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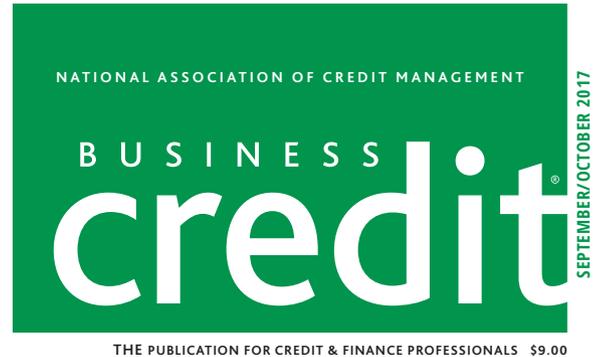
Receipt under Section 503(b)(9) Means Physical Receipt: A Mixed Bag for Trade Creditors

On its face, Section 503(b)(9) of the Bankruptcy Code looks deceptively easy to apply. It grants a goods seller an administrative priority claim for the value of goods sold to the debtor in the ordinary course of its business that the debtor had *received* within 20 days of its bankruptcy filing. However, there has been extensive litigation over various aspects of Section 503(b)(9), particularly over the meaning of the term “received.” Success or failure in these litigations has greatly impacted trade creditor recoveries because creditors have a greater likelihood of obtaining full payment of their Section 503(b)(9) priority claims in comparison to their far less valuable general unsecured claims, in which recovery prospects are oftentimes dim to nonexistent.

The United States Court of Appeals for the Third Circuit, in *In re World Imports Ltd.*, recently became the first United States Court of Appeals to address the meaning of “received” in the context of Section 503(b)(9) administrative priority claims. The Third Circuit, which includes Delaware (the venue where many large Chapter 11 cases are filed), New Jersey and Pennsylvania, held that a debtor receives goods when the debtor or its agent takes physical possession of them, instead of when title or risk of loss passes to the debtor, which might occur earlier. This decision could lead to an increase in allowed Section 503(b)(9) priority claims, particularly for creditors manufacturing and then delivering goods from outside the United States.

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Then, just a few days later, the United States Bankruptcy Court for the District of Delaware, in *SRC Liquidation LLC*, formerly known as Standard Register Company (“Standard Register”), relied on the *World Imports* decision to resolve another issue: whether a creditor’s claim for goods “drop-shipped” directly to a debtor’s customer is eligible for administrative priority status under Section 503(b)(9). The *SRC Liquidation* court denied Section 503(b)(9) administrative priority status to the claim of a goods seller that drop-shipped goods to the debtor’s



customer based on the court’s determination that neither the debtor nor its agent took physical possession of the goods. This ruling could have devastating consequences to trade creditors that sell on drop-ship terms.

You win some and you lose some!

Facts of the *World Imports* Case

Two Chinese trade creditors—Haining Wansheng Sofa Company (“Haining”) and Fujian Zhangzhou Foreign Trade Company (“Fujian”)—sold furniture (the “Goods”) to World Imports (the “Debtor”). Haining and Fujian shipped the Goods from China to the United States via a common carrier “free on board” (FOB) from ports of origin in China. Risk of loss passed to the Debtor when Haining and Fujian delivered the Goods to the common carriers in China.

The Goods that Haining had sold to the Debtor left Shanghai on May 26, 2013, and the Debtor took physical possession of them in the United States on June 21, within 20 days of the Debtor’s Chapter 11 filing date of July 3, 2013 (the “Petition Date”). Fujian shipped its goods from China on May 17 and 31, 2013, and June 7, 2013. The Debtor also received Fujian’s Goods in the United States within 20 days of the Petition Date.

Procedural History

Both Haining and Fujian filed motions in the United States Bankruptcy Court for the Eastern District of Pennsylvania (the “Bankruptcy Court”) seeking allowance and payment of administrative priority claims under Section 503(b)(9). They asserted administrative priority status under Section 503(b)(9), claiming the Debtor had physically received the Goods within 20 days of the Petition Date. The Debtor objected to both

Haining's and Fujian's Section 503(b)(9) priority claims, asserting the Debtor had "constructively received" the Goods upon their delivery to the carriers in China more than 20 days before the Petition Date.

The Bankruptcy Court denied allowance of Haining's and Fujian's Section 503(b)(9) administrative priority claims. The court held that the Debtor had constructively received the Goods more than 20 days before the Petition Date at the time the Debtor had transferred the Goods to the common carriers and the risk of loss had passed to the Debtor. The court relied on the Convention on Contracts for the International Sale of Goods ("CISG"), an international treaty to which the United States and China are parties, in determining when the Debtor had received the Goods. While the CISG also does not define "received," the Bankruptcy Court looked to international commercial terms, "Incoterms," which are incorporated in the CISG, to fill in the gap. The court relied on the Incoterm governing FOB point of origin (which was the parties' shipping term) in which the risk of damage or loss passes from seller to buyer when the seller delivers the goods to the common carrier. Thus, the Debtor was found to have received the Goods under Section 503(b)(9) when the Debtor assumed the risk of loss with respect to the Goods, not when the Debtor took physical possession of the Goods.

Haining and Fujian appealed to the United States District Court for the Eastern District of Pennsylvania (the "District Court"). The District Court affirmed the Bankruptcy Court's holding. Haining and Fujian then appealed to the Third Circuit.

The Third Circuit's Decision

The Third Circuit overruled the lower courts and held that receipt occurred when the Debtor or its agent took physical possession of the goods. The Third Circuit construed the term "received," which is not defined in the Bankruptcy Code, based on "its ordinary natural meaning." The court relied on: (i) definitions of receipt contained in *Black's Law Dictionary* and the *Oxford English Dictionary*, both of which require physical possession of goods; (ii) the definition of "receipt" in Article 2 - 103(1)(c) of the Uniform Commercial Code ("UCC"), which requires "physical possession" of goods; and (iii) the fact that Article 2 of the UCC was the law in 49 states when Section 503(b)(9) was enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") in 2005.

The Third Circuit then noted that Bankruptcy Code Section 546(c)¹, governing a creditor's reclamation rights, and Section 503(b)(9), granting an administrative priority claim **as an alternative remedy** if reclamation is unavailable, should be interpreted in the same manner because these rights are so intertwined. This is further supported by BAPCPA's placement of Section 546(c) and Section 503(b)(9) under the same heading, "Reclamation."

The Third Circuit also relied on its pre-BAPCPA decision in *In re Marin Oil*. The court in *Marin Oil* applied the UCC's definition of "receipt," based on the debtor's physical possession of goods, in the context of a creditor's reclamation rights under Section 546(c) of the Bankruptcy Code. The Third Circuit, in

World Imports, applied the same UCC definition of "receipt" to Section 503(b)(9) priority claims based on the close inter-relationship between Section 546(c) and Section 503(b)(9).

Finally, the Third Circuit rejected the Debtor's argument that it had constructively received the Goods upon their delivery to the common carriers at ports in China when the risk of loss had passed to the Debtor. The Third Circuit instead concluded that the Debtor had received the Goods when it took physical possession of them and thereby terminated Haining's and Fujian's rights to stop delivery. The court also noted that the common carriers were not the Debtor's agents, relying on the UCC's clear differentiation between a seller's delivery of goods, when title and risk of loss passes to the buyer, and the buyer's later receipt of the goods upon obtaining physical possession.

Facts and Holding of the SRC Liquidation Case

On March 12, 2014, Standard Register and its affiliates filed Chapter 11 petitions in the United States Bankruptcy Court in Delaware. One of Standard Register's vendors, International Imaging Materials Inc. ("IIMI"), at Standard Register's instruction, drop-shipped goods, using Standard Register's carrier, UPS, to deliver the goods to Standard Register's customer.

IIMI filed an administrative priority claim under Section 503(b)(9). IIMI's claim included goods that IIMI had drop-shipped to Standard Register's customer within 20 days of Standard Register's Chapter 11 filing date.

IIMI's Section 503(b)(9) priority claim for the drop-shipped goods was disputed because neither Standard Register nor its agent obtained physical possession of the goods. The objecting party relied on UCC Section 2 - 705(2), which deals with the termination of a seller's stoppage of delivery rights.² According to this provision, a seller's stoppage of delivery rights are cut off when a buyer either takes physical possession of the goods or takes constructive possession through the buyer's bailee's/agent's possession of the goods. Since only the carrier, UPS, took possession of the drop-shipped goods and was not acting as Standard Register's agent, and neither Standard Register nor its bailee took possession of the goods, IIMI was not entitled to priority status under Section 503(b)(9).

IIMI argued that UCC Section 2-705 defines receipt only in the context of reclamation rights and a broader definition of "received," which takes into consideration drop-ship transactions involving a seller, a buyer and the buyer's customer, should apply to Section 503(b)(9) priority claims. IIMI further argued that a debtor constructively receives goods in a drop-ship transaction upon the carrier's receipt of the goods, when title transfers to the debtor.

The Delaware bankruptcy court disallowed IIMI's Section 503(b)(9) priority claim with respect to the drop-shipped goods. The bankruptcy court relied on the Third Circuit's ruling, in *World Imports*, that "receipt" occurs when the debtor or its agent obtains physical possession of the goods, which terminates the seller's right to stop delivery of the goods under UCC Section 2-705. The court applied the UCC's definition of "receipt" requiring "taking physical possession ..." to a credi-

tor's right to an administrative priority claim under Section 503(b)(9) of the Bankruptcy Code, just as the Third Circuit had previously, in *Marin Oil*, applied the same definition of "receipt" in determining a creditor's reclamation rights under Section 546(c).

The Delaware bankruptcy court rejected IIMI's argument that the debtor had received the drop-shipped goods when UPS had taken possession of the goods and title passed to Standard Register. The court held that Standard Register did not receive the drop-shipped goods because neither Standard Register nor its agent took physical possession of them. While the carrier, UPS, took possession, the court did not consider UPS to be acting as Standard Register's agent. Thus, IIMI's claim was not eligible for priority status under Section 503(b)(9).

Conclusion

As the Third Circuit is the first United States Circuit Court of Appeals to address the meaning of "received" under Section 503(b)(9), its decision in *World Imports* will undoubtedly play a significant role in future courts' analysis of this issue. Since the Third Circuit determined that the debtor's or its agent's physical possession of goods—a date later than receipt by the carrier—is necessary to trigger an allowed administrative claim under Section 503(b)(9), the decision should, in certain cases, lead to an increase in allowed Section 503(b)(9) priority claims (particularly for sellers bringing in goods from outside the United States).

However, the decision also leaves at least one open issue that courts still have to address: whether a creditor that drop-ships goods to a debtor's customer is eligible for priority status under Section 503(b)(9). The *SRC Liquidation* court denied priority status to a creditor's claim for drop-shipped goods because neither the debtor nor its agent took physical possession of, and, therefore, did not receive the drop-shipped goods. IIMI did not appeal the court's decision. Other lower courts, such as the United States District Court in New Hampshire, in *Ningbo Chenglu Paper Products Manufacturing Co. v. Momenta Inc.* and the United States Bankruptcy Court for the Eastern District of Pennsylvania, in another *World Imports* case, have reached the same conclusion. However, other courts are not bound by these holdings.

Certain creditors have relied on Official Comment 2 to Section 2-705 of the UCC to argue that a debtor should be deemed to have constructively received drop-shipped goods based on their receipt by the debtor's customer. The comment 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." The United States Bankruptcy Court in Delaware, in *In re ADI Liquidation Inc.*, recently rejected this argument and denied Section 503(b)(9) administrative priority status to a creditor selling goods to the debtor, a cooperative that provided distribution and retail services to its member retailers to whom the creditor had delivered goods. The court, analogizing this arrangement to a drop-ship transaction, held the debtor had not taken actual physical possession of the goods and did not obtain constructive possession because the

debtor's members that physically received the goods were not bailees of the debtor. The creditor has appealed this decision to the United States District Court in Delaware.

Alternatively, a trade creditor might consider modifying its contracts with its buyer and carrier in a drop-shipment transaction to explicitly designate the carrier as the creditor's agent. However, no court has ruled on whether there is a contractual exception to circumvent the rulings of the Delaware bankruptcy court in *SRC Liquidation* and other lower courts that deny priority status under Section 503(b)(9) to creditors that drop-ship goods.

The bottom line is that how a court interprets when a debtor receives goods can be the difference between an allowed administrative priority claim under Section 503(b)(9), oftentimes worth 100 cents on the dollar, and a far less valuable, speculative and potentially worthless general unsecured claim. ■

1. Section 546(c) of the Bankruptcy Code provides in pertinent part that:
(1) ... subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee ... are subject to the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days before the date of the commencement of a case. ...

2. UCC § 2-705 states a pertinent part:

- (1) The seller may stop delivery of goods in the possession of a carrier or other bailee when he discovers the buyer to be insolvent ... and may stop delivery ... when the buyer repudiates or fails to make a payment due before delivery or if for any other reason the seller has a right to withhold or reclaim the goods.
- (2) As against such buyer the seller may stop delivery until:
 - (a) receipt of the goods by the buyer; or
 - (b) acknowledgement to the buyer by any bailee of the goods except a carrier that the bailee holds the goods for the buyer; or
 - (c) such acknowledgement to the buyer by a carrier by reshipment or as warehouseman; or
 - (d) negotiation to the buyer of any negotiable document of title covering the goods.

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