When Are Goods "Received" By Your Buyer?

Two 3rd Circuit courts issue recent decisions that significantly impact trade creditor claims in bankruptcy

By Daniel Slate and Brian Harvey

When the Bankruptcy Code was amended in 2005, Congress included a new protection for trade creditors who sell goods to a customer on the verge of bankruptcy. Section 503(b)(9) was added to grant the seller an administrative claim for the value of any goods received by the debtor in the 20 days leading up to a bankruptcy.[1] Without such administrative priority, the seller is left holding a lower priority general unsecured claim. The distinction is important. In many bankruptcy cases administrative claims are paid in full, while general unsecured claims are paid pennies on the dollar, if anything.

But when are the goods "received" by the debtor? What appears to be a simple question is actually the subject of much debate in bankruptcy courts across the country. For instance, are the goods "received" when the carrier chosen by the buyer puts the goods on its trucks? When the insurable risk of loss is transferred to the buyer? When the goods are delivered to a public warehouse and the buyer has the right to remove them? What if the seller acts as a fulfillment house, holds the goods in its warehouse until the buyer resells them and then delivers them directly to the buyer's customer? A pair of recent opinions, one from the Third Circuit Court of Appeals and the other from the U.S. Bankruptcy Court for the District of Delaware, tackle these issues and define when goods are "received." In doing so, the decisions illuminate the practical problems creditors face in trying to protect administrative priority claims in today's global economy.

In an opinion issued on July 10, 2017, the Third Circuit Court of Appeals concluded that the word "received" for purposes of Bankruptcy Code section 503(b)(9) means physical possession. The facts of the case (*In re World Imports Ltd.*) are fairly common: a foreign company sold goods to an American buyer in the ordinary course of business, and shipped them via common carrier from China to the U.S. "free on board" at the port of origin. Under these terms, the risk of loss or damage passed to the American buyer upon delivery at the port in China. The American buyer filed bankruptcy 38 days after the goods were loaded onto the common carrier at the Chinese port, but they arrived at the buyer's warehouse in the U.S. thirteen days before the bankruptcy. Because the seller is only entitled to an administrative claim for goods "received" by the buyer within the 20 days preceding the bankruptcy case, the seller argued that the goods were not received by the buyer until they were actually delivered to the buyer's warehouse. The bankruptcy court disagreed and determined that the goods were constructively received when they were provided to the carrier at the Chinese port, as that is when the risk of loss was transferred.

On appeal, the Third Circuit employed the definition of "receipt" used under the Uniform Commercial Code and reversed the bankruptcy court, concluding that "receipt does not occur until after the seller's ability to stop delivery ends—namely, upon the buyer's physical possession. . . . The upshot of all this is that the transfer of risk is not the same thing as receipt." The Third Circuit's ruling will enhance trade creditor protections under the Bankruptcy Code. By defining "receipt" as physical possession of the goods by the buyer, trade creditors that manufacture and ship goods from outside of the U.S. will be able to assert increased administrative claims, reducing the risks associated with a possible bankruptcy by the purchaser when the goods are in transit.

Following the Third Circuit ruling, a decision from the Delaware bankruptcy court in the case of *In re SRC Liquidation, LLC* illustrates the potential downside and risk of defining receipt as physical possession for purposes of administrative claims under section 503(b)(9) of the Bankruptcy Code. Before filing for bankruptcy, the debtor, Standard Register Company ("SRC"), ordered goods from the seller. At SRC's instruction, during the 20 days preceding the bankruptcy case, the seller arranged to drop ship the goods directly to SRC's customers utilizing SRC's account with the United Parcel Service. Under this arrangement, SRC never physically possessed the goods. Relying on the Third Circuit's definition of receipt, the bankruptcy court determined that even though UPS possessed the goods under SRC's account, as a carrier, UPS was not SRC's agent and the goods were never "received" by SRC. As a result, the seller was not entitled to an administrative claim, and was not paid for the goods it sold to SRC.

[1] An administrative claim under section 503(b)(9) of the Bankruptcy Code is in addition to a trade creditor's reclamation rights under the Uniform Commercial Code.

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So what should a trade creditor take away from these cases? While the decision from the Third Circuit expands the timeframe for asserting an administrative claim, particularly for goods shipped from overseas, the later decision from the Delaware bankruptcy court highlights one example of how the definition of "received" can harm trade creditors using common delivery practices. Care should be taken to understand the requirements and implement the procedures necessary to obtain a higher priority administrative claim. Most importantly, the goods need to be physically received by the buyer or its agent and a complete and unambiguous paper trail should be maintained. Otherwise, the trade creditor has, in essence, made a gift to the insolvent buyer and its other creditors.

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