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Third Circuit Defines 'Received' For Section 503(B)(9) Claims

By Anthony Michael Sabino

For over a decade now, the Bankruptcy Code has granted a priority of payment with regard to creditor claims for goods received by the debtor in the 20 days before bankruptcy. The law is prosaic enough on its face; a creditor merely needs to demonstrate that the debtor "received" the goods within the prescribed pre-bankruptcy interval, and its claim attains priority as an administrative expense. 11 U.S.C. § 503(b)(9). Ah, but therein lies the rub.

Precisely, what constitutes "received" by the debtor in this context? Does it mean actual physical custody of the goods? Or is the mere transfer of legal title sufficient to qualify for such improved status? Last year, we expounded upon a decision that denied administrative expense status to a claim because the district court held that "received" includes the passing of title. *See* Abatemarco & Sabino, "Bankruptcy Code, International Trade Treaty Collide over Expense Status," (October, 2016; http://bit.ly/2fay1iU). Truth be told, this writer agreed with the outcome, albeit for somewhat different reasons. Indeed, aware that the lower court decision was being appealed, we urged clarification from a higher court.

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AE Liquidation: WARN Act Comfort for Debtors Attempting a 363 Sale, or Just the 'Putin Exception'?

By Russell C. Silberglied and Katherine M. Devanney

In *In re AE Liquidation*, 2017 WL 3319963 (3d Cir. Aug. 4, 2017) (the Third Circuit Opinion or *AE Liquidation*), the U.S. Court of Appeals for the Third Circuit held that a WARN Act notice only must be given when mass layoffs are probable, not when merely foreseeable. As a result, a debtor that was attempting to effectuate a going concern sale under Bankruptcy Code Section 363 was not liable for failing to give a WARN Act notice until the day it determined it could no longer wait for approvals from the buyer to close. The case can be viewed as providing assurance to debtors that they can attempt a going concern sale without having to provide a potentially damaging "conditional" WARN Act notice.

But the facts of the case are quite unusual. The final approvals from the buyer had to be provided by none other than Russian Prime Minister Vladimir Putin. He stalled, so the approvals were not obtained. Was the court simply reluctant to hold a company accountable for the actions of the Russian dictator, or can the opinion be read more broadly? The authors conclude that, as unusual as it is to encounter Vladimir Putin in a Section 363 sale, *AE Liquidation* need not be read so narrowly.

While this particular transaction was doomed by the stringing along from an atypical, high-profile source in Putin, it is the unexpected failure to close that ultimately mattered, rather than the personage of Putin. As a result, *AE Liquidation* encourages debtors to seek a value maximizing transaction until it becomes probable that it will fail — an optimal result.

Background

Eclipse Aviation Corporation (Eclipse) was an aviation engineering and manufacturing firm with approximately 945 employees. Its largest shareholder was European Technology and Investment Research Center (ETIRC). *AE Liquidation, Inc. v. Eclipse Aviation Corp.*, 522 B.R. 62, 65 (Bankr. D. Del. 2014) (the Bankruptcy Opinion). Roel Pieper (Pieper") served as Chairman of both Eclipse and ETIRC. *Id.*

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be of limited utility to future Chapter 11 debtors; it is unlikely that Putin will play a role in another 363 sale any time soon.

But the authors believe that the opinion can be read more broadly. It doesn't indicate on its face that the standard had been altered due to the unique character of Putin. Rather, the court seemed sympathetic to a board that demanded and was being given assurances, even though those assurances turned out to be meaningless in retrospect. The court specifically cited a policy rationale: a desire not to force a company to send a premature WARN Act notice, which could harm the very workers (by causing domino-effect harm to the company, leading to its demise) that the Act is meant to help. *Id*. at 10-11. That rationale suggests the expectation of a broad interpretation of the opinion.

Such an interpretation is good news for Chapter 11 debtors. Whether a debtor will actually close on a proposed section 363 sale is frequently in at least some doubt. If debtors were unable to rely on repeated assurances, the likelihood is that they would have to operate differently. Conditional WARN Act notices would become more frequently issued, and perhaps some value-maximizing (and job-saving) sales would simply be scuttled, with a debtor believing it could not pull off the sale while the workers are in disarray after receiving such a notice. Buyers, too, might be unwilling to close in such an environment. The court's holding that WARN Act notice did not even need to be given even in the February period means that debtors need not be so trigger-happy in issuing a notice.

That is not to say that *AE Liquidation* gives companies attempting a sale carte blanche to ignore the WARN Act. The court credited the evidence that the board of directors met frequently, weighed the probability of closing at various times, and took specific action in making demands and setting drop-dead dates. In other words, it created a good record to defend its actions. Debtors who face uncertainty that a sale will close and are concerned about WARN Act liability are well advised to create a similar record in future cases.

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Third Circuit Clarification

Be careful what you wish for. An appellate tribunal has now reversed the decision (and, effectively, this writer). In *Haining Wansheng Sofa Co., Ltd. v. World Imports, Ltd*. (*In re World Imports, Ltd.*), ___ F.3d ___ (3d Cir. July 10, 2017), the venerable U.S. Court of Appeals for the Third Circuit firmly declared that "received" in Section 503(b)(9) connotes actual physical custody of the goods by the debtor. As it was undisputed at the trial level that the goods were not handed over to the debtor until well within the 20 days prior to its bankruptcy filing, the tribunal ruled that the creditors were, in fact, entitled to a 503(b)(9) administrative expense priority.

This turnabout in the interpretation of the meaning of "received" in Section 503(b)(9) is a significant development, given that such claims frequently arise in business bankruptcies. The fact that is comes from such an august tribunal as the Third Circuit adds gravitas to the reversal of the courts below. For those reasons, we now analyze the decision, all the while feasting on a healthy serving of humble pie, well deserved in this instance.

Statutory Background

Before turning to the opinion per se, a further explanation of the statute — or, better said, statutes — in question is warranted. From its inception in 1978, the modern Bankruptcy Code has consistently recognized a creditor's remedy of reclamation — which is, simply put, a creditor's right to retake goods shipped to the debtor on the eve of the latter succumbing to insolvency. *See* 11 U.S.C. § 546. The right of reclamation has long been recognized in the common law, as well as in the Uniform Commercial Code (UCC).

Congress decided to refine Section 546 as part of the lawmakers' broader reforms promulgated by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). BAPCPA appended a new subparagraph to Section 503 of the Code, the administrative expense statute. 11 U.S.C. § 503. Recognition as an administrative expense is much coveted by creditors in bankruptcy cases, as such a claim is eligible for a priority of payment. 11 U.S.C. § 507.

This 2005 addition provides that a creditor is entitled to administrative expense status, and, ergo, a right to priority of payment, for a claim rooted in goods received by the debtor within the 20 days before the debtor files for bankruptcy. 11 U.S.C. § 503(b)(9). Given that the Section 546 right to reclamation sometimes proved to be a hollow one, Congress implicitly sought to better balance the scales for afflicted creditors.

World Imports

But now, the question evolved into what the meaning is of "received" in this context. When we first reviewed the subject months ago, the trial court iteration of *World Imports* informed us of the following. There the creditors, based in China, had sold furniture and similar goods to World Imports. The goods were shipped "F.O.B." from the Far East, meaning that legal title passed to

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the buyer on that side of the Pacific. While that all transpired well before Section 503(b)(9)'s 20-day period had even commenced, physical receipt in the U.S. by World Imports readily fell within the statutory interval. None of these essential facts were in dispute.

In that initial determination, the district court made much of the terminology found in relevant international trade treaties. Relying mainly upon the F.O.B. shipping term, the lower court deemed that the debtor "received" the goods when legal title passed. Accordingly, the judge ruled that the creditors were not entitled to a priority claim, since the debtor had "received" the goods on a date well before the obligatory 20-day period had commenced.

It was against this backdrop that the Third Circuit made its intriguing reversal. And it did so understanding the gravity of the question at the bar. Writing for the panel, Circuit Judge Thomas Hardiman commenced with the notation that this appeal "has important ramifications for a creditor that sells goods to a debtor soon before the debtor files a … bankruptcy petition."

The tribunal's decision was, effectively, a triad of reasoning. For the first pillar of its rationale, the appellate court invoked a hallowed axiom of statutory construction. Words in a statute should be given their everyday meaning, opined Judge Hardiman, particularly so in matters of interpreting the Bankruptcy Code.

Accordingly, the panel first consulted the leading dictionaries, both legal and general, to divine the ordinary meaning of the word "received." The court found the relevant authorities generally agreed that "received" means actual custody, a physical taking of possession by the recipient.

Certainly, the appeals court admitted that the reference works it consulted did not provide identical definitions of the term in question; nevertheless, the panel lauded their consistency with each other, and the fact that they all ended in essentially the same place. In addition, by a process of elimination, the Third Circuit eschewed the notion that "received" was satisfied by the mere legalism of a transfer of title or risk of loss alone.

In further support, the tribunal noted that the referenced dictionary meanings were consistent with the definition of "receive" as found in the Uniform Commercial Code. *See* U.C.C. § 2-103(1)(c). Reminding that the commercial codification is very nearly universal among the American states, the panel deemed this "ample evidence" that "Congress relied on the UCC definition" when it inserted Section 509(b)(9) into the Bankruptcy Code in 2005.

Constructing the second leg of its *ratio decendi*, the *World Imports* court looked no further than its own, long-standing precedents. Over 30 years before, in *Montello Oil Corp. v. Marin Motor Oil, Inc.* (*In re Marin Motor Oil, Inc.*), 740 F.2d 220 (3d Cir. 1984), the Third Circuit decreed that the word "receipt," as found in Section 546 of the Bankruptcy Code, "means the same thing" as it does in the Uniform Commercial Code, to wit, "taking physical possession." Stressing the strong bonds between the Code's reclamation statute and the new subsection of the administrative expense proviso, the panel prepared to extend the reach of *Marin Oil's* definition of "received" to the latter.

Distinguishing Sections 546 and 503(b)(9)

But first it was incumbent upon the court to firmly rule upon the explicit interrelationship it found between Sections 546 and 503(b)(9). Judge Hardiman opined that the BAPCPA amendments codified the latter as "*exemption*" from the former. The appeals court concluded that Section 503(b)(9) is "an alternative remedy to [the] reclamation" right previously exercised by eligible creditors.

That linkage now exposited, the Third Circuit now extended *Marin Oil's* definition of "received" to Section 503(b)(9). To do so, the tribunal called upon another canon of statutory construction. Reminding that individual statutes cannot be viewed in isolation, but rather must be interpreted in the context of the overall legislation, the panel justified its expansion of *Marin Oil* definitions to companionable matters arising under Section 503(b)(9). Given that 503(b)(9) is but "an exemption to the general bankruptcy reclamation scheme," the *World Imports* court decreed that the most natural reading of the administrative expense statute would superimpose the same meaning of "received" as found in *Marin Oil*.

Geography provided the third and final piece of the foundation for *World Imports*. Attaching great significance to the fact that Congress amended Sections 546 and 503 in the same subpart of the 2005 legislation, Judge Hardiman was further persuaded that those two reforms — and only those two — were found under that particular BAPCPA heading. Given the obvious symmetry in the parallel amendments, the Third Circuit concluded it was "quite implausible that Congress meant for the date of receipt to be different between the two provisions."

Delivery vs. Receipt

While the above constituted the bulk of the court's reasoning, it had to dispose of one final point, as argued by the debtor herein. World Imports contended that the shipping company was effectively its agent; therefore, the debtor truthfully "received" the goods when title passed, a result further mandated by the F.O.B. terms of the transaction. Not so, held the panel.

Once more asserting the precedential value of *Marin Oil*, the Third Circuit reiterated that it had long ago decided that the delivery of goods and the receipt of goods "can occur at different times." Therefore, noted Judge Hardiman, the day that the debtor takes physical possession of the goods is ultimately determinative for Section 503(b)(9) administrative expense status.

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ON THE MOVE

Kobre & Kim LLP announced that **Daniel Saval** has joined the firm's cross-border insolvency litigation practice as a partner in the New York office. Formerly a partner at **Brown Rudnick**, Saval represents clients in multijurisdictional insolvency and corporate restructuring disputes, and he has particular experience in contentious proceedings involving funds in liquidation triggered by fraud or wrongdoing. Saval recently represented Carl Icahn entities in the Trump Entertainment bankruptcy proceedings, during which Mr. Saval litigated plan confirmation issues relating to cramdown interest rates, enforceability of intercreditor agreement provisions and termination of intellectual property licenses.

Joshua Morse has joined the Restructuring group of **DLA Piper** as a partner in the firm's San Francisco office. Morse focuses his practice on the representation of bondholders, debtors, secured lenders, indenture trustees and creditors' committees. His experience includes both out-of-court restructuring negotiations and representing bondholders in complex matters in bankruptcy courts across the nation. He serves clients across a wide range of industries and sectors, including technology, gaming, media, retail, aerospace, transportation, oil and gas, power generation, mining and manufacturing. Prior to joining DLA Piper, Morse was a partner with **Jones Day**.

Proskauer Rose LLP announced that **Brian S. Rosen** has joined the firm's Business Solutions, Governance, Restructuring & Bankruptcy Group as a partner in the New York office. Rosen's practice focuses on Chapter 11 and out-of-court debt restructurings, acquisitions of distressed companies and assets and matters relating to sovereign indebtedness. The move to Proskauer affords Rosen, a long-time bankruptcy and restructuring partner at **Weil, Gotshal & Manges**, the opportunity to reunite with his former colleague **Martin Bienenstock**, who joined Proskauer in 2012 after leaving Weil 10 years ago to join **Dewey & LeBoeuf**.

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To be sure, in a telling parenthetical, *World Imports* refuted the lower court's view that F.O.B. terms are controlling in these matters. In this revealing footnote, the panel rejected any need for reliance upon international trade terms, asserting that the Bankruptcy Code was more than sufficient to answer the question at bar.

At the end of the day, the Third Circuit held that "received" in the Section 503(b)(9) context means actual physical possession of the goods by the debtor within the 20 days preceding the bankruptcy. If so, the creditor is entitled to administrative expense priority for its claim. In contradistinction, if title merely passes, without physical receipt, then the claim is relegated to a lower rank in the distribution hierarchy.

Case Impact

World Imports is already influencing bankruptcy jurisprudence. This is inevitable, given that the Third Circuit supervises the Delaware bankruptcy court, a forum long favored for corporate bankruptcy filings. Strictly adhering to the instructions of the parent tribunal, a Delaware bankruptcy judge, in *In re SRC Liquidation, Inc.*, ___ B.R. ___ (No. 15-10541) (Bankr. D. Del.) (July 13, 2017), ruled that a creditor that had "drop-shipped" goods to the debtor's customers within the statutory 20 days was not entitled to an administrative expense priority, because the debtor "never physically possessed the goods." Surely, more such decisions shall follow from that popular vicinage.

In closing, we do not argue with the efficacy of the Third Circuit's ruling. That panel took the surest course, by predicating its holding upon the firmest of grounds; statutes must first and foremost be interpreted in accordance with their plain meaning. Notwithstanding the solidity of such reasoning, we nevertheless interject a word of caution pertaining to the reach of this new decision.

First, the Third Circuit is but one of over a dozen such federal tribunals. Will its peers adopt the reasoning of *World Imports* in toto or strike out on their own with varying or even conflicting rulings?

Second, while the panel's interpretation of "received" here was forthright enough, what of the impact upon other, equally auspicious maxims of commercial law? Specifically, it has long been held that legal title and insurable interest pass in accordance with the F.O.B. and similar contractual terms found in contemporary shipping documentation, regardless of subsequent physical receipt. We can speculate as to whether, in resolving this narrow question pertaining to Section 503(b)(9), *World Imports* opens the door to future conflicts in the many interactions between commercial and bankruptcy law. Only time will tell.

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