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Section 503(b)(9)'s Impact: A Proposal to Make Chapter 11 Viable Again for Retail Debtors

Written by:
Michael G. Wilson[1]
Hunton & Williams LLP; Richmond, Va.
mwilson@hunton.com

Henry P. "Toby" Long III
Hunton & Williams LLP; Richmond, Va.
hlong@hunton.com

About the Authors

Michael Wilson is a partner and Toby Long is an associate in the Bankruptcy, Restructuring and Creditors' Rights Practice at Hunton & Williams LLP in Richmond, Va.

Feature

As we surpass the five-year anniversary of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), nowhere has its full impact been more dramatic than in the bankruptcies of a number of large retailers. The Sharper Image, Goody's Family Clothing, Mervyns, Circuit City, S&K Famous Brands, Boscov's, Lillian Vernon, Filene's Basement, Steak and Ale and Linens 'N Things represent only a few of the established, name-brand retailers that recently have tried and failed to reorganize under chapter 11.

There are arguments that some of these retail debtors were suffering from economic and business issues well beyond the scope of the Bankruptcy Code. There is little debate, however, that many of the significant constraints placed on retail debtors by the BAPCPA amendments reduced, or in some circumstances eliminated, a debtor's ability to reorganize. Perhaps most importantly for a retail debtor, the addition of § 503(b)(9) to the Code represented a sea change that resulted in retail debtors having insufficient capital to reorganize their businesses.

Section 503(b)(9) provides that a creditor is entitled to an administrative-expense claim for the value of any goods sold to and received by the debtor within 20 days before the petition date.[2] While the language of § 503(b)(9) is simple, it has resulted in a spate of litigation over issues relating to, *inter alia*, what constitutes "goods," what happens when a vendor provided both goods and services, how to determine "value," whether the goods were "received" by the debtor, and whether the goods delivered constitute "new value" for purposes of defending against a preference action. This article will focus on the policy issues underlying § 503(b)(9) and how it impacts—and often hinders—the ability of a retail debtor to utilize chapter 11 to restructure its business.

The legislative history for § 503(b)(9) is virtually nonexistent. Its apparent purpose was to provide additional protection for vendors and reduce the challenges they face when asserting their state law reclamation rights under § 546(c).[3] In addressing those burdens, Congress effectively ignored one of the principal tenets underlying the Code: namely, that claims accorded administrative-expense priority should be narrowly limited to those that provide a benefit to the bankruptcy estate to ensure that a debtor has a realistic opportunity to successfully reorganize and stay in business.[4] The actual result was the creation of a new class of administrative creditors that a debtor must pay in full as a condition to confirmation of a chapter 11 plan, regardless of whether those creditors actually provided a benefit to the debtor's estate. While vendors may have appreciated this special status, retail debtors—particularly those that have a relatively quick inventory turnover rate—have struggled to satisfy § 503(b)(9) claims, and since many of those retailers have been unable to emerge from bankruptcy, their employees have lost their jobs and the vendors have lost what might have been long-term customers.

The problems created by § 503(b)(9), however, are not insurmountable. With a few minor changes, § 503(b)(9) would be able to strike a proper balance between protecting the interests of trade vendors and ensuring that debtors are required to pay administrative claims only to those creditors that provide a benefit to the bankruptcy estate.

Problem with Reclamation Rights that Led to § 503(b)(9)

Section 546(c) generally provides for the preservation of state law reclamation rights in favor of vendors that do business with a debtor. From a policy perspective, preserving reclamation

1 The views expressed in this article reflect those of the authors only and are not necessarily the views of other lawyers at Hunton & Williams or of Hunton & Williams generally.

2 *See* 11 U.S.C. § 503(b)(9).

3 *See In re Circuit City Stores Inc.*, 416 B.R. 531, 536 (Bankr. E.D. Va. 2009) ("[Section 503(b)(9)] appears to have been adopted as an attempt by Congress to enhance certain types of reclamation claims raised by creditors in bankruptcy case.").

4 *See In re Bildisco & Bildisco*, 465 U.S. 513, 527 (1984) ("[T]he policy of Chapter 11 is to permit successful rehabilitation of debtors."). *See also In re Dant & Russell Inc.*, 853 F.2d 700, 706 (9th Cir. 1988) (holding that keeping administrative expenses to minimum "serves the overwhelming concern of the Code: preservation of the estate"); *Trustees of Amalgamated Ins. Fund v. McFarlin's Inc.*, 789 F.2d 98, 100 (2d Cir. 1986) ("Because the presumption in bankruptcy cases is that the debtor's limited resources will be equally distributed among his creditors, statutory priorities are narrowly construed."); *In re SemCrude LP*, 416 B.R. 399, 403 (Bankr. D. Del. 2009) (recognizing that wealth of case law teaches that administrative claims are to be narrowly construed).

rights makes sense because it encourages vendors to continue to trade with troubled companies by giving them the right to recover goods delivered prior to bankruptcy.[5]

Under § 546(c), vendors retain the right to reclaim goods delivered to a debtor immediately prior to the commencement of a bankruptcy case by establishing that (1) they have a statutory or common-law right to reclaim the goods, (2) the goods were sold in the ordinary course of the vendor's business, (3) the debtor was insolvent at the time the goods were received and (4) the vendor made a written demand for reclamation within the statutory time limit after the debtor received the goods.[6] If a vendor successfully establishes these points, a bankruptcy court can allow the creditor to enforce its state law reclamation rights.[7]

The problem for trade vendors, however, is the daunting task of actually proving their claims. Section 546(c) requires that the vendor establish that the goods to be reclaimed were in the debtor's possession when the vendor made its written demand.[8] Satisfying that burden can be difficult or impossible given that virtually all of the necessary information is held by the debtor. Further, vendors often resort to commencing adversary proceedings and seeking restraining orders that prevent a debtor from selling the goods,[9] and the expense of the litigation often makes effectively asserting a reclamation claim impractical. In an effort to maintain vendor goodwill and avoid their own litigation costs, retail debtors have increasingly implemented court-approved "reclamation procedures" to streamline the process for vendors to assert their claims.[10]

Even if a trade vendor successfully proves which goods remained in a debtor's possession on the date of demand, the vendor also is confronted with the fact that the goods in question are frequently subject to the perfected liens of a secured creditor. Under most applicable state law and now under § 546(c), a vendor's reclamation rights are subject to the existing rights of other creditors in the goods in question. Thus, where a debtor's secured lender holds a floating lien on inventory, a trade vendor's right to seek reclamation under § 546(c) frequently proves to be an ephemeral remedy at best.

Attempts to Address Limitations of Reclamation

Section § 503(b)(9) has had the effect of taking what traditionally were prepetition unsecured trade claims, which generally will receive only pennies on the dollar under a chapter 11 plan, and elevating them to administrative expenses that must be paid in full as a condition to the plan confirmation. Unlike other administrative expenses under § 503(b), § 503(b)(9) raises the priority of a vendor's claim regardless of whether it actually benefited the post-petition bankruptcy estate.

Generally, a party claiming an administrative-expense priority for its claim has the burden of establishing that the claim arose from a post-petition transaction with the debtor and provided an "actual" and "necessary" benefit to the debtor's bankruptcy estate.[11] Existing case law makes it clear that a sound policy purpose underlies the requirement of proof of an actual and necessary post-petition benefit to the bankruptcy estate.[12]

By contrast, a creditor asserting a § 503(b)(9) claim today only needs to establish that the goods were (1) sold to the debtor, (2) received by the debtor within 20 days prior to the petition date, and (3) sold to the debtor in the ordinary course of business.[13] Section 503(b)(9), therefore, contains an inherent presumption, which is not subject to rebuttal, that those goods somehow provided a benefit to a debtor's post-petition estate.

The difference between § 546(c) and 503(b)(9) for retail debtors can be significant and potentially fatal to attempts to reorganize. In essence, § 503(b)(9) turns the policy underlying administrative claims on its head, and retail debtors must pay what traditionally would be general unsecured claims in full from their limited post-petition assets. The burden of satisfying those claims often destroys a debtor's ability to confirm a chapter 11 plan that otherwise could permit the company to survive and successfully reorganize.

Fixing § 503(b)(9)

Several proposals have been made to address the impact of § 503(b)(9) on retail debtors, including shortening the period for delivery of the goods from 20 days to 10 days prior to the petition date, changing the nature of the allowed claim from an administrative expense to a "priority" claim that could be paid over time, or repealing § 503(b)(9) altogether.[14] While each has merit, such proposals fail to bring § 503(b)(9) back within the analytical framework underlying the primary policy of chapter 11: to give the debtor the best opportunity to reorganize and successfully emerge from bankruptcy. With only minor changes that are similar to other Code provisions, § 503(b)(9) could still address the original problems with the reclamation remedy under § 546(c) while remaining faithful to the policies regarding administrative claims. Specifically, the amendment would read as follows:

> (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—
>
> ...
>
> (9) the value of any goods received by the

5 *See In re Arts Dairy LLC*, 414 B.R. 219, 220 (Bankr. N.D. Ohio 2009).

6 *See* 11 U.S.C. § 546(c); *In re Waccamaw's HomePlace*, 298 B.R. 233, 237 (Bankr. D. Del. 2003). Section 546(c) was amended by BAPCPA to, among other things, extend the period during which a vendor could seek to reclaim goods delivered prior to the commencement of a case from 10 to 45 days prior to the filing.

7 *See* 11 U.S.C. § 546(c). *See In re Circuit City Stores Inc.*, 2010 Bankr. LEXIS 697, at * 22-23 (Bankr. E.D. Va. March 5, 2010) (holding that post-BAPCPA § 546(c) does not grant either administrative-expense priority or secured lien status for reclamation claims, but instead subordinates avoiding powers of trustee to state law right of seller to reclaim its goods).

8 *Waccamaw's HomePlace*, 298 B.R. at 237 ("A reclaiming seller's right to repossess is, of course, limited to the goods still in the buyer's possession.").

9 *See, e.g., Paramount Home Entm't Inc. v. Circuit City Stores Inc.*, 2010 U.S. Dist. LEXIS 92103, at * 21 (E.D. Va. Sept. 3, 2010) (agreeing that vendor must diligently assert its reclamation rights while bankruptcy proceedings progress: "Filing a demand, but then doing little else in the end, likely creates more litigation and pressure on the Bankruptcy Court than seeking relief from the automatic stay imposed by § 362 or seeking a TRO or initiating an adversary proceeding."). *See also In re Adventist Living Ctrs. Inc.*, 52 F.3d 159, 165 (7th Cir. 1995) (denying administrative claim to reclaiming vendor because vendor "slept on its rights"); *Waccamaw's HomePlace*, 298 B.R. at 238 ("[A]fter making its Reclamation Demand, [the vendor] inexplicably took no action to protect or enforce its rights with respect to the Reclamation Goods.").

10 *See, e.g., In re Circuit City Stores Inc.*, Case No. 08-35653 (KRH) (Order Establishing Reclamation Procedures, Docket No. 897) (Bankr. E.D. Va. Dec. 11, 2008); *In re Semcrude LP*, Case No. 08-11525 (BLS) (Order Establishing Reclamation Procedures, Docket No. 1375) (Bankr. D. Del. Sept. 16, 2008). In almost all circumstances, the ultimate burden of proof remains with the vendor.

11 *See, e.g., In re Merry-Go-Round Enters. Inc.*, 180 F.3d 149, 157 (4th Cir. 1999) ("For a claim to qualify as an actual and necessary administrative expense, '(1) the claim must arise out of a postpetition transaction between the creditor and the debtor in possession (or trustee), and (2) the consideration supporting the claimant's right to payment must be supplied to and beneficial to the debtor in possession in the operation of the business.'") (quoting *In re Stewart Foods Inc.*, 64 F.3d 141, 145 n.2 (4th Cir. 1995)); *In re Megafoods Stores Inc.*, 163 F.3d 1063, 1071-72 (9th Cir. 1998); *In re DAK Indus. Inc.*, 66 F.3d 1091, 1097 (9th Cir. 1995); *Issac v. Temex Energy Inc. (In re Amarex Inc.)*, 853 F.2d 1526, 1530 (10th Cir. 1988); *In re Applied Theory Corp.*, 312 B.R. 225, 238 (Bankr. S.D.N.Y. 2004) ("An expense is administrative only if it arises out of a transaction between the creditor and the bankrupt's trustee or debtor in possession, and only to the extent that the consideration supporting the claimant's right to payment was both supplied to and beneficial to the debtor in possession in the operation of the business.") (internal quotation marks and citations omitted).

12 *See, e.g., In re Drexel Burnham Lambert Group Inc.*, 134 B.R. 482, 488 (Bankr. S.D.N.Y 1991) ("Strict construction of the terms 'actual' and 'necessary' serves to keep 'administrative expenses at a minimum so as to preserve the estate for the benefit of all creditors.'" (quoting *Otte v. U.S.*, 419 U.S. 43, 53 (1974)); *Broadcast Corp. of Georgia v. Broadfoot II*, 54 B.R. 606 (Bankr. N.D. Ga. 1985) (holding that § 503(b)(1)(A) expressly provides that administrative expenses include "'the actual, necessary costs and expenses of preserving the estate'.... The use of the words 'actual' and 'necessary' indicate that the estate must accrue a real benefit from the transaction for which the claim is being filed.").

13 *In re Goody's Family Clothing Inc.*, 401 B.R. 131, 133 (Bankr. D. Del. 2009).

14 *See* "Lehman Brothers, Sharper Image, Bennigan's and Beyond: Is Chapter 11 Bankruptcy Working?," Hearing before the Subcomm. on Commercial and Admin. Law of the Comm. on the Judiciary, 110th Cong. 71 (2008) (Response to post-hearing questions from **Lawrence C. Gottlieb**); Business Reorganization and Job Preservation Act of 2009, H.R. 1942, 110th Cong. (2009) (proposing to repeal § 503(b)(9)).

debtor within 20 days before the date of commencement of a case under this title in which (A) the goods have been sold to the debtor in the ordinary course of such debtor's business, *and (B) the goods were in the possession of the debtor on the date of commencement of a case under this title. In any hearing regarding an asserted administrative expense under this subsection (b)(9), the party opposing the allowance of an administrative expense shall have the burden of proof regarding which goods, if any, were in the possession of the debtor on the date of commencement of a case under this title and the party asserting the administrative expense shall have the burden of proof on everything else.*[15]

This proposed change would properly balance the two principal policy goals addressed by § 503(b)(9): to (1) provide a reasonable mechanism to fully compensate vendors who deliver goods to a debtor just prior to bankruptcy for the goods that remain available to benefit the debtor's post-filing bankruptcy estate and (2) limit the amount of administrative expenses that must be borne by a bankrupt debtor to only those that provided an actual benefit to the estate and creditors.

The proposed change would address the perceived difficulties associated with reclamation claims by reallocating the burden of proof with respect to the possession of goods and lessening the impact of the floating lien of a secured creditor. The claimant will still have the burden of establishing the value of goods delivered during the 20 days prior to a filing. However, similar to the shifting burdens under a relief-from-stay analysis, the burden of proof with respect to which of the goods remain on hand on the petition date would move to the party objecting to the claim, most likely the debtor.[16] Placing the burden on the debtor makes sense because it has the best available information regarding the goods that were on hand on the petition date and the most incentive to produce that information in an effort to reduce the amount of the vendor's administrative expense. Moreover, the costs of litigating a disputed § 503(b)(9) claim likely will be reduced as vendors will no longer need to seek restraining orders or take other drastic actions to preserve their ability to prove their claim.

The proposed amendment also brings § 503(b)(9) in line with traditional policy considerations underlying administrative claims by limiting the amount that can be recovered to the value of the goods that actually will be available to benefit the post-bankruptcy estate. The proposed change more appropriately balances the burden on a debtor's estate that will have to be satisfied to confirm a reorganization plan and successfully reorganize with the need to compensate vendors who continue to trade with troubled companies prior to a filing.

Conclusion

The amendment to § 503(b)(9) proposed above does not attempt to deal with the numerous potential ambiguities or other areas of dispute that have garnered so much attention from courts and commentators. What it would do, however, is bring the balance of the equities back in line with the underlying purposes and goals of chapter 11: the successful reorganization of debtors. Vendors that provided a benefit to a debtor's bankruptcy estate would have a workable mechanism to protect their interests, but only to the extent of the actual benefit conferred. A debtor, on the other hand, would not be required to pay unsecured trade claims that provide no value to the estate in full as a condition to confirmation of a plan and the reorganization of its business. As a result, retail debtors will be afforded a realistic opportunity to successfully reorganize and preserve their businesses for the benefit of their creditors, employees and other stakeholders. ■

15 Emphasis given to show added text.

16 *See* 11 U.S.C. § 362(g), which provides for a shifting burden in the context of a motion for relief from stay where the movant has the burden of proof on the issue of a debtor's equity in property and the party opposing relief has the burden on all other issues.

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