



Sparks Continue to Fly

Electricity is Not a Good and is Ineligible for Section 503(b)(9) Priority Status and Other Shocking Developments

Over the last few months, there has been a “charged” debate over whether electricity is a good entitled to Section 503(b)(9) priority status or a service ineligible for such status. The United States Bankruptcy Court for the District of Delaware in *In re NE Opco, Inc. d/b/a National Envelope*, contrary to decisions in other jurisdictions, recently ruled that electricity is a service, not a good, and, therefore, is not entitled to Section 503(b)(9) priority.

The *NE Opco* Court’s holding came down shortly after the rulings of two other courts on whether electricity is a good or service. The United States Bankruptcy Court for the District of Puerto Rico, in *In re PMC Marketing Corporation*, recently held that electricity provided by a government owned utility is a service. The United States District Court for the Southern District of New York, in *Hudson Energy Services, LLC v. The Great Atlantic & Pacific Tea Company, Inc. (In re The Great Atlantic & Pacific Tea Company, Inc.) (A&P)* vacated the order of the United States Bankruptcy Court for the Southern District of New York holding that electricity is a service and not a good, and, therefore, not eligible for Section 503(b)(9) priority status, and directed the Bankruptcy Court to hold an evidentiary hearing on this issue.

The *NE Opco* Court primarily considered whether electricity is moveable at the time it is identified by passing through the meter, thus making it *moveable and identifiable*, and a good as defined by the Uniform Commercial Code (UCC), or whether electricity is consumed simultaneously with identification and, therefore, a service, and not a good.

The *NE Opco* Court also held that natural gas is a good entitled to Section 503(b)(9) priority status, but the services associated with the transmission of the natural gas should not be afforded Section 503(b)(9) priority status. This could have far ranging implications for many creditors asserting Section 503(b)(9) priority status for



their delivery charges and even taxes relating to the sale of the goods that are part of their claim.

Here are the “shocking” details.

In re NE Opco, Inc.

NE Opco, Inc. d/b/a National Envelope and its affiliated debtors (the debtors) filed for Chapter 11 protection on June 10, 2013 (the petition date), the debtors’ second trip through Chapter 11.

On August 28, 2013, the City of Westfield Gas & Electric Light Department filed a motion seeking the allowance and immediate payment of a Section 503(b)(9) claim totaling \$93,262.55 for electricity and natural gas Westfield had sold to the debtors and the debtors had received within 20 days of the petition date. Westfield is a municipal lighting plant created under Massachusetts law that provides natural gas and electricity to residents and businesses in the City of Westfield, including the debtors. It was undisputed that Westfield was a utility.

The *NE Opco* Court addressed the following issues: (i) whether electricity and natural gas are “goods” entitled to Section 503(b)(9) priority; (ii) whether Westfield’s entire claim for the sale and delivery of natural gas is entitled to Section 503(b)(9) administrative priority status or is Westfield’s priority claim limited to only the charges for the natural gas; and (iii) should the *NE Opco* Court require immediate payment of any allowed Section 503(b)(9) claim in favor of Westfield?

The *NE Opco* Court’s Analysis

The *NE Opco* Court ultimately concluded that electricity is not a good, and is, therefore, not entitled to Section

503(b)(9) administrative priority. The *NE Opco* Court primarily considered whether electricity is moveable at the time it is identified by passing through the meter, thus making it *moveable and identifiable*, and a good as defined by the Uniform Commercial Code (UCC), or whether electricity is consumed simultaneously with identification and, therefore, a service, and not a good.

Like the *PMC* Court and the *A&P* District Court, the *NE Opco* Court also focused on the District of Massachusetts Bankruptcy Court's holding in *In re Erving Industries*. In *Erving*, Constellation NewEnergy, Inc., an electricity reseller, had timely asserted a Section 503(b)(9) priority claim in the amount of \$281,667.88 on account of electricity delivered to Erving Industries, Inc. and two affiliate debtors (collectively, Erving) within 20 days of Erving's bankruptcy filing. Erving objected to the Constellation claim and argued that electricity was a service and not a good.

The *Erving* Court held that the electricity Constellation had resold to Erving was a good. First, applying the definition of "goods" contained in UCC Section 2-105(1), the *Erving* Court held that electricity is movable and identifiable because it can be measured at the point it passes through a consumer's meter, and that "logic dictates" that some period of time, however imperceptible, must pass between the measurement of the electricity at the meter and its use. UCC Section 2-105(1) defines goods as "all things...which are movable at the time of identification to the contract for sale." The *Erving* Court rejected Erving's argument that electricity ceases to be movable when it is measured by the meter because identification and consumption occur simultaneously. Instead, electricity does not simply cease to exist when it reaches customers' meters, but moves through the meters and continues to move to the customers' homes and businesses until the customers ultimately use it. The *Erving* Court held that it is the infinitesimal period of time between identification and use that makes electricity a good.

The *NE Opco* Court disagreed with this logic and ruled that:

"First, it is not necessarily true that there is a period, infinitesimal or not, between identification and use... second, and more importantly, it is simply the wrong approach... [I]n order for electricity to be a good, there must be a period between when electricity is identifiable and consumed. But, in order to do justice to the term as it has developed over 1,000 years, *the period between identification and consumption must be meaningful*. This is not the case with electricity... [A] difference of approximately 1/60th of 1/60th of 1/60th of a second between identification and consumption renders the separation between the two meaningless. Electricity cannot be shoehorned into the definition of a good based on such an infinitesimal delay."

The *NE Opco* Court therefore concluded that, based on Section 503(b)(9)'s "plain language," electricity is not moveable at the time of identification, and is, therefore, not a good

because there was no meaningful delay between identification and consumption.

Even though the *NE Opco* Court had already decided that electricity is a service and not a good, the court also considered factors relied upon by other courts in determining whether electricity is a good or service. The *NE Opco* Court concluded that these other factors either supported or had no bearing on its ruling that electricity is not a good.

1. Is electricity "comparable" with other things that are goods under the UCC?

Several courts have determined that whether electricity is a good is based, in part, on its comparability to other things that are goods under the UCC. For example, the United States District Court for the Western District of Wisconsin, in *GFI Wisconsin Inc. v. Reedsburg Utility Co.*, held that water and natural gas are movable goods, and "there is no principled distinction to be made between natural gas, water, or electricity" so electricity is a good as well.

The *NE Opco* Court held that water and gas are goods under the UCC's plain meaning. Water and gas, which can be stored in a tank or pipes for an indefinite period of time before use, unlike electricity, can be identified well before consumption. The *NE Opco* Court noted that while electricity can be stored in a battery by using an electric current to charge the battery, when that occurs, it is no longer electricity (and is instead potential energy stored in materials or chemicals that will produce energy) and only the battery itself is a good. On the other hand, the electricity used to charge the battery ultimately is not a good. For purposes of this analysis, query whether a battery is the only means by which electricity can be stored.

2. Does Section 546(c) governing reclamation of goods control whether electricity is a good or a service?

Some courts have considered whether a good under Section 503(b)(9) must be subject to reclamation under Section 546(c). The *NE Opco* Court held that Section 546(c) governing reclamation is irrelevant for purposes of determining whether electricity is a good under Section 503(b)(9). The *NE Opco* Court noted that although there is a "kinship" between reclamation and Section 503(b)(9), reclamation is a narrow remedy, whereas Section 503(b)(9) is the broader "default" provision. "Goods under Section 503(b)(9) cannot and are not defined by the exception to the rule." Even if a good is not subject to reclamation (for example, because it was already consumed before the reclamation demand was sent), those same goods may still be entitled to Section 503(b)(9) priority.

The *NE Opco* Court's holding appears to question the holding of the United States District Court for the District of New Hampshire, in *Ningbo Chenglu Paper Products Manufacturing Co. v. Momenta, Inc.*, that certain drop-shipped goods the seller had shipped to the buyer's customer, on the buyer's instruction, were not entitled to Section 503(b)(9) priority because these goods were not subject to reclamation. According to the *NE Opco* Court's logic, the seller's inability to assert

reclamation rights should have no bearing on whether drop-shipped goods are entitled to Section 503(b)(9) priority.

3. Does Section 366 of the Bankruptcy Code governing “utility services” control whether electricity is a good or a service?

The question raised by some courts is whether the use of the terms “service” and “utility service” in Section 366 (affording certain protections to utilities after the commencement of a bankruptcy case) means that a utility providing electricity is providing only a service and not a good for purposes of Section 503(b)(9). Just as it ruled in the context of reclamation, the *NE Opco* Court held that Section 366 governing utilities is irrelevant for purposes of determining whether electricity is a good under Section 503(b)(9). The *NE Opco* Court agreed with the *GFI Wisconsin* Court’s holding that utilities can provide both goods, within the meaning of Section 503(b)(9), and services, within the meaning of Section 366. Section 503(b)(9) addresses the sale of goods pre-bankruptcy, while Section 366 addresses the provision of utility services during a bankruptcy case, and the terms are not mutually exclusive. For example, a utility can supply natural gas, which is identified as a good under the UCC, but is a service under Section 366. Section 366 cannot control whether something is a good under the UCC, and, by extension, Section 503(b)(9).

The court noted that electricity can be bought and sold on a wholesale level where the buyer is not an end user, but instead sells the electricity to another wholesaler or a consumer.

4. Should the nature of the parties’ relationship, e.g., does the claimant’s status as a “public utility,” determine whether electricity is a good or a service?

The *NE Opco* Court recognized the division among the courts over whether electricity is a “good” or a “service” based on the identity of the electricity seller and the identity of the customer. For example, the *PMC* Court held that the electricity supplied by P.R. Electric Power Authority (PREPA) was a service and not a good because PREPA: (i) like other traditional utilities, was subject to governmental regulation; (ii) enjoyed a “special relationship” with PMC, as PREPA was the only electricity provider in Puerto Rico and PMC was its customer; (iii) had a monopoly; and (iv) was owned by the government and directed by a government board. The *A&P* District Court in *In re Great Atlantic & Pacific Tea Co.* also contemplated a potential individualized assessment of the parties’ business arrangements that would be determined based on the outcome of the *A&P* District Court’s remand of the case back to the *A&P* Bankruptcy Court.

The *NE Opco* Court believed that an analysis of whether electricity is a good or service based on the relationship of the parties is flawed. The court noted that electricity can be bought and sold on a wholesale level where the buyer is not an end user, but instead sells the electricity to another whole-

salor or a consumer. “If one makes the good/service determination based on the parties’ relationship, then the electric current could travel from origination to use, starting as a good and ending as a service.” Instead, courts should determine whether electricity “in and of itself” is a good.

5. Should Section 503(b)(9) be strictly construed because it provides an otherwise unsecured creditor with an administrative expense claim and, if so, to what extent?

In *In re Pilgrim’s Pride Corp.*, the United States Bankruptcy Court for the Northern District of Texas held that electricity is not a good. The court relied on the plain meaning of the UCC and the Bankruptcy Code and noted that narrowly defining goods so as not to include electricity for purposes of Section 503(b)(9) is consistent with public policy under the Bankruptcy Code that provisions of the Bankruptcy Code granting claims priority are to be narrowly construed. In addition, the *A&P* District Court noted that the *A&P* Bankruptcy Court made its determination that electricity is not a good based, in part, on the principle that administrative priority claims should be narrowly construed. The *NE Opco* Court disagreed that Section 503(b)(9) should be either loosely or strictly construed. “The court should simply apply the law as written and not put a judicially created obstacle in the path of an administrative expense claimant.”

Determining the Allowed Amount of Westfield’s Section 503(b)(9) Claim for Providing Natural Gas: The “Predominate Purpose” Test versus “Apportionment” Test

The *NE Opco* Court also addressed the remainder of Westfield’s Section 503(b)(9) claim relating to its provision of natural gas to the debtors. The court held that natural gas is a good under the UCC. However, the provision of natural gas is a hybrid goods and services transaction in that it includes both the provision of a service, in the form of the delivery of the natural gas, which is not independently entitled to the Section 503(b)(9) priority, and also the sale of gas, which is clearly entitled to priority under Section 503(b)(9). The *NE Opco* Court considered whether the entire amount of Westfield’s claim associated with the sale and delivery of natural gas is entitled to administrative priority or whether only the charge for the natural gas is entitled to administrative priority.

Some courts, faced with “hybrid” transactions that involve both the sale of goods and provision of services, have followed the predominate purpose test to determine whether the transaction is a sale of goods. Under the predominate purpose test, if the transaction involves predominantly the sale of goods, with the provision of services only incidentally involved, the transaction is considered a sale of goods and the Section 503(b)(9) priority applies to the entire claim. Conversely, where the transaction involves primarily services, with only an incidental sale of goods, the transaction is not considered a sale of goods and the Section 503(b)(9) priority would not apply.

Other courts have utilized the “apportionment” test and considered each component of the claim or transaction (item by

item). Section 503(b)(9) administrative priority status would be granted only for the portion of the claim related to the sale of goods.

The *NE Opco* Court followed the “apportionment” test. The court relied on the decision of the United States Bankruptcy Court for the Eastern District of Michigan, in *In re Plastech Engineered Products, Inc.*, that nothing in Section 503(b)(9) requires the predominate purpose test, and Westfield’s claim should be broken out to grant Section 503(b)(9) priority for the goods portion and a general unsecured claim for the services portion. “There is nothing in Section 503(b)(9) that dictates the use of a winner take all approach.” The *NE Opco* Court then proceeded to go through the categories of Westfield’s bill, specifically: “(i) the customer charge; (ii) the transportation charge; (iii) the distribution charge; and (iv) the gas supply charge.” Based on Westfield’s description of these charges, the *NE Opco* Court held that Westfield had only met its burden of proving that the gas supply charge (totaling approximately \$78) was entitled to Section 503(b)(9) priority and not the remainder of the charges, which the *NE Opco* Court concluded were attributable to services.

Timing for Payment of the Allowed Section 503(b)(9) Claim

Although the *NE Opco* Court only awarded Westfield an allowed Section 503(b)(9) priority claim in the approximate amount of \$78, the court also had to determine whether the claim should be immediately paid, as requested by Westfield. Courts generally have discretion to determine the timing for payment of an administrative expense claim, although Section 503(b)(9) claims, as administrative priority claims, must be paid in full upon confirmation of a bankruptcy plan in order for the plan to be approved. The court’s goal should be an orderly and equal distribution among creditors. Consistent with prior decisions, the *NE Opco* Court adopted these standards and considered the following factors: prejudice to the debtor, hardship to the claimant and potential detriment to other creditors.

The *NE Opco* Court ruled that regardless of whether the debtors had an ability to pay, no evidence was provided suggesting that there was a necessity to pay Westfield prior to plan confirmation. The only argument that Westfield made in support of immediate payment was the *possibility* that the debtors would not be able to pay their Section 503(b)(9) claims in full, which the court rejected. The court also found that requiring immediate payment would unduly prejudice the debtors.

Conclusion and Takeaways

The *NE Opco* decision is noteworthy in that it is the first time the Bankruptcy Court for the District of Delaware (the home of sophisticated bankruptcy actions involving complex Chapter 11 cases, and whose decisions are well respected), in a reported decision, considered whether electricity is a good in the context of Section 503(b)(9). The court’s decision that electricity is a service, and not a good, and, therefore not entitled to Section 503(b)(9) priority status, addressed numerous

considerations analyzed by other courts that have addressed the issue, and rejected many of them. However, the basis for the court’s statement that the period between identification and consumption of electricity must be meaningful is unclear, and may be challenged in subsequent court decisions.

Although not precedential for other bankruptcy judges (in Delaware or otherwise), other courts may very well defer to this decision. Energy-related and other goods suppliers should be vigilant when making credit decisions in connection with distressed business customers as they might not have the benefit of the Section 503(b)(9) priority claim for the provision of electricity in every bankruptcy case.

The *NE Opco* Court’s adoption of the “apportionment” test, in lieu of the “predominate purpose” test, should also concern both energy suppliers, as well as suppliers of goods generally. Beware that the portion of a goods seller’s claim attributable to services, such as freight and delivery charges, might not be afforded priority status.

However, this is not the end of the story. Westfield recently appealed the *NE Opco* Court’s decision to the United States District Court for the District of Delaware. So stay tuned... There are many more developments to come with respect to rights under Section 503(b)(9). ■

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