

# AMERICAN BANKRUPTCY INSTITUTE JOURNAL

The Essential Resource for Today's Busy Insolvency Professional

## Last in Line

BY BRUCE S. NATHAN AND SCOTT CARGILL

### Third Circuit Applies Plain Meaning to “Receipt” Under § 503(b)(9)



**Bruce S. Nathan**  
Lowenstein Sandler LLP  
New York



**Scott Cargill**  
Lowenstein Sandler LLP  
Roseland, N.J.

Bruce Nathan is a partner in Lowenstein Sandler LLP's Bankruptcy, Financial Reorganization and Creditors' Rights Group in New York. Scott Cargill is Of Counsel in the firm's Roseland, N.J., office.

**Editor's Note:** For an overview of this topic, read *Building Blocks* in the November 2017 issue.

Section 503(b)(9) of the Bankruptcy Code, enacted just over 10 years ago, has been a boon for goods sellers seeking to recover from financially troubled companies in bankruptcy. This provision grants sellers an administrative 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”<sup>1</sup> (a “§ 503(b)(9) claim”). The holder of an allowed § 503(b)(9) claim is generally entitled to full payment of its claim under any approved chapter 11 plan, and in any event, prior to any recovery by lower-priority creditors.

One of the most frequently litigated issues in determining the allowed amount of a § 503(b)(9) claim is when a debtor is deemed to have “received” goods. In July 2017, the U.S. Court of Appeals for the Third Circuit in the *World Imports* case became the first U.S. Court of Appeals case to consider the meaning of the term “received” with respect to § 503(b)(9) claims.<sup>2</sup> The Third Circuit applied the definition of “receipt” contained in Article 2 of the Uniform Commercial Code (UCC)<sup>3</sup> to rule that a debtor is deemed to have “received” goods, for purposes of § 503(b)(9), when a debtor or its agent takes physical possession of the goods.<sup>4</sup>

In so holding, the Third Circuit reversed the holding of the U.S. District Court for the Eastern District of Pennsylvania,<sup>5</sup> which had affirmed the U.S. Bankruptcy Court for the Eastern District of

Pennsylvania,<sup>6</sup> that the debtor was deemed to have received goods by obtaining constructive possession of them upon the passage of title to, or assumption of the risk of loss with respect to, the goods following their delivery to a common carrier. The lower courts had rejected the UCC as the appropriate applicable law and instead relied on the Convention on Contracts for the International Sale of Goods (CISG)<sup>7</sup> and international commercial terms and trade customs.

#### Lower Court Decisions

The sellers, Haining Wansheng Sofa Co. and Fujian Zhangzhou Foreign Trade Co., had sold furniture and similar goods to the debtor, World Imports Ltd., based on free-on-board (FOB) terms at various ports in China, in the ordinary course of business prior to the debtor's bankruptcy filing.<sup>8</sup> According to the FOB terms, the risk of loss or damage to the goods passed from the sellers to the debtor when the goods were transferred to the common carrier in China.<sup>9</sup>

The sellers' goods were loaded onto vessels in China more than 20 days before the debtor's bankruptcy filing, and the debtor took physical possession of the goods in the U.S. within 20 days of the bankruptcy filing.<sup>10</sup> Accordingly, the sellers' ability to obtain priority status under § 503(b)(9) was contingent on when the debtor had “received” the goods, either upon the common carrier's receipt of the goods at the ports in China, or at a later date when the debtor took physical possession of the goods in the U.S.<sup>11</sup> A

1 11 U.S.C. § 503(b)(9) (emphasis added).

2 See generally *In re World Imports Ltd.*, 862 F.3d 338 (3d Cir. 2017).

3 See U.C.C. § 2-103(1)(c).

4 *World Imports*, 862 F.3d at 346.

5 See *In re World Imports Ltd.*, 549 B.R. 820 (E.D. Pa. 2016).

6 See *In re World Imports Ltd.*, 511 B.R. 738 (Bankr. E.D. Pa. 2014).

7 The CISG is an international treaty to which the U.S. and China are parties.

8 *World Imports*, 862 F.3d at 340.

9 *Id.*

10 *Id.* at 340-41.

11 *Id.* at 341.

later receipt date would have increased the amount of the sellers' § 503(b)(9) priority claims.

During the debtor's bankruptcy case, both sellers sought allowance and payment of certain of their outstanding invoices as administrative expense claims pursuant to § 503(b)(9).<sup>12</sup> The bankruptcy court denied the sellers' priority status because the debtor had "constructively received" the goods when the goods were transferred to the common carrier in China more than 20 days prior to the bankruptcy filing.<sup>13</sup>

The bankruptcy court refused to apply the UCC to determine the meaning of the term "received." The court instead relied on the CISG, which applies to disputes arising under contracts for the sale of goods between parties whose places of business are in different countries.<sup>14</sup> The court noted that the CISG is a federal treaty that pre-empts otherwise-applicable state law, including the UCC.<sup>15</sup>

While the CISG does not define "received," the bankruptcy court considered standard commercial terms used in international trade known as "Incoterms."<sup>16</sup> According to the Incoterm governing FOB contracts, the risk of loss of or damage to the goods passes to the buyer when the seller transfers the goods to the common carrier's vessel at a designated location.<sup>17</sup> Therefore, the debtor was deemed to have constructively received the goods when the goods were delivered to the vessels at the China ports and the risk of loss had passed to the debtor.<sup>18</sup> The district court affirmed the decision of the bankruptcy court, substantially adopting the reasoning of the lower court.<sup>19</sup>

## The Third Circuit's Holding

The Third Circuit held that the debtor received the sellers' goods when the debtor took physical possession of them in the U.S. within 20 days of the debtor's bankruptcy filing, and not when title and risk of loss had passed to the debtors prior to the 20-day period.<sup>20</sup> As a result, the sellers satisfied the requirements of § 503(b)(9), and their claims were entitled to administrative priority status.

The Third Circuit applied a plain-meaning analysis, by first reviewing two well-known dictionaries,<sup>21</sup> which defined "received" as requiring physical possession.<sup>22</sup> The dictionary definitions were consistent with the UCC's definition of "receipt of goods," requiring "taking physical possession of them."<sup>23</sup> Congress intended to adopt this well-understood meaning of the term "receipt," particularly because the UCC provision was the governing law in 49 states when § 503(b)(9) was enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).<sup>24</sup> The Third Circuit noted that the "reclamation" provision in BAPCPA (1) clarified the rights of parties exercising reclamation rights under § 546(c) and (2) created

§ 503(b)(9).<sup>25</sup> Because § 503(b)(9) provides an alternative remedy to reclamation, the court interpreted creditors' priority rights under § 503(b)(9) consistently with creditors' reclamation rights under § 546(c).<sup>26</sup>

The Third Circuit relied on its pre-BAPCPA 1984 decision, *In re Marin Motor Oil Inc.*, which had applied the UCC's definition of receipt, namely, "taking physical possession" of goods to creditors' reclamation rights under § 546(c).<sup>27</sup> In *World Imports*, the Third Circuit applied the same meaning of the term "received" — taking physical possession of the goods — to § 503(b)(9) claims based on the interrelationship between §§ 546(c) and 503(b)(9).<sup>28</sup>

The Third Circuit rejected the lower courts' holding that the debtor had "constructively received" the sellers' goods upon delivery of the goods to the common carrier's vessels in China.<sup>29</sup> Instead, the Third Circuit relied on Comment 2 to UCC § 2-103, which distinguishes physical "receipt" from the "delivery" of goods.<sup>30</sup> A seller may "deliver" goods to a common carrier, transfer title to the goods and pass the risk of loss prior to the buyer obtaining physical possession of — and thereby receiving — the goods.<sup>31</sup>

The Third Circuit also found that a buyer receives goods when a seller can no longer stop delivery of the goods.<sup>32</sup> According to UCC § 2-705, a seller can stop delivery of goods in the possession of a carrier, warehouse or other third party that is holding or transporting the seller's goods.<sup>33</sup> Stoppage-of-delivery rights terminate when a buyer or its agent takes physical possession of the goods — not when the title or risk of loss of the goods passes to the buyer.<sup>34</sup> The Third Circuit held that although a buyer is deemed to have constructively received goods when its agent obtains physical possession of goods, a common carrier does not qualify as a buyer's agent.<sup>35</sup>

The Third Circuit's decision left unresolved whether a seller that drop-ships goods directly to a debtor's customer is eligible for priority status under § 503(b)(9). To succeed on such a claim, a seller would have to persuade a court that a carrier or the debtor's customer was acting as the debtor's agent to prove physical possession of the seller's goods.

Just three days after the Third Circuit's *World Imports* ruling, the U.S. Bankruptcy Court for the District of Delaware, in *In re SRC Liquidation LLC*,<sup>36</sup> considered whether a seller's claim based on its drop-shipment of goods directly to the debtor's customers within 20 days of the debtor's bankruptcy filing was eligible for priority status under § 503(b)(9). One of the debtor's vendors, International Imaging Materials Inc.

<sup>25</sup> *Id.* at 342-43.

<sup>26</sup> *Id.* at 343.

<sup>27</sup> *Id.* (quoting *Montello Oil Corp. v. Marin Motor Oil Inc.* (*In re Marin Motor Oil Inc.*), 740 F.2d 220, 224-25 (3d Cir. 1984)).

<sup>28</sup> *Id.* at 343-44.

<sup>29</sup> *See id.* at 345.

<sup>30</sup> *Id.* at 344; U.C.C. § 2-103 cmt. 2 ("Receipt" must be distinguished from delivery, particularly in regard to the problems arising out of shipment of goods, whether or not the contract calls for making delivery by way of documents of title, since the seller may frequently fulfill his obligations to 'deliver' even though the buyer may never 'receive' the goods.).

<sup>31</sup> *Id.* at 345.

<sup>32</sup> *Id.*; see also U.C.C. § 2-705(2) ("As against such buyer the seller may stop delivery until (a) receipt of the goods by the buyer; or (b) acknowledgment to the buyer by any bailee of the goods except a carrier that the bailee holds the goods for the buyer; or (c) such acknowledgment to the buyer by a carrier by reshipment or as warehouseman; or (d) negotiation to the buyer any negotiable document of title covering the goods.).

<sup>33</sup> *See id.* at 345.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 345-46; see also *Cargill Inc. v. Trico Steel Co. LLC* (*In re Trico Steel Co. LLC*), 282 B.R. 318, 323 (Bankr. D. Del. 2002); *Mayer Pollock Steel Corp. v. London Salvage & Trading Co. Ltd.* (*In re Mayer Pollock Steel Corp.*), 157 B.R. 952, 960 (Bankr. E.D. Pa. 1993); *Marin*, 740 F.2d 225.

<sup>36</sup> *In re SRC Liquidation LLC*, No. 15-10541 (BLS), 2017 WL 2992718 (Bankr. D. Del. July 13, 2017).

<sup>12</sup> *See id.*

<sup>13</sup> *World Imports*, 511 B.R. 745-46.

<sup>14</sup> *Id.* at 743.

<sup>15</sup> *Id.* at 742-43.

<sup>16</sup> *Id.* at 744-45.

<sup>17</sup> *Id.* at 745.

<sup>18</sup> *Id.* at 745-46.

<sup>19</sup> *See World Imports*, 549 B.R. at 824.

<sup>20</sup> *World Imports*, 862 F.3d at 346.

<sup>21</sup> *Id.* at 342 (citing *Black's Law Dictionary* and *Oxford English Dictionary*).

<sup>22</sup> *World Imports*, 862 F.3d at 342.

<sup>23</sup> *Id.* at 342; see also U.C.C. § 2-103(1)(c).

<sup>24</sup> *Id.* at 342.

(IIMAK), drop-shipped goods (at the debtor’s instruction) to the debtor’s customers by using the debtor’s carrier, United Parcel Service (UPS).<sup>37</sup>

IIMAK argued for a broad interpretation of “received” that takes into account different types of delivery arrangements, such as drop shipments of goods involving a seller, buyer and the buyer’s customer, and the commercial realities surrounding § 503(b)(9) priority claims.<sup>38</sup> IIMAK asserted that the debtor should be deemed to have constructively received the drop-shipped goods when the title to the goods had passed from IIMAK to the debtor upon IIMAK’s transfer of the goods to UPS.<sup>39</sup>

The purchaser of the debtor’s business, having agreed to pay all allowed § 503(b)(9) claims, opposed priority status for IIMAK’s § 503(b)(9) claim because the debtor had not obtained physical or, through its agent, constructive possession of the drop-shipped goods that would have otherwise cut off IIMAK’s stoppage-of-delivery rights under UCC § 2-705(2)(a)-(d). UPS’s possession of the drop-shipped goods did not change the outcome because UPS, as a carrier, was not the debtor’s agent.<sup>40</sup>

The SRC court, relying on the Third Circuit’s holding in *World Imports*, denied priority status for IIMAK’s § 503(b)(9) claim and ruled that the debtor had not “received” the drop-shipped goods because neither the debtor nor its agent had obtained physical possession of the goods.<sup>41</sup> The court explained that the debtor did not receive the drop-shipped goods when title to or risk of loss of the goods had passed to the debtor upon their transfer to UPS, nor had the debtor constructively received the goods upon their delivery to UPS because UPS, as the carrier, was not the debtor’s agent.<sup>42</sup> In addition, the court found that the word “received” should have the same meaning, “obtaining physical possession,” for reclamation rights under § 546(c) and priority claims under § 503(b)(9).<sup>43</sup>

The SRC court denied priority status under § 503(b)(9) without analyzing whether the debtor’s customer could be deemed to be the debtor’s agent for purposes of physical receipt of the drop-shipped goods.<sup>44</sup> In particular, the court never addressed Comment 2 to UCC § 2-705, which states that a “[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.”<sup>45</sup> It remains to be seen whether any court will rely on Comment 2 to support the allowance of a § 503(b)(9) claim under a drop-ship arrangement.

## Conclusion

The premise underpinning the lower courts’ rulings in the *World Imports* case — that goods delivered on FOB terms

are “constructively received” by a buyer when transferred to a common carrier — risks defining “received” under § 503(b)(9) based on a passage of title or risk of loss. Even more troubling, the lower courts left open the possibility that different meanings would apply to the term “received” depending on the happenstance of whether parties to the transaction were residents of different countries that were signatories to the CISG.

The Third Circuit’s holding rejecting the applicability of the CISG in determining the meaning of “received” eliminates this uncertainty and instead provides a single definition of “received” that is derived from the UCC and grounded on the physical possession requirements established by stoppage-of-delivery and reclamation case law. The Third Circuit’s decision is binding upon the U.S. Bankruptcy Court for the District of Delaware, a popular venue for business chapter 11 cases, and will likely influence the arguments of future litigants and courts as § 503(b)(9) jurisprudence continues to develop. **abi**

*Reprinted with permission from the ABI Journal, Vol. XXXVI, No. 12, December 2017.*

*The American Bankruptcy Institute is a multi-disciplinary, non-partisan organization devoted to bankruptcy issues. ABI has more than 12,000 members, representing all facets of the insolvency field. For more information, visit [abi.org](http://abi.org).*

<sup>37</sup> *Id.* at \*1.

<sup>38</sup> *Id.* at \*4.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at \*4.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* IIMARC did not appeal the bankruptcy court’s order, which is now final.

<sup>43</sup> *Id.* at \*3; see also *Ningbo Chenglu Paper Products Mfg. Co. Ltd. v. Momenta Inc.*, No. 11-cv-479, SM, 2012 WL 3765171 at \*6 (D.N.H. Aug. 29, 2012); *In re World Imports*, 516 B.R. 296, 300 (Bankr. E.D. Pa. 2014).

<sup>44</sup> See *SRC Liquidation LLC*, 2017 WL 2992718, at \*4. The SRC court held that “as a carrier, UPS does not qualify as an agent.” However, this prohibition on a carrier as an agent appears to be a broader reading than the Third Circuit’s ruling that “common carriers” do not qualify as agents. See *World Imports*, 862 F.3d at 345. This distinction could be significant to future litigation because Article 2 of the UCC does not define “common carrier,” and *Black’s Law Dictionary* distinguishes between a “common carrier” and a “private or contract carrier.”

<sup>45</sup> Cmt. 2, U.C.C. § 2-705 (emphasis added).