



## Section 503(b)(9) Priority Status Limited for Shipments from Abroad

**B**ankruptcy Code section 503(b)(9) was promulgated in 2005 to provide goods suppliers additional protection in the event their customer files for bankruptcy. Trade creditors are granted an administrative priority claim for the value of the goods they have sold to a financially distressed customer in the ordinary course of business that were received within 20 days of the customer's bankruptcy filing.

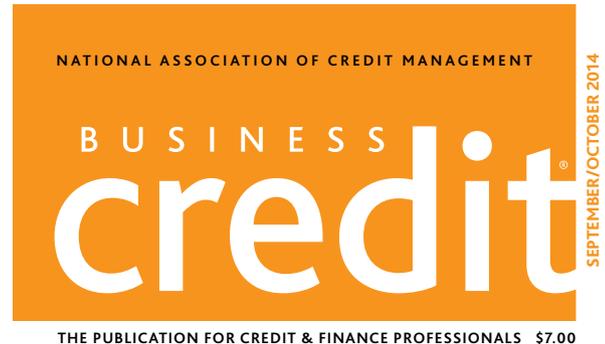
Section 503(b)(9) appears to be a relatively simple straightforward provision that grants trade creditors an administrative priority claim for:

...the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.

However, in practice, the application of Section 503(b)(9) has been anything but simple. Section 503(b)(9)'s benefits have been diluted by costly litigation over the meaning of various terms Congress included in Section 503(b)(9). That includes the meaning of the word "received," the date of which determines whether a creditor is entitled to an administrative claim and the allowed amount of the claim.

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FOB from the port of origin, when the vendor had loaded the goods onto a ship in China destined for the US (outside the 20-day period); not when the debtor had physical possession of the goods in the US (inside the 20-day period), almost a month after they were loaded.<sup>1</sup> In determining the meaning of "received" for purposes of Section 503(b)(9), the court relied on the Convention on Contracts for the International Sale of Goods (CISG),<sup>2</sup> a treaty to which the United States and China are parties, instead of the Uniform Commercial Code (UCC).

### Factual Background

The debtor filed its Chapter 11 petition on July 2, 2013. Two of the debtor's foreign vendors, Fujian Zhangzhou Foreign Trade Co., Ltd. and Haining Wansheng Sofa Co., Ltd., filed a motion (collectively, the "motions") for allowance and payment of an administrative expense claim under Section 503(b)(9) of the Bankruptcy Code. The debtor and the Official Committee of Unsecured Creditors opposed the motions.

The Haining claim included goods shipped from Shanghai, China on May 26, 2013 (more than 20 days before the petition date). The debtor took physical possession of the goods in the United States on June 21, 2013 (within 20 days of the petition date). The Fujian claim included goods shipped from Xiamen, China on May 17, May 31 and June 7, 2013 (more than 20 days before the petition date). The main difference between Fujian's and Haining's claims is that certain of the goods that were part of Fujian's claim were drop shipped (shipped directly to the debtor's customer)<sup>3</sup>, while other goods were shipped directly to the debtor. The parties appeared

to agree that the debtor, or its customers in the case of drop shipped goods, had obtained physical possession of Haining's goods within 20 days of the petition date.

Each of the debtor's orders placed with either Fujian or Haining involved four different documents: a purchase order, a packing list, a commercial invoice and a bill of lading (collectively, the "order documents"). The shipping terms governing all of the order documents were "FOB in the country of origin."

### The Issue and the Parties' Arguments

The only issue before the court was whether the debtor had received the goods purchased from Fujian and Haining within 20 days of the petition date. Neither Section 503(b)(9) nor any other provision of the Bankruptcy Code defines "received" or "receipt." The debtor and committee argued that receipt occurred when the goods were loaded onto the ship in China (outside of the 20-day period), while Fujian and Haining argued that receipt did not occur until the debtor received actual physical possession of the goods, which occurred in the US (within the 20-day period).

The debtor and the committee also argued that the applicable body of law governing receipt in this context is international commercial law, specifically, the CISG, a treaty to which the US and China are signatories. According to the CISG, where the sale terms are "FOB in the country of origin," the goods are deemed to have been transferred to the buyer when the goods are loaded on the ship. As a result, the debtor was deemed to have received the goods outside of the 20-day window before the petition date and would not be entitled to an administrative claim under Section 503(b)(9).

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On the other hand, Fujian and Haining argued that Article 2 of the UCC, dealing with the sale of goods, should govern the determination of when "receipt" occurs. Fujian and Haining pointed out that Section 2-103 of the UCC explicitly defines "receipt" as "taking physical possession" of the goods. Utilizing this definition of "receipt," Fujian and Haining would be entitled to an administrative claim under Section 503(b)(9) since physical possession of the goods did not occur until the goods were in US ports, which took place within the 20-day period prior to the petition date.

### The Court's Analysis

The court agreed with the debtor and the committee that Fujian's and Haining's sales of goods to the debtor were subject to the CISG. This created a federal interest that trumps any contradictory state law, such as the UCC.

The court also noted that, although the terms "receive" or "receipt" are not referenced in FOB's definition, the manner in which "FOB" discusses delivery is relevant.

The CISG treaty applies to "contracts of sale of goods between parties whose places of business are in different States... [w]hen the States are Contracting States."<sup>4</sup> The court recognized that both the US and China are "Contracting States" and signatories to the CISG. As such, the court noted that unless the contracting parties opted in their contracts to substitute another body of law, the CISG, as the governing federal law, and not state law, like the UCC, should govern when goods are deemed "received" to resolve the claimants' Section 503(b)(9) claims. The court found nothing in the record indicating that either Fujian or Haining had agreed to the application of another body of law.

The court also noted that while the CISG is the governing law for determining when the goods were "received," the CISG, like the Bankruptcy Code, does not define this term. However, the CISG does include provisions that deal with instances where the CISG is silent on an issue, such as the absence of a defined term for "receipt."<sup>5</sup> Moreover, the court focused on how parties to the CISG are "considered, unless otherwise agreed, to have impliedly made applicable to their contract or its formation a *usage of which* the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned."<sup>6</sup>

These usages, referred to as Incoterms, have been memorialized by the International Commerce Commission in order to harmonize commonly used trade terms. Incoterms are a set of standard trade terms meant to provide parties to international contracts for the sale of goods with clear definitions of their respective rights and liabilities with regard to the shipment of goods. The courts have held that these Incoterms are explicitly incorporated into the CISG through Article 9(2), quoted above.

The shipping term included in the order documents was "FOB<sup>7</sup> from the point of origin." Specifically, the term related to the shipments from Fujian was "FOB Xiamen" and the term related to the shipment from Haining was "FOB Shanghai." The court recognized that the Incoterm "FOB" does not contain either the word "receive" or "receipt." However, the court concluded that the Incoterm's definition of "FOB" is useful in

determining the intended meaning of the terms “receive” or “receipt” under the CISG. The term “FOB”:

[means] that the *seller delivers* the goods on board the vessel nominated by the buyer at the named port of shipment or procures the goods already so delivered. The *risk of loss of or damage to the goods passes when the goods are on board the vessel*, and the buyer bears all costs from that moment onwards.<sup>8</sup>

The court also noted that, although the terms “receive” or “receipt” are not referenced in FOB’s definition, the manner in which “FOB” discusses delivery is relevant. FOB states the following with respect to delivery:

[T]he seller must deliver the goods either by placing them on board the vessel nominated by the buyer at the loading point, if any, indicated by the buyer at the named port of shipment or by procuring the goods so delivered. In either case, the seller must deliver the goods on the agreed date or within the agreed period and in the manner customary at the port.

Thereafter, the buyer’s responsibility is to then “...take delivery of the goods when they have been delivered.”

Relying on Incoterms’ definition of FOB, the court observed that as soon as the seller delivers the goods to the carrier, the risk of loss or damage immediately passes to the buyer. Based on these facts, the court concluded that the debtor had constructively received Fujian’s and Haining’s goods in China when the goods were loaded on the vessels, more than 20 days prior to the debtor’s bankruptcy filing. As such, neither Fujian nor Haining were entitled to a Section 503(b)(9) administrative priority claim.

## Conclusion

The court’s holding is a stark reminder to trade creditors that the meaning of Section 503(b)(9)’s seemingly simple terms is anything but simple.<sup>9</sup> It now appears that the definition of the term “received” in Section 503(b)(9) may have different meanings depending on whether a vendor is shipping goods from a foreign country that is a signatory to the CISG, or from the US.<sup>10</sup>

In the aftermath of *In re World Imports, Ltd.*, trade creditors that sell goods delivered from abroad to buyers in the US risk an abridgment of their rights under Section 503(b)(9). This might occur based on a determination that the debtor had received the goods earlier, when they were loaded on the vessel abroad, instead of later when the debtor takes physical possession of the goods in the US. Vendors shipping goods from abroad should consider making US law, such as the UCC, rather than the CISG, the governing law of the transaction or explicitly defining the term “receipt” or “received” in their agreements.<sup>11</sup> ■

1. The period of time between the time of loading of goods on a vessel and a debtor’s receipt of the goods can be significant and, as demonstrated by the court’s decision, oftentimes is determinative as to whether a trade creditor is entitled to a Section 503(b)(9) priority claim or a lower priority general unsecured claim.

2. As of June 13, 2014, 81 countries have adopted the CISG. See <http://www.CISG.law.pace.edu/CISG/countries/entries.html>. Interestingly, other countries, such as the United Kingdom, Portugal, India, Algeria, Kazakhstan and South Africa, are not signatories to the CISG. It is unclear what body of law a court would apply if a company doing business with a debtor is located outside of the United States, but is not a signatory to the CISG.

3. Relying on the District of New Hampshire Bankruptcy Court’s decision in *Ningbo Chenglu Paper Products MrF. Co., Ltd. v. Momenta, Inc. (In re Momenta, Inc.)*, the court noted that the “drop shipped” goods were not entitled to Section 503(b)(9) priority status because they were never received by the debtor, either during or prior to the 20-day period before the debtor’s bankruptcy filing.

4. See CISG Article 1(1)(a).

5. Article 7(2) of the CISG states that a gap should be filled “in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.”

6. See CISG Article 9(2) (emphasis added).

7. “FOB,” one of the 11 Incoterms, means Free on Board.

8. Incoterms 2010 (emphasis added).

9. It should be noted that Fujian and Haining filed a notice of appeal in connection with the court’s decision. In addition, at least one other creditor that filed a Section 503(b)(9) claim in the *In re World Imports, Ltd.* case filed a detailed letter brief arguing that the court’s analysis and ultimate decision on the treatment of Fujian’s and Haining’s claims is incorrect. To date, neither of these matters has been resolved.

10. According to well settled US law, if two domestic companies located in the United States are doing business with one another, it is likely that the UCC would apply and actual physical receipt of the goods should dictate whether a trade creditor is entitled to a Section 503(b)(9) priority claim.

11. The views expressed in this article do not necessarily represent the views of Lowenstein Sandler LLP, its attorneys, or its clients

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