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It's Not Double-Counting: Using §503(b)(9) Invoices as New Value Defense to Preferences

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Editor's Note: Please see the September 2009 Code to Code, November 2009 News at 11 and the December/January 2010 Practice & Procedure columns of the ABI Journal for articles analyzing different issues regarding §503(b)(9) referenced in the introduction of this article.

Section 503(b)(9) of the Bankruptcy Code was added as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). While legislative history “suggests that it was aimed at providing relief to sellers of goods who fail to give the required notice under the reclamation provisions of 546(c),”¹ §503(b)(9) has become one of the more litigated Code changes in the last four years as debtors and creditors each test the meaning of §503(b)(9) in contexts unrelated to reclamation. Accordingly, courts have been asked to address what is a “good,”² whether electricity is a “good,”³ whether natural gas is a “good,”⁴ whether sewage and garbage removal services are “goods,”⁵ whether a good includes accompanying services,⁶ and whether the winner-take-all “predominant purposes” test is applicable to mixed transactions involving both goods and services.⁷

While no opinions have yet been issued, debtors and creditors are jousting over what it means for goods to be “received by the debtor,” and what it

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means for goods to have been “sold to the debtor in the ordinary course of such debtor’s business.” In short, to the extent that the express language of §503(b)(9) can be litigated, debtors and creditors are locking horns on nearly every word.

In addition to resolving litigation involving the language of §503(b)(9), courts have also been asked to opine on the treatment of such claims during the bankruptcy case, and the affect those

the court held that 11 U.S.C. §502(d) does not preclude allowance of an administrative expense under 11 U.S.C. §503(b)(9).¹⁰ The court reached this conclusion because: (1) allowance of claims under §502 is separate from allowance of administrative expenses under §503; (2) requests for allowance of administrative expenses are filed under §503(a) and not via proof of claim filed under §501; (3) a finding that §502(d) provides for disallowance of a §503(b)(9) expense results in a collision between two mandatory statutory provisions—§§502(d) and 503(b); (4) the logic and reasoning behind cases that have denied the application of §§502(d) to 503(b) have done so in the context of postpetition obligations, and such logic and reasoning remains sound and should apply with equal force to §503(b)(9) expenses; (5) the Bankruptcy Code does not distinguish

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claims may have on other provisions of the Bankruptcy Code. For example, courts have issued opinions discussing whether §503(b)(9) claims should be paid in the ordinary course of business or whether they should be paid as part of a plan.⁸

More recently, creditors’ ability to assert §503(b)(9) administrative claims are being challenged in the preference litigation context. Specifically, a creditor’s right to receive payment of a §503(b)(9) claim while under threat of a preference action has been challenged under §502(d) with mixed results. In *In re Plastech Engineered Prods. Inc.*,⁹

between §503(b)(9) expenses and other enumerated §503(b) administrative expenses; and (6) if Congress intended to make §503(b)(9) expenses a special class of prepetition claims subject to the claims provisions of §§501 and 502, then Congress could have created a separate priority for this special class under §507 rather than providing for second priority payment for all §503(b) administrative expenses.¹¹

Just this year, the bankruptcy court reached the opposite conclusion in *In re Circuit City Stores Inc.*¹² The court rejected the “majority” view that §502(d) is generally not applicable to §503(b) claims (a view even espoused

¹ *In re Brown & Cold Stores LLC*, 375 B.R. 873 (9th Cir. B.A.P. 2007).

² *In re Goody's Family Clothing Inc.*, 401 B.R. 131 (Bankr. D. Del. 2009) (goods must be movable).

³ *In re Pilgrim's Pride Corp.*, 421 B.R. 231 (Bankr. N.D. Tex. 2009) (it is not). But see *In re Pacific Gas & Electric Co.*, 271 B.R. 626 (N.D. Cal. 2002) (holding in context of contractual dispute that electricity was “good” within meaning of Article 2 of Uniform Commercial Code).

⁴ *Id.* (it is).

⁵ *Id.* (they are not).

⁶ See *Goody's*, *supra* (it does not).

⁷ *In re Plastech Engineered Prods. Inc.*, 397 B.R. 828 (E.D. Mich. 2008) (it is not); but see *In re Circuit City Stores Inc.*, 416 B.R. 531 (Bankr. E.D. Va. 2009) (it is).

⁸ *In re Global Home Products LLC*, No. 06-10340, 2006 WL 3791955 (Bankr. D. Del. Dec. 21, 2006) (absent proven hardship to creditor, immediate payment of §503(b)(9) claim not required).

⁹ *In re Plastech Engineered Prods. Inc.*, 394 B.R. 147 (Bankr. E.D. Mich. 2008).

¹⁰ *Id.* at 164.

¹¹ See also *In re TI Acquisition LLC*, 410 B.R. 742 (Bankr. N.D. Ga. 2009).

by the Fourth Circuit). In doing so, the court determined that §503(b)(9) claimants were prepetition “creditors” who had to file proofs of claim under §501(a). As such, the court opined that “the creditor must, first, file a proof of claim under §501, second, have a claim allowed under §502, and then, third, request administrative expense priority under §503(a).”¹³ Thus, the court held that “nothing in the Bankruptcy Code makes §§501, 502 and 503 mutually exclusive.”¹⁴ In light of existing law allowing the use of §502(d) to disallow claims filed under §501(a), the court held that §502(d) could be used to disallow §503(b)(9) claims.¹⁵

Valuable Weapon for Preference Defendants

On Jan. 7, 2010, the day after the bankruptcy court issued its opinion in *Circuit City*, Hon. **Marian F. Harrison** of the U.S. Bankruptcy Court for the Middle District of Tennessee issued a decision that will not only impact the continuing §503(b)(9) vs. §502(d) debate, but will strengthen the cases of many preference defendants. Judge Harrison held that preference defendants could use invoices that would be afforded §503(b)(9) administrative treatment as “new value” within the meaning of 11 U.S.C. §547(c)(4). In connection with a series of adversary proceedings related to the debtor, *In re Commissary Operations*,¹⁶ Judge Harrison ruled that creditors who might be entitled to be paid in full for goods received by the debtor within 20 days prior to the petition date by virtue of §503(b)(9) were still able to count those invoices in a new value defense raised in response to a preference complaint.¹⁷

The court allowed briefing and argument on the discrete legal issue of whether the goods and invoices included in the defendants’ §503(b)(9) claims could be included in the new value defense. The debtor’s primary argument was that enabling a preference defendant to have an allowed administrative claim under §503(b)(9) and also use the same invoices as subsequent new value under §547(c)(4) would permit the creditor to receive a windfall—by double-counting

the same invoices: once to obtain administrative claim treatment and once to defend the preference. The debtor argued that such a scenario would be tantamount to allowing reclamation of the goods, but then allowing the value of the goods to be a defense to the preference. In support of its argument, the debtor cited to *Phoenix Rest. Group Inc. v. Proficient Food Co.*¹⁸ *Phoenix* held that a reclamation claim “essentially kept strings on those goods,” and that such goods therefore provided no benefit to the estate where the creditor received the full value of the reclamation claim.

The adversary defendants disagreed with the debtor’s contentions. They countered that there is no double-counting and that a §503(b)(9) claim is not the same as a right of reclamation. First, while reclamation is a right that arises prior to the bankruptcy filing, a §503(b)(9) administrative claim only arises after the petition date. Second, a §503(b)(9) claim only provides the creditor with a post-bankruptcy claim, but does not compel return of the goods. Third, any payment on a §503(b)(9) claim arises only after the bankruptcy filing, and postpetition payments cannot be used to defeat a new value defense. Lastly, the adversary defendants noted that to hold otherwise would not only defeat the policy of encouraging creditors to deal with distressed debtors by forcing creditors to choose between providing new goods or losing their statutory defenses, it would also run counter to prior case law holding that new value defenses cannot be reduced by allowance of administrative claims.

Judge Harrison, in parsing through the positions of the debtor and the adversary defendants, carefully distinguished the *Phoenix* case. She noted that “[a] creditor’s right to assert an administrative expense claim under...§503(b)(9) is not linked to or conditioned upon the creditor’s separate, potential right to assert a reclamation claim against the debtor pursuant to 11 U.S.C. §546(c).”¹⁹ Addressing the Second Circuit’s decision in *ASM Capital LP v. Ames Dep’t Stores Inc.*,²⁰ Judge Harrison agreed that Congress “amended section 546(c)(2) to provide that ‘[i]f a seller of goods fails to provide notice in the manner described in paragraph (1), the seller may still assert the rights contained in section

503(b)(9).”²¹ Given that guidance, Judge Harrison simply concluded that a §503(b)(9) claim “is not a reclamation claim,” and the *Phoenix* rationale “does not apply to §503(b)(9) claims.”²²

In support of her finding, Judge Harrison noted that a creditor’s right to a §503(b)(9) claim can only occur after a bankruptcy filing, and that assertion of a §503(b)(9) claim gives the creditor no greater right to assert a lien or take back the goods.²³ In contrast to goods subject to a reclamation claim, neither the goods nor their value are held in trust by the debtor; rather, the creditor’s rights are dependent entirely on the court’s allowance of a §503(b)(9) claim and the debtor’s ability to pay.²⁴

The court further noted that “the plain language of 547 closes the preference window at the petition, limiting the §547(c)(4) defense to new value supplied and payments made before the debtor crosses into bankruptcy.”²⁵ The court also acknowledged favorably that postpetition payments made to “critical vendors” on account of prepetition invoices did not strip the critical vendor of the new value defense.²⁶ Accordingly, the court saw no reason to provide §503(b)(9) creditors less favorable treatment. “The deliveries benefit the estate, for purposes of 11 U.S.C. §§547(a)(2) and 547(c)(4), regardless of whether the 503(b)(9) claimants are paid at a later date for those deliveries.”²⁷

Finally, the court agreed that any other decision would chill the policies behind §§503(b)(9) and 547(c)(4), namely encouraging parties to engage in business with distressed debtors. The court observed that Congress had not amended §547(c)(4) to except goods subject to §503(b)(9) treatment from the definition of new value. Thus, the court determined that, in the absence of congressional direction to the contrary, creditors should not be forced to choose between doing business with a debtor and losing statutory defenses to subsequent preference actions.

Although not addressed in the court’s opinion, Judge Harrison noted at the hearing that requiring a reduction in new value on account of §503(b)(9)

¹² *In re Circuit City Stores Inc.*, No. 08-35653, 2010 WL 56076 (Bankr. E.D. Va. Jan. 6, 2010).

¹³ *Id.* at *5.

¹⁴ *Id.* at *6.

¹⁵ At the time that this article was written, a motion for reconsideration was pending.

¹⁶ *In re Commissary Operations*, Case No. 08-06279, pending in the Middle District of Tennessee.

¹⁷ *Commissary Operations Inc. v. Dot Foods Inc.* (*In re Commissary Operations Inc.*), 421 B.R. 873 (Bankr. M.D. Tenn. 2010).

¹⁸ *Phoenix Rest. Group Inc. v. Proficient Food Co.*, 373 B.R. 541 (M.D. Tenn. 2007).

¹⁹ *Commissary Operations*, 421 B.R. at 877.

²⁰ *ASM Capital LP v. Ames Dep’t Stores Inc.*, 582 F.3d 422 (2d Cir. 2009).

²¹ *Commissary Operations*, 421 B.R. at 877.

²² *Id.*

²³ *Id.* at 877.

²⁴ *Id.* at 878.

²⁵ *Id.* at 878 (internal citations omitted), citing *Phoenix Rest. Group Inc. v. Aijlon Prof’l Staffing* (*In re Phoenix Rest. Group*), 317 B.R. 491 (Bankr. M.D. Tenn. 2004).

²⁶ See *Kaye v. Accord Mfg. Inc.* (*In re Murray Inc.*), Adv. No. 05-0732, 2007 WL 5595447 (Bankr. M.D. Tenn. June 6, 2007).

²⁷ *Commissary Operations*, 421 B.R. at 878.

payments would lead to uncertainty in cases where §503(b)(9) claims would not be paid in full. In such cases, the amount of the distributions payable to §503(b)(9) claims could not be finally ascertained until the completion of avoidance action litigation. As a result, a §503(b)(9) claimant asserting its new value defense would never know the true amount of the appropriate offset during the pendency of its case.

Conclusion

In light of this new weapon in the arsenal of preference defendants,²⁸ we can likely expect more vigorous attacks on the allowance of §503(b)(9) claims as debtors and creditors continue to scrutinize each word of the statute. It is safe to assume that we can expect to see the definition of “received” debated and also expect to see litigation over whether goods were received “by the debtor.” To the extent that debtors can be successful in reducing such §503(b)(9) claims or recharacterizing them entirely as prepetition general unsecured claims, it will lessen the concern that creditors are getting the benefit of “double counting” when the same invoices are used to defend a subsequent preference action. ■

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²⁸ Judge Harrison's decision has not been appealed.