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## Protecting Trade Creditors' Rights in Bankruptcy

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The Bankruptcy Code provides several protections for parties that have supplied goods or services to a debtor on credit prior to the debtor's bankruptcy petition date. A trade creditor that timely invokes these protections can elevate what might otherwise be an unsecured claim to a claim that is either secured or has administrative expense priority, thereby greatly increasing the likelihood that it will receive a meaningful distribution from the debtor's bankruptcy estate.



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For a practitioner new to bankruptcy, ready familiarity with these protections is essential to counsel suppliers who find themselves creditors in a bankruptcy case. This article surveys some of the most important protections for suppliers and recent significant case law developments.

### Section 503(b)(9) Request for Administrative Expense<sup>1</sup>

Those who sell goods to a debtor in the 20 days before a bankruptcy case is filed are entitled, upon application to the bankruptcy court, to elevate their claims for the value of such goods to an administrative expense priority. Section 503(a) of the Code provides, in relevant part, that "[a]n entity may file a request for payment

<sup>1</sup> There have been numerous *Journal* articles addressing § 503(b)(9) and the issues arising thereunder. For a list of articles, please contact Elizabeth Stoltz at [estoltz@abiworld.org](mailto:estoltz@abiworld.org).

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of an administrative expense." In turn, § 503(b)(9) states, in relevant part,

(b) After notice and a hearing, there shall be allowed administrative expenses...including...

(9) the value of any goods received by the debtor within 20 days before the

growing crops and other identified things attached to realty as described in the section on goods to be severed from realty.

However, each state that has enacted the UCC has developed its own case law interpreting it. Therefore, it is possible that what might be a good in one state might not be a good in another, which could lead to surprising results. For instance, there is a split of authority over whether electricity is a good or a service.<sup>3</sup> A bankruptcy court could find that one supplier of electricity in a state where electricity is a good under the

## Building Blocks

date of commencement of a case under this title in which goods have been sold to the debtor in the ordinary course of such debtor's business.

Section 503(b)(9) grants such an administrative expense only for "goods" (as opposed to services). Bankruptcy courts generally employ the definition of "goods" found in the Uniform Commercial Code (UCC).<sup>2</sup> Section 2-105(1) of the UCC defines goods as:

[A]ll things (including specially manufactured goods) which are moveable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action. "Goods" also includes the unborn young of animals and

UCC may properly have a § 503(b)(9) claim (or reclamation rights under § 546(c)), while another supplier of electricity in a state where electricity is a service would not have the same rights.

When a transaction involves a combination of goods and services, some courts have applied a "predominant purpose" test and will deny a § 503(b)(9) claim where the predominant purpose of the transaction was the delivery of services.<sup>4</sup> Other courts have rejected this approach for transactions involving the sale of both goods and services holding that the value of the goods is entitled to § 503(b)(9) priority.<sup>5</sup>

<sup>3</sup> See, e.g., *In re Grede Foundries Inc.*, Case No. 09-14337, 2010 WL 2196280, \*3 (Bankr. W.D. Wis. June 1, 2010) (holding that electricity is a good under UCC); *In re Irving Indus. Inc.*, Case No. 06-30623, 2010 WL 1416148, \*14 (Bankr. D. Mass. April 7, 2010) (same); *contra In re Pilgrim's Pride Corp.*, 421 B.R. 231, 240 (Bankr. N.D. Tex. 2009); *In re Samaritan Alliance LLC*, Case No. 07-50735, 2008 WL 2520107, \*4 (Bankr. E.D. Ky. June 20, 2008).

<sup>4</sup> See *In re Circuit City Store Inc.*, 416 B.R. 531, 538 (Bankr. E.D. Va. 2009).

<sup>5</sup> See *In re Plastech Engineered Prods. Inc.*, 397 B.R. 828, 838 (Bankr. E.D. Mich. 2008).

<sup>2</sup> See, e.g., *In re Goody's Family Clothing Inc.*, 401 B.R. 131, 134 (Bankr. D. Del. 2009).

Administrative expenses allowed under § 503(b)(9) are afforded priority of payment under § 507(a)(2). Importantly, § 1129(a)(9)(A) provides that a plan may not be confirmed in a chapter 11 case unless the plan provides for full payment of “a claim of a kind specified in section 507(a)(2)...on the effective date of the plan.” This requirement that administrative expenses be paid in full for a plan to be confirmed gives trade creditors who qualify under § 503(b)(9) a substantial advantage. Accordingly, if a supplier has sold “goods” to a debtor within 20 days before the debtor filed its petition, the supplier should file a request for administrative expense under § 503(b)(9) for the value of those goods. The value typically is presumed to be the invoice or purchase price; however, that presumption may be rebutted if there is evidence showing that the invoice or purchase price is not an appropriate measure of value.<sup>6</sup> If the claim is allowed, whether the debtor must make payment prior to the effective date of a plan will be in the bankruptcy court’s discretion.<sup>7</sup>

However, an emerging issue that suppliers must confront is whether, notwithstanding that it holds an allowed administrative expense under § 503(b)(9), the court may disallow that administrative claim under § 502(d), which provides that certain claims may be disallowed where the claimant received an avoidable transfer and has not returned the amount of the avoidable transfer to the debtor’s estate. The U.S. Court of Appeals for the Second Circuit has held that § 502(d) does not bar allowance of an administrative claim.<sup>8</sup> The U.S. Bankruptcy Court for the Eastern District of Virginia has ruled that a § 503(b)(9) claim may be disallowed on § 502(d) grounds.<sup>9</sup> Therefore, any attorney counseling a client with a § 503(b)(9) claim but that may also have preference liability should discuss with the client the possibility that the timing and extent of payment of the § 503(b)(9) claim may not be as simple as it first appears.

## Section 546(c) Reclamation Demand

Trade creditors that have sold goods to debtors pre-petition are also

protected by the reclamation rights that are preserved under § 546(c)(1) of the Code. Section 546(c)(1) provides, in relevant part,

[S]ubject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee...are subject to the right of a seller of goods that has sold such goods to the debtor, in the ordinary course of such seller’s business, to reclaim such goods if the debtor has received such goods while insolvent within 45 days before the date of commencement of a case under this title, but such a seller may not reclaim such goods unless such seller demands in writing reclamation of such goods

(A) not later than 45 days after the date of receipt of such goods by the debtor; or

(B) not later than 20 days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.

Section 546(c)(1) is more expansive than § 503(b)(9) because it extends to goods sold in the 45 days before the filing of the petition, rather than 20 days. Even so, § 546(c)(1) often turns out to be far less valuable because, unlike § 503(b)(9)’s protections, the rights of sellers to reclaim goods are subject to the prior interests of secured parties.<sup>10</sup> For instance, when a secured lender holds a floating lien on a debtor’s property that includes a security interest in all of a debtor’s inventory, “a reclaiming seller is entitled to a lien or administrative expense only to the extent that the value of the specific inventory in which the reclaiming seller asserts an interest exceeds the amount of the floating lien in the debtor’s inventory.”<sup>11</sup> In addition, to preserve the reclamation right, a reclaiming seller that has made the timely written reclamation demand may also need to act immediately to file an adversary proceeding to prevent the

debtor from using the goods or commingling them with its other supplies.<sup>12</sup> The expense may not be justified, particularly when it is often the case that a debtor’s secured lender will have a prior floating lien on the debtor’s inventory.

Despite these limitations, it is still useful for sellers of goods to issue a reclamation demand (in addition to asserting their § 503(b)(9) rights) within the specified periods in an effort to preserve their rights if it turns out that the debtor’s secured lender does not have a prior security interest (or if it is avoided). In addition, many large chapter 11 debtors will request that the bankruptcy court establish procedures for resolving valid reclamation claims. Such procedures often provide that such claims (if not subject to prior security interests) will be given administrative-expense priority.<sup>13</sup> These enhanced rights will not be available if the trade creditor has not filed a timely reclamation demand.

## Post-Petition Assertion of Mechanics’ Liens

The Code sections described above are limited to providers of goods; however, all states have adopted mechanic’s lien laws to protect creditors that have provided certain labor, services, equipment or materials to improve another’s land or improvements. These laws vary from state to state, and the applicable requirements must generally be strictly satisfied. Properly perfected mechanics’ liens generally attach to the land and the improvement for which such goods and services were provided. The priority of such liens over other secured creditors varies under applicable state law.

After a debtor has filed a petition, § 362(a)(4) automatically stays “any act to create, perfect, or enforce any lien against property of the estate.” However, § 362(b)(3) provides that the automatic stay does not apply to “any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee’s rights and powers are subject to such perfection under section 546(b) of this title.” Section 546(b)(1)(A), in turn, provides that the rights and powers of a trustee are subject to any “generally applicable law”

<sup>6</sup> See, e.g., *In re SemCrude LP*, 416 B.R. 399, 405 (Bankr. D. Del. 2009).

<sup>7</sup> See *In re Arts Dairy LLC*, 414 B.R. 219, 221 (Bankr. N.D. Ohio 2009) (citing *In re Plastech Engineered Prods. Inc.*, 394 B.R. 147, 152 (Bankr. E.D. Mich. 2008)); *In re HQ Global Holdings Inc.*, 282 B.R. 169, 173 (Bankr. D. Del. 2002) (timing of payment of administrative expense within discretion of court).

<sup>8</sup> *ASM Capital LP v. Ames Dep’t Stores Inc.* (*In re Ames Dep’t Stores Inc.*), 582 F.3d 422, 431 (2d Cir. 2009).

<sup>9</sup> *In re Circuit City Stores Inc.*, 426 B.R. 560, 571 (Bankr. E.D. Va. 2010).

<sup>10</sup> See, e.g., *Simon & Schuster Inc. v. Advanced Mktg. Servs.* (*In re Advanced Mktg. Serv. Inc.*), 360 B.R. 421, 426 (Bankr. D. Del. 2007) (“Under the express language of 546(c)(1) of the Bankruptcy Code, Senior Lenders’ pre-petition and post-petition liens on the [d]ebtors’ inventory are superior to [a seller’s] reclamation claim.”).

<sup>11</sup> *In re Dana Corp.*, 367 B.R. 409, 419 (Bankr. S.D.N.Y. 2007) (quoting *In re Pittsburgh-Canfield Corp.*, 309 B.R. 277, 287 (6th Cir. B.A.P. 2004)); see also *In re Primary Health Sys. Inc.*, 258 B.R. 111, 117 (Bankr. D. Del. 2001) (holding that reclaiming seller cannot reclaim its goods if goods not worth more than value of lien).

<sup>12</sup> See *McLouth Steel Prods. Corp. v. Quaker Chem. Co.* (*In re McLouth Prods. Corp.*), 213 B.R. 978, 987 (E.D. Mich. 1997).

<sup>13</sup> See, e.g., *In re SemCrude LP*, Case No. 08-11525 (Bankr. D. Del. Sept. 15, 2008); *In re Dana Corp.*, Case No. 06-10354 (Bankr. S.D.N.Y. March 6, 2006); *In re Collins Aikman Corp.*, Case No. 05-55927 (Bankr. E.D. Mich. June 9, 2005); but see *In re Circuit City Stores Inc.*, Case No. 08-35653, 2010 WL 843394 (Bankr. E.D. Va. March 5, 2010) (holding that reclamation claimant administrative expense limited to administrative expense to which it would be entitled under § 503(b)(9), with balance being unsecured nonpriority claim).

that “permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection.”

As a result, a creditor can take post-petition steps to perfect a mechanic’s lien without violating the automatic stay if applicable law would permit the perfection to be effective against another entity that had acquired rights to the property before the date of perfection.<sup>14</sup> Many states have laws that permit the perfection of a mechanic’s lien to “relate back” to an earlier time (for example, when the work may have begun) or to otherwise have priority over an interest in the premises acquired by another party before the date of perfection. Thus, if the applicable state’s mechanic’s lien law contains such a provision and the creditor otherwise took the necessary statutory steps required on a pre-petition basis, a trade creditor that provided lienable labor, services, equipment or materials can take the final steps necessary to perfect its mechanic’s lien on a post-petition basis without violating the automatic stay.

Having taken the permitted steps to perfect a mechanic’s lien, a claimant must also ensure that it does not inadvertently lose its lien rights. Many states’ mechanic’s lien laws provide that a claimant forfeit its lien rights if it does not take action to foreclose its lien within a certain period of time after perfecting it. Of course, such enforcement action is automatically stayed by § 362(a)(3), and § 362(b) does not contain an applicable exception. However, § 546(b)(2) provides that if a generally applicable law “requires seizure of such property or commencement of an action to accomplish such perfection, or maintenance or continuation of perfection of an interest in property... such interest in such property shall be perfected, or perfection of such interest shall be maintained or continued, by giving notice within the time fixed by such law for such seizure or such commencement.” Consequently, mechanic’s lien claimants are well-advised to file a § 546(b)(2) notice of perfection, con-

tinuation or maintenance of lien in the bankruptcy court as soon as possible after perfecting their liens. In addition to attaching the lien documents, the notice should specify that (1) the claimant is perfecting, maintaining and continuing its lien pursuant to § 546(b)(2), (2) the claimant intends to enforce its interest in the property securing the lien, (3) the claimant does not consent to any sale of the property free and clear of the lien and (4) proceeds of any sale of the property securing the lien shall constitute cash collateral under § 363(a) and may not be used unless the claimant consents.

### **Further Protecting Secured Claim or Administrative-Expense Priority**

Despite having taken steps to assert a § 503(b)(9) administrative-priority claim, file a reclamation demand and/or assert its mechanic’s lien rights, a claimant must exercise vigilance to be sure that no other action is taken during the bankruptcy case to impair these rights. As a primary example, post-petition debtor-in-possession financing often contemplates giving the post-petition lender priming liens on all assets of the debtor as well as superpriority claim status over all administrative claims.<sup>15</sup> In addition, a debtor may take action in the bankruptcy case to sell property free and clear of liens, including mechanics’ liens.<sup>16</sup> Creditors that fail to object to such efforts may have their rights impaired or lose them entirely. In contrast, creditors that timely object often will find that debtors will voluntarily insert carve-outs in the applicable orders to preserve the objecting creditor’s rights.

### **Conclusion**

The Bankruptcy Code contains powerful provisions that a trade creditor can utilize to substantially increase the prospects of receiving an enhanced recovery on its pre-petition claims. Specifically, a seller of goods can assert administrative-expense priority under § 503(b)(9) and assert reclamation demands under § 546(c). Providers of certain goods and services can also take action, without violating the automatic stay, to perfect mechanic’s liens under state law if such perfection relates back in time or the perfected lien has priority over parties who previously acquired an interest in the property. However, none of these provisions is self-executing, and a creditor

must be vigilant in asserting and protecting these rights. ■

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<sup>14</sup> See, e.g., *Klein v. Civalo & Trovato Inc. (In re Lionel Corp.)*, 29 F.3d 88, 93 (2d Cir. 1994) (holding that post-petition perfection of mechanic’s lien via service of previously filed notice of lien did not violate automatic stay because New York state law provided that mechanic’s lien had priority over conveyance not recorded at time of filing of notice of such lien); see also *In re Ar Accessories Group Inc.*, 345 F.3d 454, 458 (7th Cir. 2003) (holding that automatic stay did not prevent post-petition perfection of wage lien that had priority over all other types of debts under Wisconsin state law); see also H.R. Rep. No. 95-595, at 371-72 (1978), reprinted in 1978 U.S.C.C.A.N. 6327 (noting that purpose of § 546(b) is to “protect, in spite of the surprise intervention of a bankruptcy petition, those whom state law protects by allowing them to perfect their liens or interests as of an effective date that is earlier than the date of perfection.”).

<sup>15</sup> See 11 U.S.C. § 364(c) and (d).

<sup>16</sup> See 11 U.S.C. § 363(f).