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Client Alert: Vendor Section 503(b)(9) Administrative Priority Claims: When Goods are Received is Critical

Debtors in Chapter 11 proceedings rarely pay unsecured creditors a meaningful dividend on prepetition accounts receivable balances, much less pay them in full. In an era of aggressive lending to place capital in the market, loan to value ratios are high. When a company experiences financial distress or insolvency, unsecured creditors may be “out of the money” from the get-go. To improve its outcome, a vendor must pursue available “vendor” remedies, including critical vendor status, the assumption of a sales contract, reclamation, exercise of setoff, or a priority administrative claim under Section 503(b)(9) of the Bankruptcy Code, known as a “20-day administrative priority.”

The 20-day administrative priority claim allows a vendor to effectively convert a portion of its prepetition accounts receivable balance to a post-petition administrative priority claim. Since administrative priority claims are normally paid in full (absent “administrative insolvency”), this remedy significantly improves the outcome for the vendor. To qualify, the vendor must establish the value of goods it delivered to the debtor that were received by the debtor within 20 days prior to the Chapter 11 filing.

Debtors (and behind the scenes, their lenders) seek to minimize administrative claims, including 20-day administrative claims. Debtors often challenge the claim by asserting that the goods were not received in the 20-day period. When are goods “received”? In an F.O.B. seller’s plant contract, are goods “received” when placed with a carrier when risk of loss and possibly title pass to the buyer? Are goods “received” when the seller delivers goods to the debtor’s agent such as a third-party logistics company? When are

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goods “received” if the seller drop ships the goods directly to the debtor’s customers? In a recent Delaware Chapter 11 case (*World Imports Ltd.*), a Chinese supplier shipped goods to its U.S. customer F.O.B. point of origin, so risk of loss passed to the U.S. buyer at port in China. The goods were loaded on the ship 38 days prior to the Chapter 11 filing, and arrived at the debtor’s warehouse 13 days prior to the filing. The seller argued the goods were “received” upon physical possession. Of course, the buyer argued that the goods were constructively “received” when loaded on the ship. The Bankruptcy Court ruled that goods were received when loaded on the ship, and thus not delivered within the required 20 days.

Fortunately, the seller persisted and appealed the Bankruptcy Court ruling to the Third Circuit Court of Appeals, which, on July 10, 2017, ruled that “receipt” does not occur until after the seller’s ability to stop delivery ends – namely upon the buyer’s physical possession . . .” A victory for vendors!

Subsequently, the Bankruptcy Court in another Delaware Chapter 11 case, *SRC Liquidation, LLC*, addressed receipt in the context of goods that were drop shipped from the seller directly to the debtor’s customers. Jumping on the Third Circuit’s “physical possession” test, the SRC Bankruptcy Court ruled that the debtor never had physical possession, so the goods were never “received”. The Delaware Bankruptcy Court should have distinguished the F.O.B. shipment case from the drop ship case. Both are used in very different market circumstances and should be treated differently. In a world of Amazon, Google, and Alibaba, sellers of goods do not deliver goods to buyers; rather, sellers deliver goods to the buyer’s customers, at the buyer’s request. The buyer clearly receives “value” from the seller, and value should be the fountainhead of the analysis. This is precisely the circumstance where “constructive receipt” should be applied.

The takeaway is that the 20-day administrative priority claim remedy adds significant value for vendors. Anticipate that debtors will challenge such claims, but knowing the rules, and persistence will pay off for vendors.

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

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