

## “Caveat Venditor”: Building Strategy Based on Recent Reclamation and Section 503(b)(9) Developments

In today’s difficult economic environment, it is vital for trade vendors faced with customers’ bankruptcies to have optimal strategies for collecting invoices for past shipments and protecting prior payments from being clawed back by a bankruptcy estate as preferences. The need for such strategies will only increase as record amounts of corporate debt mature. Nelson D. Schwartz, *Corporate Debt Coming Due May Squeeze Credit*, N.Y. Times, March 15, 2010 (Business Section, p.1), available at: <http://www.nytimes.com/2010/03/16/business/16debt.html?dbk>.

The bankruptcy cases dealing with vendor rights, the main source for guidance in formulating strategies that work, are becoming increasingly non-uniform. Pitfalls abound. The location of the customer bankruptcy case is a major factor in determining the proper course of action, because the law differs from jurisdiction to jurisdiction. The case law is still mostly at the bankruptcy court level, so there is no assurance of what will happen on appeal. The need for immediate action based on expert legal advice has never been more crucial.

### Reclamation After *Circuit City Stores*

Vendors thought the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) expanded rights of reclamation to cover goods received by a debtor as early as 45 days prior to the petition date, but the right to reclaim has no value unless written demand for the goods is timely made. Even then, only goods still in the debtor’s possession at the time of demand can be reclaimed, and, if reclamation is demanded pre-bankruptcy, only those goods still present on the date of the petition will be protected. The burden is on the vendor to prove what goods are still identifiably present on the later of the petition date or demand date.

But one very recent case, *In re Circuit City Stores, Inc.*, 2010 WL 843394 (Bankr. E.D. Va. March 5, 2010) (“*Circuit City II*”), has set the hurdle even higher: The vendor must not only demand reclamation but must also immediately move to lift the stay to obtain possession of the reclaimed goods. Even then, the vendor’s only right may be to actually obtain possession pursuant to court order because, in the Court’s view, BAPCPA’s amendment of § 546(c)(2) of the Bankruptcy Code deprives vendors of the right to an administrative expense in lieu of reclamation. In *Circuit City II*, the Court was confronted with a fairly straight forward issue: Whether vendors were entitled to an administrative expense or replacement lien in lieu of reclamation rights properly asserted in compliance with § 546(c)(1) of the Bankruptcy Code. The Court relied on two lines of argument to deny relief to the vendors.

The first line of argument, in effect, was that reclamation demands have no legal effect other than as a necessary precondition for seeking repossession of goods with court assistance. In the Court’s view, a vendor who has demanded reclamation merely has grounds to ask a court for the return of goods—but not a property interest in the goods—and must diligently pursue the return of the reclaimed goods or lose any rights. This was not a case in which the vendor was unable to prove what goods were identifiable and remained on the petition date. See *In re Waccamaw’s Home Place*, 298 B.R. 233 (Bankr. D.Del. 2003). The vendors were simply denied any rights to proceeds of reclaimed goods that were identifiable at the time of their reclamation demands due to the vendors’ failure to pursue physical repossession of their goods. The Court found that the vendors’

failure to diligently pursue the return of their reclaimed goods coupled with the failure to object to the debtors' post-petition refinancing of the pre-petition credit facility, which used the goods as collateral for such refinancing, or to the liquidation of the debtors' inventory through subsequent going-out-of-business sales, waived all reclamation rights.

But even if the vendors had invested the resources needed to diligently pursue the return of their reclaimed goods and had objected to the refinancing or inventory liquidation, it is doubtful the Court would have reached a different conclusion, given the second ground for the decision. The Court, relying on *In re Dana Corp.*, 367 B.R. 409 (Bankr. S.D.N.Y. 2007), found that the right of reclamation was valueless because the reclaimed goods were subject to the pre-petition floating lien of the debtors' pre-petition lenders. As the Court itself noted, efforts to obtain repossession of the goods, in the face of that lien, would have been futile.

Perhaps if there is no floating lien, the vendor obtains an order requiring turnover of its reclaimed goods, and the debtor sells or uses the goods in defiance of that court order, an administrative expense will be awarded, but short of that, the *Circuit City II* decision leaves a reclaiming vendor's right to an administrative expense in lieu of reclamation under any circumstance entirely uncertain.

### **Using Section 503(b)(9) To Form a Strategy**

According to *Circuit City II*, the only administrative expense Congress intended to remain available to reclaiming vendors is an administrative expense under § 503(b)(9) for the value of goods received by the debtor in the ordinary course of its business within 20 days of the petition date. This expense, made available by BAPCPA, may provide vendors with a systematic method to protect themselves if they are able to shorten delivery intervals and payment terms.

The irony is that vendors whose reclamation demands are disregarded may have no right to an administrative expense, but vendors with no right to reclaim (because their goods have been sold or consumed prior to the petition date) are routinely granted an administrative expense under § 503(b)(9). The rationale for granting such expense to all vendors (whether or not their goods provided value to the debtor's estate and whether or not they could have been reclaimed) is entirely obscure and contrary to all prior law governing interpretation of § 503 administrative expenses. Nevertheless, to date courts have been untroubled by this, and they have been awarding § 503(b)(9) expenses to all vendors of goods received by the debtor during the 20 day pre-petition period whether or not the debtor still had the goods on the petition date. Thus, the § 503(b)(9) expense may be the only administrative expense reclaiming vendors can count on.

The allowance of a § 503(b)(9) expense has significant benefits for a vendor. The near certainty of allowance upon proof of the debtor's receipt of goods, with no need to prove reclamation rights, makes it feasible to sell the § 503(b)(9) expense for immediate cash. On the other hand, the value of that claim will be discounted by the fact that it is virtually never paid before plan confirmation and would be of an uncertain value in a subsequent conversion to a Chapter 7 case. But § 503(b)(9) expenses may have significant additional value to vendors with preference exposure as discussed below.

### **Split of Authority Concerning Disallowance of § 503(b)(9) Expenses Until Preferences are Repaid**

A recent Georgia bankruptcy court decision, *Southern Polymer, Inc. v. TI Acquisition, LLC (In re TI Acquisition)*, 410 B.R. 742 (Bankr. Ga. 2009), provides a warning for vendors. It holds, among other things, that in determining the § 503(b)(9) expense, the court should not deduct payments received during the 20 days prior to the bankruptcy filing, if the debtor and vendor agreed such payments

would not be applied toward the goods delivered during the 20 day period. Thus, a vendor's § 503(b)(9) expense may be impaired if it does not correctly document how payments it receives during the 20 day period are to be applied.

The *TI Acquisition* decision joins the group of earlier cases from Delaware (*Camelot Music, Inc. v. MHW Adver. & Public Relations, Inc. (In re CM Holdings, Inc.)*, 264 B.R. 159 (Bankr. D. Del. 2000)), Georgia (*Beasley Forest Products, Inc. v. Durango Georgia Paper Co. (In re Durango Georgia Paper Co.)*, 297 B.R. 326 (Bankr. S.D. Ga. 2003)), Michigan (*In re Plastech Engineered Products, Inc.*, 394 B.R. 147 (Bankr. E.D. Mich. 2008)) and Ohio (*Roberds, Inc. v. Broyhill Furniture (In re Roberds, Inc.)*, 315 B.R. 443 (Bankr. S.D. Ohio 2004)), that decline to require a vendor to repay preferences before obtaining allowance of its § 503(b)(9) expense. *ASM Capital, LP v. Ames Department Stores, Inc. (In re Ames Department Stores, Inc.)*, 582 F.3d 422 (2d Cir. 2009), suggests that the same rule will be applied to § 503(b)(9) expenses in cases filed in New York, Connecticut and Vermont. This rule further enhances the value of administrative expenses for vendors who desire to sell them, by preventing disallowance of the expenses in the hands of a claim purchaser based on the vendor's preference liability. It also supports the right of a vendor with preference liability to offset its unpaid administration expense against the preference judgment, but this is untested in the context of conversion to a Chapter 7 case.

On the other hand, vendors in cases in the 9th Circuit (covering Arizona, California, Idaho, Montana, Nevada, Oregon and Washington), where the *Brown & Cole Stores, LLC v. Associated Grocers, Inc. (In re Brown & Cole Stores, LLC)*, 375 B.R. 873 (B.A.P. 9th Cir. 2007), and *MircoAge, Inc. v. Viewsonic Corp. (In re Microage, Inc.)*, 291 B.R. 503 (B.A.P. 9th Cir. 2002), cases were decided, and Virginia (*In re Circuit City Stores, Inc.*, \_\_\_ B.R. \_\_\_, 2010 WL 56076 (Bankr. E.D.Va. Jan. 6, 2010) ("*Circuit City I*")), may be unable to obtain payment of their § 503(b)(9) expenses until they pay any preference judgments.

### Two for One in the Commissary

A recent decision from Tennessee gives an allowed § 503(b)(9) expense double value for the vendor with preference exposure. A prior district court decision in Tennessee, *Phoenix Restaurant Group, Inc. v. Proficient Food Co. (In re Phoenix Restaurant Group, Inc.)*, 373 B.R. 541 (M.D. Tenn. 2007), affirmed the bankruptcy court's finding that a vendor who ships goods on open account after receiving a preferential payment can utilize the value of that subsequent shipment as a defensive offset to a preference claim under § 547(c)(4) of the Bankruptcy Code, despite the fact that during the course of the Chapter 11 proceedings the vendor was actually paid for those goods under a "critical vendor" order. The Bankruptcy Court in *In re Commissary Operations, Inc.*, 421 B.R. 873 (Bankr. M.D. Tenn. 2010), relied on that precedent to hold that a vendor with a § 503(b)(9) expense may both use the value of the shipped goods as a subsequent new value defense under § 547(c)(4) and retain the administrative expense claim for payment of such goods. A perfect example of eating your cake and having it too.

However, it is unclear whether other courts will follow the *Commissary Operations* decision. At least one court has indicated that it would not have reached the same outcome. In a prior decision (not discussed in *Commissary Operations*), the *Circuit City I* Court temporarily disallowed § 503(b)(9) expenses until resolution of the vendors' preference liability. In doing so, the Court expressed concern about the windfall created in the hypothetical situation where a vendor seeks payment of its § 503(b)(9) expense and also uses the value of the underlying goods as a defensive offset in preference litigation and found that such windfall could be prevented if the § 503(b)(9) expense is disallowed—a somewhat indirect and ineffective way of dealing with the windfall problem.

Furthermore, the treatment afforded the vendor in *Commissary Operations* is very unlike the treatment that likely will be received by vendors who do succeed in reclaiming their goods (or, perhaps, who obtain an administrative expense in lieu of reclamation despite *Circuit City II*). A reclaiming vendor, like a secured creditor, cannot utilize the invoice amount of the reclaimed goods as a subsequent new value defense to a preference claim. *Phoenix Restaurant*, 373 B.R. at 547-48. On the principle of “Be careful what you wish for, lest you get it”, vendors who have preference exposure should think twice before investing the necessary effort and expense required to reclaim goods delivered within the 20 day pre-petition period rather than relying on § 503(b)(9).

### Procedural Order Traps

The *Circuit City II* decision is also an example of the traps for vendors in the now routine procedural orders governing the determination of reclamation and section 503(b)(9) expenses. These orders must be carefully reviewed. The “streamlined” procedures differ in each bankruptcy case. With respect to asserting a § 503(b)(9) expense, vendors may be required to use a particular form (akin to a proof of claim form), provide specific supporting documentary evidence that might otherwise only be ascertainable through the discovery process, and must meet shortened deadlines. Failure to comply with the procedures order can defeat the § 503(b)(9) expense.

By setting a bar date separate from that for unsecured claims, a debtor can create confusion and significantly shorten the time vendors have to assert § 503(b)(9) expenses. Bar dates as soon as thirty days after notice of such procedures have been set. Vendors may not be clear on how to compute the bar date and may miss the deadline inadvertently. The notice period may be further shortened by service on the P.O. Box of those vendors who fail to take advantage of new notice provisions in the Bankruptcy Code, causing delay in the vendor’s actual receipt of notice.

Procedure orders also may contain provisions governing other rights of vendors. These can create a trap, as they did in *Circuit City II*. There, the reclamation procedures order provided that nothing in the order was intended to prohibit, hinder, or delay any vendor from asserting or prosecuting any of its rights to reclaim the goods. The order also set up an orderly procedure for the debtor to respond to reclamation demands in due course. Based on that, vendors may have been lulled into relying on their compliance with the order and § 546(c)(1) to protect their reclamation rights, only to learn later that such compliance resulted in the loss of any reclamation rights.

Vendors need to review these and other relevant precedents with experienced counsel to avoid pitfalls and to understand the opportunities they provide for strategic planning to protect receivables in case of a customer’s bankruptcy filing. In short, vendors should be developing strategies that focus on shipment schedules, payment terms, whether to reclaim, what goods to reclaim, what steps to take to obtain possession of reclaimed goods and how to utilize the available administrative expenses to obtain the greatest value for them. Vendors also need to carefully review blanket reclamation and § 503(b)(9) procedure orders for the traps hidden in them. The stakes have never been higher.

If you have questions or need further information about this Client Alert, please contact **Alan Kolod**, co-chair of the Reorganization and Bankruptcy Department, at 212.554.7866/[akolod@mosessinger.com](mailto:akolod@mosessinger.com) or **Kent C. Kolbig** at 212.554.7822/[kkolbig@mosessinger.com](mailto:kkolbig@mosessinger.com)

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