." The *Circuit City* Court concluded that Section 503(b)(9) only applies if the contract between the creditor and debtor was predominantly a sale of goods. Since the contract in question was predominantly a provision of services, the *Circuit City* Court denied Section 503(b)(9) status. The *Sklar Exploration* Court disagreed with the *Circuit City* Court's analysis, since, as noted above, nothing in Section 503(b)(9) requires that the entire transaction involve the sale of goods.

- 3 The Court also rejected the Debtor's argument that "the Congressional intent behind § 503(b)(9) was to provide a remedy to creditors with reclamation rights under the UCC and that this supposed intent somehow requires application of the predominant purpose test." The Court found no meaningful link between Section 503(b)(9) and the Bankruptcy Code's reclamation statute. The Court also noted that, even if such a link existed, it would not support the application of the predominant purpose test, which is about the applicability of UCC Article 2 and not necessarily reclamation rights under the Bankruptcy Code.

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