

Pratt's Journal of Bankruptcy Law

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Bankruptcy Code Section 503(b)(9) and E-Commerce: Seller Protections May Not Be As They Appear

*By Peter C. Blain**

Two recent cases have ruled that the word “received” in Section 503(b)(9) of the U.S. Bankruptcy Code means the debtor taking actual, physical possession of the goods. The author of this article discusses these decisions, which will have significant impact on the sellers of goods who drop ship, or deliver the goods directly, to the debtor’s customers.

As part of the Bankruptcy Abuse and Consumer Protection Act of 2005, Congress included Section 503(b)(9) of the U.S. Bankruptcy Code,¹ which grants administrative expense priority to ordinary course sellers of goods where the goods are received by the debtor within the 20 days preceding the filing of the bankruptcy petition. Two recent cases have ruled that the word “received” in Section 503(b)(9) means the debtor taking actual, physical possession of the goods. These decisions will have significant impact on the sellers of goods who drop-ship, or deliver the goods directly, to the debtor’s customers. In the exploding world of e-commerce, sellers are increasingly directing their vendors to drop-ship goods directly to the sellers’ customers, thereby avoiding the need to finance the acquisition of a substantial stock of inventory. Under these recent decisions, vendors drop-shipping goods to third-party buyers are not entitled to Code Section 503(b)(9)’s enhanced protections. This significantly changes the credit risk which vendors assume in these types of transactions.

***IN RE SRC LIQUIDATION, LLC*²**

Standard Register Company (“SRC”) filed a petition under Chapter 11 of the Code and entered into an asset purchase agreement (“APA”) providing for the purchase of certain assets and the assumption by the buyer of certain liabilities, including Code Section 503(b)(9) claims. The agreement was approved by the bankruptcy court and the sale closed. The buyer, which had the right to designate a party to acquire the assets and assume the liabilities under

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¹ 11 U.S.C. §§ 101–1532 (hereinafter “Code”).

² *In re SRC Liquidation, LLC*, 573 B.R. 537 (Bankr. D. Del. 2017).

the APA, designated Standard Register, Inc. (“Standard”). After the closing of the sale, SRC confirmed a Plan of Liquidation which provided that Standard as designee had the exclusive authority to resolve any disputed claims against SRC.

In the 20 days preceding the Chapter 11, International Imaging Materials, Inc. (“IIM”) delivered some goods to SRC, and other goods directly to SRC’s customers at SRC’s direction using SRC’s account with United Parcel Service. Standard agreed that the claim for goods delivered directly to SRC was entitled to administrative expense priority under Code Section 503(b)(9), but objected to IIM’s administrative claim for \$48,000 for goods delivered directly to SRC’s customers.

The court began its decision by noting the language of Section 503(b)(9) required goods to be “received by the debtor” within 20 days of the filing of the bankruptcy petition, and by reviewing the Uniform Commercial Code’s (“UCC”) definition of “receipt.”³ Under the UCC, said the court, “receipt” means taking physical possession of goods, unless the context requires otherwise.⁴ The “context requiring otherwise” includes the right to stop goods in transit under UCC § 2-705 until the goods are received by the buyer or constructively received by the buyer’s agent, thereby triggering the seller’s reclamation rights under UCC § 2-702.⁵

Relying on the U.S. Court of Appeals for the Third Circuit’s decision in *Marin Motor Oil*,⁶ Standard argued that IIM’s delivery of goods directly to the customer did not qualify as “receipt by the debtor” under the UCC. IMM sought to distinguish *Marin*, noting that the case related not to Code Section 503(b)(9), but to Code Section 546, which provides that the rights of a debtor in goods are subject to the rights of the seller to reclaim them.⁷ Code Section 503(b)(9), argued IIM, may include constructive receipt situations different from those established in UCC § 2-705. Moreover, courts using UCC § 2-705 to interpret receipt of goods under Code Section 546 (the reclamation section) ignore the commercial realities surrounding Code Section 503(b)(9) claims.⁸ Only the passage of title, argued IIM, can provide a clear answer as to whether

³ *Id.*

⁴ *Id.*

⁵ *Id.*

⁶ *Montello Oil Corp. v. Marin Motor Oil, Inc. (In re Marin Motor Oil, Inc.)*, 740 F.2d 220 (3d Cir. 1984).

⁷ *In re SRC Liquidation, LLC, supra.*

⁸ *Id.*

the debtor received goods.⁹

The court rejected IIM's arguments, holding that, although the remedies under Code Sections 503(b)(9) and 546 are different, because Code Section 546 provides that if a seller fails to comply with the section's requirements for reclamation,¹⁰ it is still entitled to the priority set forth in Code Section 503(b)(9), the two sections are linked.) Consequently, "the words 'received' in both provisions are related and entitled to identical interpretation."¹¹ In addition, said the court, the UCC does not rely on the concept of "title" to define the rights of buyers and sellers. Rather, possession is the key concept.¹²

***IN RE WORLD IMPORTS, LTD.*¹³**

In reaching its decision, the SRC court relied heavily on *In re World Imports, Ltd.*, decided by the Third Circuit Court of Appeals while the SRC case was still pending. In *World Imports*, goods were shipped from China "free on board" ("FOB") at the port of origin, passing the risk of loss and title to the goods to debtor World Imports upon transfer at the port. The goods were shipped more than 20 days before the bankruptcy filing, but were physically received by the debtor within the 20 days preceding the filing. Because Code Section 503(b)(9) does not define the term "received," the sellers asserted a Code Section 503(b)(9) claim, arguing the bankruptcy court should look to the UCC for guidance on the words "received by the debtor." The bankruptcy court rejected this approach and instead looked to the Contracts for the International Sale of Goods ("CISG"), and found that, under the CISG, goods were constructively received by the debtor when they were loaded for transit in China. Because this occurred more than 20 days preceding the bankruptcy filing, the court denied the sellers' Code Section 503(b)(9) claim. The district court affirmed and the sellers appealed to the Third Circuit Court of Appeals.

The Court of Appeals began by indicating that words should be construed in accordance with their ordinary meaning. The court observed that "Black's Law Dictionary defines 'receive' as '[to] take . . . ; to come into possession of or to

⁹ *Id.*

¹⁰ Code § 546(c) provides that a reclaiming seller of goods must make a reclamation demand not later than 45 days after the debtor's receipt of the goods, or if the 45 days expires after the commencement of the case, within 20 days after the commencement of the case.

¹¹ *In re SRC Liquidation, LLC, supra.*

¹² *Id.*

¹³ *In re World Imps., Ltd.*, 862 F.3d 338 (3d Cir. 2017).

get from some outside source,”¹⁴ and “The Oxford English Dictionary defines ‘receive’ with respect to physical goods, as ‘[t]o take into one’s hands or one’s possession (something offered or given by another); to take delivery of (something) from another either for oneself or for a third party.’”¹⁵ These definitions, said the court, require physical possession of goods. Applying these definitions to Code Section 503(b)(9), the court concluded that “a debtor must ‘take’ goods into its ‘possession,’ ‘custody,’ or ‘hands’ in order to receive them.” The court said this definition comports with the UCC definition of “receipt” of goods as “taking possession of them.”¹⁶

The Third Circuit noted that because Congress borrowed Code Section 546’s reclamation provision from the UCC, and because Code Section 546 and 503(b)(9) were interrelated because Code Section 503(b)(9) applies even if Code Section 546’s requirements cannot be met, “receipt” under both sections should be interpreted the same. It referred to its earlier decision in *Marin Motor Oil*, where, as noted above, it held that “receipt” in Code Section 546 has the same meaning as that in the UCC. Extending the rationale of *Marin* to “receipt” under Code Section 503(b)(9), the court said that neither the debtor nor the courts below pointed to anything that suggested Congress intended Code Sections 503(b)(9) and 546 to interpret the word “received” differently.¹⁷

The debtor argued that it constructively received the goods when they were delivered FOB to the common carrier—well outside of the 20-day period. Rejecting this assertion, the court noted that, under the UCC, a common carrier is not the “buyer’s agent” for the purposes of receipt of goods. Delivery to a common carrier may shift the risk of loss and transfer title, but, as *Marin* made clear, title is not a concept used in determining the rights of buyers and sellers of goods under the UCC.¹⁸ Reversing, the court said that, under Code Section 503(b)(9), physical possession of the goods by the debtor, not the shifting of the risk of loss or the transfer of title, was the determinative factor. Because a common carrier is not the debtor’s agent for the purposes of possession, possession takes place when the debtor actually, physically receives the goods, which in this case was within the Code Section 503(b)(9) 20-day period.¹⁹

¹⁴ *Id.* at 342 (citing Black’s Law Dictionary (10th ed. 2014)).

¹⁵ *Id.* (citing Oxford English Dictionary (3d ed. 2009)).

¹⁶ *Id.*

¹⁷ *Id.* at 345.

¹⁸ *Id.*

¹⁹ *Id.* at 346.

CONCLUSION

SRC and *World Imports*, although appearing to be correctly decided, certainly narrow the protection to sellers of goods Code Section 503(b)(9) appears to provide. Many debtors, particularly retail debtors, are desperately trying to reduce costs to survive in an environment that is undergoing a seismic shift due to e-commerce. Reducing costs by minimizing the stock of inventory debtors own and have to finance by having their vendors drop-ship goods directly to the debtor's customers who order online is an obvious strategy. However, the vendors who agree to drop-ship goods at the debtor's request using the debtor's UPS account (as was the case in *SRC*) must do so knowing that their credit risk is now much greater.