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Problems in the Code

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Harmonizing § 503(b)(1) and (b)(9) to Provide Comfort and Clarity



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Few areas of bankruptcy law have been so beset by confusion and conflicting decisions as the entitlement of vendors to administrative-expense priority for goods physically received, inspected and accepted by debtors from and after the 20th day preceding the filing of a bankruptcy case, as exemplified in the *Kmart/Sears* chapter 11 cases,¹ in which seemingly contradictory rulings were issued by the court. In *Kmart/Sears*, the debtors filed a first-day motion seeking to affirm the administrative-expense priority of goods under pre-petition purchase orders or sale agreements (the “pre-petition orders”) that were shipped or delivered to the debtor after the commencement of the case. The court entered an order providing that “[a]ll undisputed obligations of the Debtors arising from the post-petition delivery or shipment of goods under the Pre-petition Orders are granted administrative-expense priority pursuant to § 503(b)(1)(A).”

Notwithstanding this order (and the hundreds of similar first-day orders entered in cases across the country for more than 20 years), the *Kmart/Sears* debtors, facing administrative insolvency, objected to the requests for administrative-expense priority of vendors and asserted that goods were not delivered or received when the debtors gained physical possession, but rather when title transferred, often when the goods were placed on a common carrier.²

While ruling on the debtors’ objection — in apparent contradiction to its own first-day order, the bankruptcy court indicated that under the debtors’ pre-petition orders, “the transaction was pre-petition” and the debtors’ receipt and acceptance of the goods post-petition “doesn’t matter,” and concluded that “[t]he mere fact of delivery post-petition where the transaction was entered into pre-petition is insufficient to give rise to such a claim.” The *Kmart/Sears* court’s ruling means that in the case of foreign vendors of goods shipped from Asia, administrative priority was lost while the goods were at sea, before *Kmart/Sears* could physically receive, inspect or accept the goods, although that did occur after the bankruptcy case filing.

The foreign-vendor scenario in *Kmart/Sears* could happen in nearly every chapter 11 case filed. The sheer number of vendors and the aggregate value of the subject goods impacted in many bankruptcy cases requires congressional action to provide both clarity and uniformity in the rules governing whether goods are entitled to administrative-expense priority. A debtor’s physical receipt and acceptance of such goods should be determinative of administrative-expense priority for goods received in the 20 days prior to a bankruptcy and thereafter. Absent congressional action, this victimization will continue to be prevalent.

Section 503(b)(1)

As an initial matter, § 503(b)(1)(A) mandates that “[a]fter notice and a hearing, there shall be allowed administrative expenses,” including “the actual, necessary costs and expenses of preserving the estate.” Such a claim typically arises when there is a post-petition transaction — one between the debtor-in-possession (DIP) and creditor — from

¹ *In re Sears Holding Corp., et al.*, Case No. 7:18-BK-23538-RDD (Bankr. S.D.N.Y. 2018). The authors represented a Hong Kong vendor of *Kmart/Sears* and obtained a settlement for an allowed administrative-expense claim for goods physically received by the debtors, both in the 20 days prior to the filing and thereafter. The briefing on the appeal of the bankruptcy court’s § 503(b)(1) decision can be found at *Winners Indus. Co. LTD., v. Sears Holding Corp.*, Case No. 7:19-cv-10231-NSR (S.D.N.Y. 2019) (the “Winners Appeal”). Extensive portions of the exchange on the issues discussed and cited herein are available in the *Winners Appeal* briefing.

² The *Kmart/Sears* debtors informed the court that if physical receipt rather than passage of title determined entitlement to administrative-expense priority, it would add \$10 million to \$100 million of additional claims that the debtors could not afford. The statement was made during the May 21, 2019, hearing by debtors’ counsel. The transcript is located at ECF Docket No. 5500 at 88, which was filed on Oct. 24, 2019. See *In re Sears Holdings Corp., et al.*, Case No. 18-23538-rdd (Bankr. S.D.N.Y. 2019).

which the estate receives value.³ A vendor of goods ordered by a DIP after the bankruptcy case filing and shipped to and received by the DIP is entitled to administrative-expense priority under § 503(b)(1) as an actual, necessary expense of preserving the estate. These post-petition ordinary-course liabilities are usually paid in the regular course. This statutory priority encourages sellers to continue to do business with a chapter 11 debtor, to enable it to avoid damage to its going-concern value and its prospects for a successful reorganization.

Pre/Post Goods

What about pre/post goods that were shipped under the debtors' pre-petition orders that are physically received by the chapter 11 DIP after the filing of the bankruptcy petition? On the one hand, the underlying contract was entered into pre-petition. On the other hand, the goods are received and accepted by a DIP post-petition and confer benefit on the estate. Although this specific situation arises in almost every chapter 11 case for operating debtors, published decisions directly on point are few and stale.⁴ Hundreds, if not more, of first-day orders granted early in chapter 11 cases over the decades, in response to debtors seeking to ensure the uninterrupted flow of goods, expressly and conclusively address the issue by confirming or affirming relevant law recognizing the administrative expense entitlement as to pre/post goods.

Stopping the Flow of Goods

It is axiomatic that a debtor's ability to continue to receive goods is essential. Foundational to the bankruptcy questions is that nonbankruptcy law affords legal remedies to sellers of goods in transit to an insolvent buyer. Both the Uniform Commercial Code (UCC) and United Nations Convention on Contracts for the International Sale of Goods protect sellers by giving them certain meaningful rights and remedies up until goods are physically received by an insolvent buyer, including the right to stop goods in transit,⁵ even if title has previously passed to the buyer.⁶

Physical receipt and acceptance of the goods, not the passage of title, is determinative under applicable non-bankruptcy law. In certain circumstances, even after goods are physically received by an insolvent buyer, a seller can demand reclamation of those goods.⁷ Moreover, the automatic stay that arises on the filing of a bankruptcy does not affect the seller's nonbankruptcy right to stop goods in transit.⁸

³ *Trustees of the Amalgamated Ins. Fund v. McFarlin's Inc.*, 789 F.2d 98, 101 (2d Cir. 1986).

⁴ See *Collingwood Grain Inc. v. Coast Trading Co.* (In re *Coast Trading Co.*), 744 F.2d 686, 693 (9th Cir. 1984); *In re John Clay and Co. Inc.*, 43 B.R. 797, 809 (Bankr. D. Utah 1984).

⁵ See U.C.C. § 2-702(1) ("Where the seller discovers the buyer to be insolvent, he may refuse delivery except for cash including payments for all goods theretofore delivered under the contract, and stop delivery under this Article (2-705)."); U.C.C. § 2-705 ("The seller may stop delivery of goods in the possession of a carrier or other bailee when he discovers the buyer to be insolvent (§ 2-702)."); Contract for International Sale of Goods (CISG) Article 71(2) (seller "may prevent the handing over of the goods to the buyer even though the buyer holds a document which entitles him to obtain them").

⁶ See, e.g., *In re Nat'l Sugar Ref. Co.*, 27 B.R. 564, 569 (S.D.N.Y. 1983) (passage of title did not affect seller's right to stop goods in transit); *In re Trico Steel Co. LLC*, 282 B.R. 318, 324 (Bankr. D. Del. 2002) (passage of title and delivery to non-bailee common carrier who did not cut off seller's right to stop delivery).

⁷ See U.C.C. § 2-702(2) ("Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt.").

⁸ See, e.g., *Nat'l Sugar Ref.*, 27 B.R. at 572-73 (seller not required to seek stay relief before exercising its right of stoppage); *Matter of Pester Ref. Co.*, 66 B.R. 801, 820 (S.D. Iowa 1986) (automatic stay does not affect seller's right to stop goods in transit).

Vendor-Comfort Motions and Orders

Because chapter 11 debtors rely on the uninterrupted supply of goods (e.g., inventory for a retailer, parts for a manufacturer), and because of a seller's ability to stop goods in transit, as part of their first-day relief debtors routinely seek to provide comfort to their suppliers by making it abundantly clear that if goods are provided and accepted by the chapter 11 debtor after the bankruptcy filing, even if those goods were shipped under the debtors' pre-petition orders, they are entitled to administrative-expense priority and often are payable in the ordinary course of business. These motions uniformly recognize the risk that sellers, to assure themselves of administrative-priority entitlement, may stop goods in transit and demand that the DIP reissue the purchase orders post-petition.

Although not reflected in bankruptcy decision reporters, established chapter 11 practice memorializes that as part of the first-day relief, vendors of pre/post goods are universally granted administrative-expense claims under § 503(b)(1) (collectively, "vendor-comfort orders").⁹ In each of these cases, bankruptcy courts confirm or affirm the generally universally accepted legal conclusion that pre/post goods satisfy the elements required for administrative-expense priority.

Physical Receipt Determinative for Vendor Priority for 20-Day Goods

Section 503(b)(9), adopted in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), elevates the priority of goods that are received by a debtor in the 20 days prior to filing for bankruptcy. This section provides that "[a]fter notice and a hearing, there shall be allowed, administrative expenses ... including — (9) 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."¹⁰

In *In re World Imports Ltd.*, the Third Circuit — the only circuit court that has to date ruled on this issue — determined that goods are not "received" for purposes of § 503(b)(9) until debtors or their agents take physical possession of the goods and not when title passes, and rejected the argument that common carriers qualify as a debtor's agents.¹¹ Again, in its efforts to minimize the class of claims entitled to administrative priority, the *Kmart/Sears* debtors objected to vendors claiming § 503(b)(9) priority — arguing that receipt occurred on the transfer of title and not physical receipt — and asserted that *World Imports* was wrongly decided.

⁹ See, e.g., *In re Bumble Bee Parent Inc.*, Case No. 19-12502 (Bankr. D. Del. Nov. 22, 2019); *In re Herb Philipson's Army and Navy Stores Inc.*, Case No. 18-61376-6 (Bankr. N.D.N.Y. Nov. 19, 2018); *In re Toys "R" Us Inc.*, Case No. 17-34665 (Bankr. E.D. Va. Oct. 25, 2017); *In re Arch Coal Inc.*, Case No. 16-40120-705 (Bankr. E.D. Mo. Jan. 13, 2016); *In re PG&E Corp.*, Case No. 19-30088 (Bankr. N.D. Cal. Feb. 27, 2019); *In re Tops Holding II Corp.*, Case No. 18-22279 (Bankr. S.D.N.Y. March 22, 2018); *In Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. Oct. 14, 2005); *In re Delta Air Lines Inc.*, Case No. 05-17923 (Bankr. S.D.N.Y. Sept. 16, 2005); *In re Winn-Dixie Stores Inc.*, Case No. 05-11063 (Bankr. S.D.N.Y. March 15, 2005); *In re Westpoint Stevens Inc.*, Case No. 03-13532 (Bankr. S.D.N.Y. June 3, 2003); *In re Fleming Co.*, Case No. 03-10945 (Bankr. D. Del. April 3, 2003); *In re Enron Corp.*, Case No. 01-16034 (Bankr. S.D.N.Y. Dec. 3, 2001); *In re Ames Dept' Stores Inc.*, Case No. 01-42217 (Bankr. S.D.N.Y. Aug. 20, 2001).

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

¹¹ 862 F.3d 338, 342-45 (3d Cir. 2017).

Physical Receipt and Pre-BAPCPA Administrative Claim for Goods Subject to Reclamation

Although, unlike the other current subsections in § 503(b) that all address post-petition claims, § 503(b)(9) grants administrative-expense priority for a claim arising before the commencement of the case, recognizing administrative-expense priority for a pre-petition claim for goods received by a debtor is nothing new. Prior to the BAPCPA amendments, 11 U.S.C. § 546(c), in addressing alternatives to relief for vendors with valid reclamation demands,¹² permitted a court to deny a valid reclamation demand only if it “grants the claim of such seller priority as a claim of a kind specified in § 503(b).”¹³

In *In re Marin Motor Oil Inc.*,¹⁴ the Third Circuit held that in determining allowance of a reclamation claim asserted under pre-BAPCPA § 546(c) for goods sold, “receipt” of goods under the UCC was the moment that the debtor or its bailee physically possessed the goods, rather than the moment that the title passes (by delivery to the common carrier), which would qualify for administrative expense under § 503(b). Again, physical receipt was determinative of the reclamation right and the consequent entitlement to administrative-expense priority. Permitting the debtor to keep goods subject to reclamation provided a benefit to the estate and warranted granting an administrative expense claim under the pre-BAPCPA Code.

The Need for Congressional Action

As a result of contradictory and confusing rulings, and the efforts of creative debtor lawyers to limit entitlement administrative claims to avoid administrative solvency, many nationwide and foreign global vendors have learned to distrust vendor-comfort orders and communications from DIPs suggesting that they will honor and pay pre-petition orders for pre/post goods. A distressed entity’s ability to physically receive the goods it purchases is the protected interest. If the physical receipt of the goods by the debtor is determinative for qualifying for administrative-expense priority for goods received pre-petition under § 503(b)(9), it should follow that the post-petition physical receipt of pre/post goods should satisfy the elements of an administrative-expense claim under § 503(b)(1).

It would be nonsensical to give a claim for goods physically received on or after the bankruptcy filing a lower priority than a claim for goods received before the filing date, which was in essence what the *Kmart/Sears* debtors and court were willing to accept. Moreover, if the date of the passage of title is determinative of priority, vendors would be incentivized to exercise their statutory remedies, stop the flow of goods in transit, and deprive or delay the DIP’s receipt of essential goods, gratuitously damaging the value of their going concerns undergoing attempted reorganization.

Because certain debtors and courts have created uncertainty as to what constitutes delivery to, or receipt by, a

debtor, for vendor entitlement to an administrative-expense priority claim, Congress should clarify that the date of physical receipt of goods by the debtor or its agent, and not the transfer of title to the goods when placed with a common carrier, is determinative of administrative-expense priority, both for pre/post goods under § 503(b)(1) or 20-day goods under § 503(b)(9). **abi**

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¹² See 11 U.S.C. § 546(c)(1) (pre-Oct. 17, 2005) (recognizing statutory or common law right of seller of goods to debtor, in ordinary course of such seller’s business, to reclaim goods if debtor has “received such goods while insolvent”) (emphasis added).

¹³ 11 U.S.C. § 546(c)(2) (pre-Oct. 17, 2005).

¹⁴ 740 F.2d 220, 224-25 (3d Cir. 1984).