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Client Alert

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Bankruptcy Code Sections 503(b)(9) and 546(c): A Bitter Pill For Healthcare Debtors Is Pain Relief For Their Vendors

It's a common scenario, especially in these tough economic times: a vendor that sells large volumes of supplies to a healthcare facility, with which it has done business for years, learns that the facility has suddenly (and perhaps unexpectedly) filed for bankruptcy protection. Thousands of dollars in invoices to the facility remain unpaid. And while the vendor may be able to require cash on delivery for any further supplies that it sells to the facility during the reorganization process, the facility is in possession of the supplies that were previously delivered, the "automatic stay" triggered by the bankruptcy filing prevents the vendor from seeking any payment for those goods, and the vendor may be left holding an unsecured pre-bankruptcy claim against the facility that is likely to be paid at only "pennies on the dollar." But all is not as it once was for the vendor or the newly-bankrupt healthcare debtor, thanks to two relatively recent additions to the Bankruptcy Code: section 503(b)(9) and amended section 546(c).

Bankruptcy Code Section 503(b)(9)

Among the significant amendments to the Bankruptcy Code that took effect in October of 2005 was the addition of section 503(b)(9), which created a new category of so-called administrative expense claims. Administrative expenses are unsecured claims that a debtor in bankruptcy is required to pay at one of the highest levels of priority because of the benefit that the associated goods, services or other consideration provided by the claimant have conferred upon the debtor's estate as it proceeds through the bankruptcy process. As such, most allowed administrative expenses are claims or expenses that the debtor incurred *after* filing for bankruptcy protection, and all administrative claims are required to be paid in full before virtually any pre-petition creditor, other than a secured creditor, receives anything on its claim.

With the enactment of section 503(b)(9), Congress established a new type of administrative expense claim for "the value of any goods received by the debtor within 20 days *before* the date of commencement" of the bankruptcy case (emphasis added), so long as the goods were "sold to the debtor in the ordinary course of such debtor's business." 11 U.S.C. § 503(b)(9). Congress did so ostensibly to prevent a debtor from acquiring goods at a time when it knows that bankruptcy is imminent, and that it will not be able to pay for the goods. In this one fell swoop, a category of claims against the debtor that

formerly had qualified as pre-petition general unsecured claims only, and was afforded a lower-level priority that usually resulted in a small *pro rata* payment (if any payment at all), was suddenly elevated to a higher priority status that usually results, at least in Chapter 11 reorganizations, in payment in full.

Section 503(b)(9) Eligibility

Precisely what does it take for unpaid pre-bankruptcy charges owed to a vendor to qualify for this new priority and be eligible for payment ahead of most other pre-bankruptcy claimants, and thus usually in full? Essentially, only three criteria are required to be satisfied.

First, the charges must be for "goods". Charges for services, information or monetary transactions, for example, do not qualify. Recent court decisions have confirmed, however, that the definition of "goods" for purposes of section 503(b)(9) coincides with the extremely broad definition of the term provided in the Uniform Commercial Code (UCC)—"all things that are movable at the time of identification to a contract for sale"—and thus covers all manner of materials, supplies, merchandise, tools, equipment and even food. See *In re Circuit City Stores, Inc.*, 416 B.R. 531 (Bankr. E.D.Va. 2009); UCC § 2-103(1)(k). (Certain types of food, namely fruits and vegetables, are also entitled to an even greater and less time-restricted payment "superpriority" under the federal Perishable Agricultural Commodities Act of 1930.)

Second, the goods must have been "received by the debtor" within 20 days before the bankruptcy case was filed. The date on which items were ordered, processed or invoiced is irrelevant. In cases where the goods were delivered by the vendor itself, the term "received by the debtor" plainly refers to when the debtor-purchaser took actual, physical possession of the goods at issue. Where the vendor shipped the goods via a third-party carrier under an "F.O.B. Shipping Point" agreement, however, the debtor's receipt is perhaps open to debate. Under such an agreement, legal title to the purchased goods typically passes to the buyer when the goods are accepted for shipment by the third-party carrier. Arguably, then, goods could have been "received by the debtor" prior to the 20-day period of section 503(b)(9) eligibility, even though they were actually delivered into the debtor's physical possession during the 20-day period. Even in this scenario, however, bankruptcy courts have historically adopted the concept of actual receipt—as opposed to the transfer of legal title or ownership—embodied in the UCC, and consider the date of physical delivery to be the date on which the goods were "received by the debtor." See *Aventura Sportswear LTC v. Maloney Enterprises, Inc.*, 37 B.R. 290 (Bankr. E.D.Ky. 1983). To date, there is no reason to expect that courts applying section 503(b)(9) will conclude differently.

Third, the goods must have been "sold to the debtor in the ordinary course of [its] business." This simply means that the goods at issue were not a highly unusual or "one-off" acquisition, but rather were goods that the debtor commonly purchased, or would ordinarily be expected to purchase, in connection with operating its business.

What If Goods Were Delivered More Than 20 Days Before Bankruptcy?
The Right of Reclamation Under Section 546(c)

Frequently, as companies slide towards bankruptcy, they stretch out their vendors. Consequently, it is not surprising for a vendor to be owed money for goods delivered to a debtor more than 20 days prior to the bankruptcy filing. All still may not be lost for such a vendor. At the same time that Congress added section 503(b)(9) to the Bankruptcy Code, it modified another section of the Bankruptcy Code, section 546(c), which now gives sellers additional rights for goods delivered to a debtor within 45 days prior to the bankruptcy filing. While less likely as a practical matter to afford relief to vendors in many cases, this section allows sellers of goods to reclaim those goods (or receive payment for them) provided that the strict requirements of the section are met.

First, as with section 503(b)(9), the vendor must have sold "goods," but this time in the "ordinary course of the *[vendor's]* business" (emphasis added). *Second*, the debtor must have been "insolvent" when it received the goods. An entity generally is insolvent, for Bankruptcy Code purposes, if its liabilities exceed its assets at a fair valuation. *Third*, the debtor must have "received such goods" within 45 days before the bankruptcy filing. *Fourth*, and in contrast to section 503(b)(9), which does not prescribe the time by which the vendor must make demand, a vendor seeking reclamation under section 546(c) must make written demand either (i) not later than 45 days after the date of the debtor's receipt of the goods, or (ii) not later than 20 days after the bankruptcy petition date, if the 45-day period expires after the petition date. As a practical matter, this means that in virtually every instance the vendor must make its reclamation demand within 20 days after the petition date. *Fifth*, the goods must still be in the debtor's possession when reclamation is sought, and they must be identifiable. So, for example, a vendor cannot reclaim raw materials if they have been incorporated into a finished product.

Finally, although there is some debate, a vendor's reclamation rights generally are "subject to" a secured creditor's rights. So, for example, a vendor's reclamation rights may be "subject to" the rights of a secured creditor with a lien on the debtor's inventory. Practically, then, an otherwise valid reclamation claim could be valueless if the amount of the secured creditor's claim exceeds the value of that creditor's collateral.

What Does All Of This Mean For Bankrupt Healthcare Facilities And Their Vendors?

For healthcare debtors potentially going into Bankruptcy, the effects of section 503(b)(9) in particular, and sometimes section 546(c), can be extremely problematic. Section 503(b)(9) will afford a vendor an administrative claim in each and every case in which goods were received by a debtor within 20 days before the bankruptcy filing. Section 546(c) will create a further right for a vendor, and complicate matters for a debtor, for goods received as much as 45 days before the bankruptcy filing. In many cases, the elevation to administrative payment priority of charges for goods that the healthcare debtor purchased and received as much as 45 days before filing for bankruptcy severely diminishes the estate resources available to address the claims of creditor constituencies whose support is needed in order to mount a successful reorganization effort.

For this reason, a prospective healthcare debtor that needs virtually all of its resources in order to appease a lender with liens on all of its assets and get a plan of reorganization confirmed must be mindful of the blanket administrative priority granted under section 503(b)(9), and of whether any of its vendors will be able to assert valid reclamation claims under section 546(c). Therefore, a prospective healthcare debtor may want to plan to time bankruptcy filings so as to be more than 20 days (and perhaps as much as 46 days) beyond its last sizeable delivery of any supplies or other goods.

For vendors that supplied a healthcare debtor in the weeks before it filed for bankruptcy protection, on the other hand, the effect of section 503(b)(9) in particular, and potentially section 546(c), is nothing but good. Under section 503(b)(9), claims that previously would have been paid only in part, if at all, are now eligible to be paid before most other types of pre-bankruptcy claimants receive a penny, and thus are usually paid in full. The vendor need only assert its section 503(b)(9) claim at the appropriate time (and more frequently, courts are setting relatively early deadlines for such claims), either by negotiating with the debtor's bankruptcy counsel or filing a motion to have the claim allowed and afforded its higher payment priority. For those goods received by the debtor from 21 to 45 days prior to the bankruptcy, though, the vendor should be careful to assert its right to reclamation within 20 days after the petition date.