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Recent Article on the Nuts and Bolts of Section 503(b)(9) Claims in Chapter 11 Cases.

The so-called 20-day administrative priority claim (set forth in Section 503(b)(9) of the Bankruptcy Code) is perhaps the best remedy available to vendor creditors in Chapter 11 cases.

In 2005, Congress amended the U.S. Bankruptcy Code and added Chapter 15 (cross-border insolvency), and the game-changing Section 503(b)(9) claim, which functionally eclipsed the reclamation

claim. At its essence, Section 503(b)(9) claims allow vendors to convert a portion of their pre-petition claims (arising from goods delivered within 20 days prior to filing) from near valueless general unsecured claims to administrative priority claims, which are generally paid in Chapter 11 cases. Section 503(b)(9) claims have had a major impact on Chapter 11 cases because they add a significant financial obligation that must be paid. Naturally, Chapter 11 debtors and their lenders have challenged such claims to minimize the financial impact of Section 503(b)(9). Since 2005, there have been a number of reported and unreported cases that provide guidance on successfully utilizing the remedy.

Below is an excellent article by my partner David Grogan on the nuts and bolts of Section 503(b)(9) claims in Chapter 11 cases.

We hope you find this useful and informative. Please contact us if you have any questions about this, or any other matter.

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The Chapter 11 Vendor Game Changer: Section 503(b)(9) Claims

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What is Section 503(b)(9)? This section of the Bankruptcy Code provides an allowed administrative expense for “the value of any goods received by the debtor within 20 days before the date of commencement of a case * * * in which the goods have been sold to the debtor in the ordinary course of such debtor’s business.”

What is an administrative expense? Administrative expenses have the highest priority of claims that are not secured by collateral. Usually, administrative expenses are paid in full, whereas nonpriority prepetition claims are generally paid a fraction of their dollar amount.

What is the purpose of Section 503(b)(9)? This section has the effect of substantially increasing the distribution that manufacturers, suppliers, and distributors can expect on those goods that they delivered to the debtor in the last 20 days before the bankruptcy filing.

What does it apply to? It applies only to goods. The easy requirement is that these goods must have been sold to the debtor in the ordinary course of the debtor’s business. But after getting past this hurdle, the statute has been very narrowly interpreted by the courts.

What is in, what is out? Services are definitely out. Natural gas utilities, for example, are in. So are water utilities. Sewer utilities are probably out—they are taking “goods” from the debtor, and really are providing a service. The jury is out on electric utilities. Some courts have found electricity to be the provision of “energy,” and thus not a movable “thing,” and thus not a good. Other courts have found electricity to be the sale and movement of electrons, and thus a good.



So much for “goods,” what about “received by the debtor”?

The courts have held that the statute must be strictly and literally construed. Therefore, a drop shipment by a vendor to the debtor’s customer does *not* qualify for administrative expense priority. The debtor gets the value of the goods, so why should it matter that the goods were shipped to the debtor’s customer rather than being shipped to the debtor and the debtor immediately shipping to its customer? The explanation is that the courts strictly interpret “goods received by the debtor” and will not expand that to include goods for which only the value was received by debtor. This may be due to the general attempt by some stakeholders to reduce the financial impact of Section 503(b)(9).

When are goods received by the debtor? Section 503(b)(9) extends priority to goods received by the debtor within 20 days before the bankruptcy filing. How is the time of such receipt determined? The Bankruptcy Code does not define this term, and the courts look to other law, again being the Uniform Commercial Code, and other portions of the Bankruptcy Code for guidance concerning shipments within the United States.

The old common-law doctrine of reclamation has been incorporated into the UCC for decades. Prior to 2003, Section 2-702 of the UCC provided that a seller could reclaim goods within 10 days after their receipt by the buyer. Further, the Bankruptcy Code also has a provision for reclamation, with Section 546(c) now allowing for reclamation of goods received by an insolvent debtor within 45 days before the bankruptcy filing, and bankruptcy courts interpreting that section have looked to the UCC regarding reclamation.

One circuit court decision from 1984 concerned a shipment of oil by barge under shipping terms of “FOB New York Harbor.” The common-carrier barge received the oil in New York Harbor and delivered it the next day to the buyer’s facility in New Jersey. Relying on several earlier cases interpreting reclamation under the UCC, the court held that the shipping terms meant that the goods had been sold and risk of loss passed when loaded on the barge, as is consistent with FOB terms, but nonetheless the oil was not “received by the buyer” until unloaded at the buyer’s facility. Therefore, even if shipping on FOB terms, the 20-day period starts to run on the debtor’s actual receipt of the goods, and not on their delivery to a common carrier.

In a 2016 decision concerning Section 503(b)(9) where goods sold under FOB terms were in transit from China to the United States, the U.S. District Court (on appeal from the bankruptcy court) ruled that the UCC was not applicable because The United Nations Convention on Contracts for the International Sale of Goods controlled. The debtor constructively received the goods when they were loaded on the ship in China, and thus the goods were beyond the 20-day time limit of Section 503(b)(9).

How does one file a 503(b)(9) claim? The Bankruptcy Code and Rules do not specify the means of filing for this claim or a time limit

for filing. Initially, creditors would generally file an application for allowance of the claim. In most cases, the debtor seeks a “first day” order, setting out the procedures for filing and resolving these claims. Normally, a creditor can assert its Section 503(b)(9) claim in the form Proof of Claim. Occasionally, there is a separate 503(b)(9) claim form adopted for a particular case, which looks similar to the usual proof of claim form and is merely filed with the court or a claims agent. A creditor should be vigilant regarding a Section 503(b)(9) procedures order, as it will set a bar date for filing the claim.

When is a 503(b)(9) claim paid? The Bankruptcy Code requires only that administrative expense claims be paid upon confirmation of a plan, so it may be some time before the claim is actually paid. The Code provides that a plan cannot be confirmed unless administrative expense claims are paid in full, or the holder consents to other treatment. However, the claim holder should be alert to sharp dealing in a plan where the debtor may propose that 503(b)(9) claims are paid off over several years, and holders of the claims are deemed to consent to this treatment unless they expressly object to the plan.

How does allowance of a 503(b)(9) claim affect the subsequent new value defense to a preference claim? Unpaid prepetition shipments of goods by a creditor can count toward the defense of subsequent new value when the debtor later files a complaint against the creditor to recover allegedly preferential payments.

But what happens if the creditor has filed, and has had allowed, a 503(b)(9) claim for these very same shipments of goods? Can the creditor have both its 503(b)(9) claim (and be paid for it) and also count those shipments for the subsequent new value defense?

Although the early court decisions generally held not, more recent rulings have held only shipments prior to Chapter 11 filing count for subsequent new value, so payments after that date are similarly precluded from affecting occurrences prior to that date. Thus a creditor can count unpaid (that is, unpaid before the bankruptcy filing) prepetition shipments toward the subsequent new value defense, but the creditor can also file a Section 503(b)(9) claim for these very same goods and be paid in full for them as a postpetition administrative expense.

How is a Section 503(b)(9) claim affected by setoff? If at the time of a bankruptcy filing there are open invoices due the creditor, it can set off any credits that the creditor owes to the debtor that relate to the invoices. Bankruptcy Courts have generally approved debtors’ motions to offset the prepetition credits, which may have accumulated for months, against the 503(b)(9) invoices that accrued in the 20 days prior to filing. It is thus advisable for a creditor to offset these claims fairly often, and always offset against the *oldest* outstanding invoices owed to the creditor, which have no chance of 503(b)(9) priority. This strategy will maximize the 503(b)(9) claim and protect it as much as possible from setoff by the debtor.