

**DO THE TRADE WINDS BLOW FAIR OR IS
BAPCPA FULL OF HOT AIR?
TREATMENT OF TRADE CREDITORS UNDER BAPCPA**

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EXCERPTED MATERIALS:

**SWIRLING TRADE WINDS:
TREATMENT OF SECTION 503(B)(9) CLAIMS UNDER BAPCPA**

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INTRODUCTION

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) created a powerful new right for the benefit of certain creditors that sell goods on credit prepetition to a company that later files for bankruptcy by creating a new category of administrative expense. Specifically, section 503(b)(9) of the Bankruptcy Code provides:

(b) After notice and 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.²

This new category of administrative expense, sometimes also referred to as a “20 day administrative claim”, elevates what previously would have been at best a reclamation claim and at worst a general unsecured claim, to full administrative expense status. Further, unlike reclamation claims, a section 503(b)(9) claim is not subject to a floating inventory lien.³

With the benefit of two years of hindsight, these materials explore (i) the general rights of holders of 503(b)(9) claims, (ii) the applicability of section 502(d) to these administrative claims, and (iii) prepetition measures that a creditor can employ to position itself to take advantage of the benefits of this section of the Bankruptcy Code.

² 11 U.S.C. § 503(b)(9).

³ See 11 U.S.C. § 546(c)(1) (reclamation rights are subject, *inter alia*, to “the prior rights of a holder of a security interest in such goods or the proceeds thereof”).

GENERAL RIGHTS UNDER SECTION 503(B)(9)

A. The Basic Elements

The plain language of section 503(b)(9) appears straightforward. Most notably, this section only elevates prepetition claims of suppliers of goods, provided that the goods (i) were received by the debtor within 20 days before the commencement of the bankruptcy, and (ii) were sold to the debtor in the ordinary course of the debtor's business. However, within these requirements are several potential pitfalls that, at a minimum, will provide a debtor with negotiating leverage regarding the amount of the claim or the timing of payment of the claim.

First, depending on the manner in which the goods were shipped and the terms of the contract between the parties, there could be a dispute regarding when the goods were "received." Bankruptcy courts will likely look to underlying state law to determine when goods are received, and under the Uniform Commercial Code, passage of title or even delivery to a common carrier does not necessarily constitute receipt of goods by the buyer.

Second, a debtor that plans its bankruptcy carefully could modify its ordinary purchasing protocol and in the days before a bankruptcy filing start stockpiling product from suppliers that are still providing credit. This change in protocol (ordering several weeks of product vs. the debtor's customary practice of buying product on a just-in-time basis) could take the sale outside of the debtor's ordinary course of business. It is not clear whether this ordinary course of business requirement applies only to the type of goods, *i.e.*, a good that the debtor ordinarily buys, or whether it will extend to the price, method of delivery, shipment terms and quantity.

Finally, the administrative expense is to be allowed in an amount equal to the value of the goods. Where the value of the goods differs from the contract price, for instance, it

is possible that the section 503(b)(9) claim will be allowed in an amount other than the contract price. This could be the case where the debtor has a long term agreement at a fixed price and the market price has dropped significantly. Courts have not yet addressed these issues in any public opinions, but counsel should consider these potential challenge points and advise clients to manage their customer relationships in a manner that minimizes the risks that the client will be susceptible to these challenges.

B. How and When To Assert the Claim

Since BAPCPA became effective, most of the attention involving section 503(b)(9) have involved when the debtor must pay such administrative expenses.⁴ However, as an administrative expense, the Bankruptcy Code does not presume the claim to be valid. Instead, the first step is for the claimant to seek allowance of its 503(b)(9) claim. As a general rule, section 503(b)(9) claimants should file an application for allowance and immediate payment of their claim as soon as possible. Further, if a creditor has not yet filed its 503(b)(9) request, it should watch the bankruptcy court's docket very carefully to make sure that it complied with any bar date order applicable to such claims.

C. When Will the Debtor Pay?

Even if a section 503(b)(9) administrative expense is allowed, the current state of the law is that such claims need not be paid until the effective date of a chapter 11 plan. By contrast, it would be typical for administrative claims incurred for ongoing postpetition extensions of credit would be paid in the ordinary course of business. In this manner, section 503(b)(9) claims may bear a disproportionate risk of administrative insolvency, thus demonstrating that not all administrative expenses enjoy equal treatment. Unfortunately, other

⁴ See *In re Global Home Products, LLC*, 2006 WL 3791955 (Bankr. D. Del.); and *In re Bookbinder's Restaurant, Inc.*, 2006 WL 3858020 (Bankr. E.D. Pa.).

than availing themselves of the benefits of “first day” essential supplier motions these creditors have few ways to protect themselves from the risk of administrative insolvency. By contrast, many other entities that incur administrative expenses have ways to protect against such risk. For example, debtor’s professionals often hold retainers and they and other professionals often enjoy the benefit of a carveout from the secured creditor’s collateral; landlords and lessors enjoy certain protections under section 365;⁵ utilities are protected by section 366;⁶ and courts are more likely to direct a debtor to pay the administrative expenses of postpetition suppliers of goods and services. Accordingly, section 503(b)(9) claimants are somewhat unique both in terms of their relegation to the end of the administrative expense food chain as well as their relative lack of alternative mechanisms to protect their rights.

With that said, it should be noted that the *Global Home Products* court did not establish a *per se* prohibition of payment of section 503(b)(9) claims. Rather, the court acknowledged that it must consider three factors in determining when an administrative expense should be paid: (1) prejudice to the debtor; (2) hardship to the claimant; and (3) potential detriment to other creditors.⁷ As to the first factor, the bankruptcy court will likely consider the impact on the debtor’s liquidity and therefore the potential negative impact on the debtor’s ability to maintain ongoing operations. This factor also requires consideration of the aggregate amount of all section 503(b)(9) claims and not just the amount sought to be paid by a single claimant. The second factor requires a showing of the harm of nonpayment to the specific claimant. A mere showing of temporal disparate treatment among administrative expenses is

⁵ See 11 U.S.C. § 365(d)(3),(5); see also *Bookbinder’s*, 2006 WL 3858020 at *6 (pointing to section 365(d)(3) as evidence that when Congress intends to require current or prompt payment of certain obligations, it has clearly stated such a requirement).

⁶ See 11 U.S.C. § 366 (requiring debtors to provide utilities with adequate assurance of payment).

⁷ *In re Global Home Products*, 2006 WL 3791955 at *4, citing *In re Garden Ridge Corp.*, 323 B.R. 136 (Bankr. D. Del. 2005).

insufficient. The third factor seems to dovetail with the consideration of harm to the debtor, as any impact on the debtor as a going concern will harm the general creditor body.

Based on the developing caselaw, in order to be paid prior to confirmation, and assuming no critical vendor relief is available, a section 503(b)(9) claimant will have to demonstrate some specific harm that it will suffer absent payment, and it should be prepared to make this showing before a debtor's hands are tied by a court-approved DIP financing or cash collateral budget.

FIRST DAY VENDOR MOTIONS

“First day” motions such as critical vendor (or essential supplier) motions and postpetition financing motions may provide an opportunity for section 503(b)(9) claimants to enhance their position. In large cases, debtors are increasingly filing motions that may impact the balance of rights and obligations between a debtor and its suppliers. These motions often seek to limit the exercise of reclamation rights, enjoin the exercise of a vendor's stoppage of delivery rights, and obtain an order permitting the debtor to withhold payment of section 503(b)(9) claims until confirmation. The overarching purpose of such motions is to conserve the debtor's liquidity while ensuring an ongoing supply of product from its vendors. Accordingly, where these motions are filed, creditors should review them carefully. They provide opportunities to accelerate payment, but such payments often come with strings attached. For instance, these motions typically require extension of credit throughout the pendency of the debtor's bankruptcy. Typically, it is helpful for a creditor to attempt to resolve as many of its rights as possible (allowance of claims, reclamation rights, preference waivers, payment of 503(b)(9) claims) in the context of these motions. This leaves a creditor with fewer “unknowns”

going forward in its business with the debtor.

SECTION 503(B)(9) CARVEOUTS

In addition to establishing that the weight of the three *Global Home Products* factors favors payment before confirmation, section 503(b)(9) claimants can argue that deferral of payment renders them involuntary unsecured lenders. For this reason, especially where such suppliers enjoy leverage in terms of the necessity of their product, they should attempt to obtain a carveout in the DIP financing order. This is certainly an uphill battle, but it may also sensitize the court to the somewhat unique predicament of these suppliers. Even if a carveout is not available, section 503(b)(9) claimants should seek a line item in the debtor's DIP budget so that opponents cannot later point their fingers at an approved budget as the basis for the debtor's inability to pay these administrative expenses. There certainly is no downside to seeking either a carveout or a budget line item, and even limited relief in either regard is better than waiting years for payment while simply crossing one's fingers that the debtor remains administratively solvent.

APPLICABILITY OF SECTION 502(D) TO 503(B)(9) CLAIMS

There has been much discussion in the legal profession regarding whether section 502(d) of the Bankruptcy Code provides a basis for disallowing a section 503(b)(9) claim. Section 502(d) provides for the disallowance of a claim asserted by a creditor who has received and has not returned an avoidable transfer.⁸ Courts are split on whether section 502(d) applies to

⁸ "Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545 547, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title." 11 U.S.C. § 502(d).

administrative expenses.⁹ The better reasoning seems to support those courts that decline to apply section 502(d) to administrative expenses. First, under the doctrine of *expressio unius est exclusio alterius*, the express inclusion of certain postpetition claims within the purview of section 502 and the lack of any reference to section 503 administrative expenses supports the conclusion that section 502(d) does not apply to administrative expenses. Second, the purpose of equality of distribution among unsecured creditors is not furthered by application of section 502(d) to administrative expenses. Third, section 502 read as a whole applies to claims and interests “proof of which is filed under section 501 of this title”¹⁰ The other subsections of section 502 then establish various mechanisms for objecting to and disallowing such claims. Indeed, section 502(d) itself states “Notwithstanding subsections (a) and (b) of [section 502]” Of note, section 502(d) does not provide for disallowance of claims “notwithstanding section 503” – there is no reference whatsoever to section 503 in this regard. Finally, section 503 governs “administrative expenses” and that phrase is used to the exclusion of the term “claim” in section 503 as well as section 507 of the Bankruptcy Code. The application of section 502(d) to administrative expenses thus would require a court to ignore the clear distinction in terminology used by Congress with respect to “claims” versus “administrative expenses.”

PREPETITION CREDIT PRACTICES: HOW TO PREPARE DURING THE CALM BEFORE THE STORM

It is not unusual for creditors to see warning signs of a customer’s looming bankruptcy and to evaluate measures to reduce the creditor’s exposure. Quite often, the warning

⁹ Compare *In re Lids Corp.*, 260 B.R. 680 (Bankr. D. Del. 2001) (holding that section 502(d) does not apply to administrative expenses) and *In re CM Holdings, Inc.*, 264 B.R. 141 (Bankr. D. Del. 2000) (same) with *In re Microage, Inc.*, 291 B.R. 503 (9th Cir. B.A.P. 2002) (holding that section 502(d) does apply to section 503 administrative expenses, but further holding that it cannot serve to disallow an administrative expense that has already been allowed).

¹⁰ 11 U.S.C. § 502(a).

sign is a growing past due account receivable balance. Faced with such a situation, customers should consider resisting the ordinary reaction of placing the customer on cash in advance or COD terms. Section 503(b)(9) provides a greater blended recovery to the creditor whose prepetition balance is weighted with receivables less than 20 days old.

The challenge is to manage the account in a manner that does not (i) increase the aggregate receivable, and (ii) impose a great risk of preference exposure. Fortunately, vendors can manage both of these risks. The key is that while continuing to extend credit, the vendor must require payment on account of an old invoice contemporaneously with releasing the new shipment. The payment should not exceed the amount of charges for the new shipment, and the vendor should obtain something from the customer in writing clearly stating that the payment is on account of the old invoice and that it has agreed to make the payment in exchange for the vendor's shipment of new product on credit.

This structure of payments and shipments should create a strong contemporaneous exchange for new value defense to any preference action, while keeping the new invoices eligible for allowance under section 503(b)(9), and without increasing the vendor's overall receivable balance. This approach will return a higher average recovery of the prepetition balance than if the balance received only a pro rata distribution as a general unsecured claim.

CONCLUSION

Certainly suppliers of goods are better off with section 503(b)(9) in their arsenal than they were prior to the enactment of BAPCPA. However, it is clear that the waters are at times murky and the winds sometimes lead such creditors to unexpected destinations. However,

experienced counsel can help these vendors navigate the waters and harness the trade winds to lead to calm seas and brighter days.