By Stephen M. Packman

In 2005, Section 503(b)(9) was added to the Bankruptcy Code. This section protects vendors who supply product to a debtor within 20 days of the date of the debtor’s bankruptcy filing. Vendors who supply product to the debtor within this time period (and who have not received payment) are afforded administrative claims in the bankruptcy proceedings for the value of those goods sold in the ordinary course to the debtor prior to the bankruptcy filing. The goods must have been delivered to the debtor prior to the filing. This is true regardless of the fact that the vendor’s claim arises prepetition and would, ordinarily, be classified as an unsecured claim subject to certain potential reclamation rights by the vendor under state law if such rights were properly preserved by the vendor as to the goods delivered before the bankruptcy.

Many issues have arisen over the last few years under this new Code provision. These include the date of delivery for claim purposes, the value of the goods to the debtor, and payment requirements. The issue of timing of payment is perhaps the most difficult one for debtors to reconcile. If the debtor chooses to pay 503(b)(9) claims at the outset of the case, it invariably will not have sufficient cash to operate. If the debtor waits until confirmation to pay these claims, the cumulative administrative expenses of the case may prevent reorganization.

As with all administrative claims, an allowed 503(b)(9) claim must be satisfied in full by the debtor upon the effective date of a confirmed reorganization plan unless the claimant accepts other treatment. Prior to the 2005 amendment to the Code, a vendor who supplied product to the debtor immediately before the bankruptcy filing had to take fairly quick action to preserve its rights to assert an administrative claim.

A vendor was previously forced to send an insolvent debtor a reclamation demand for return of the unpaid goods within 10 days (expanded to 45 days under the amended Code) after the debtor received the goods. Uniform Commercial Code, Article 2, § 702; 11 USC § 546(c). The notice period is extended to 20 days in the event of a bankruptcy filing, provided that the original period has not expired as of the date of the filing.

If timely reclamation notice was given by the vendor to the debtor, the debtor would then have the opportunity to return the goods to the vendor. If the goods were not returned, the vendor could then assert an administrative claim in the bankruptcy proceeding for the goods. However, vendors were often unaware of such rights. Frequently, debtors would contest these claims, even where the vendors had asserted them in a timely fashion, arguing that the goods were otherwise subject to a paramount secured claim or that the debtor was not insolvent when the goods were delivered.

Section 503(b)(9) essentially streamlines the administrative claims process by requiring a vendor with a legitimate 20-day reclamation claim to file only written proof of its administrative claim in the bankruptcy proceeding with a request for payment. The legislative history behind section 503(b)(9) “suggests that it was aimed at providing relief to sellers of goods who fail to give the required notice under the reclamation provisions of section 546(c).” In re Brown & Cold Stores,

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In Bookbinders, 2006 WL 385240, the court determined that the debtor must make immediate payment of an asserted §503(b)(9) claim. The court noted that the evidence presented by the debtor demonstrated that the debtor had insufficient cash to pay all allowed §503(b)(9) claims and did not have sufficient borrowing ability to pay such claims. The debtor’s principal testified that if the debtor were required to pay all §503(b)(9) claims in full, its “reorganization efforts would collapse.”

Under the amended Section 503(b)(9), the typical Chapter 11 debtor is faced with the dilemma of arguing poverty early on in its reorganization case, knowing that eventually it must have sufficient cash resources at the time of confirmation to pay all of its §503(b)(9) claimants in full. This dilemma presents a particularly difficult issue for debtors who previously (under the pre-2005 amendments to the Code) may have limited their exposure to reclamation-type administrative claims as a result of the difficult burden placed on the reclamation creditor to preserve its administration claim, as well as viable defenses available to the debtor against these claims as detailed above. Now, the debtor must either scrap its cash reserves early in the case in order to pay §503(b)(9) claims or toil in the reorganization proceeding knowing that a plan cannot be confirmed absent the §503(b)(9) claimants being paid in full on the effective date of the plan or those claimants accepting other treatment of their allowed claims.

A debtor can seek to limit the number of §503(b)(9) claims by requesting the
court to enter an order setting a bar date for filing of 503(b)(9) claims. See In re Dana Corp., 2007 WL 1577763 (Bankr. S.D.N.Y.). Claims filed beyond the bar date after notice are routinely disallowed.

Another potential option for an operating debtor would be for it to escrow cash over time during the case for the eventual payment of allowed 503(b)(9) claims on the effective date of the confirmed plan. Resistance to this concept will come from secured lenders and other claimants who may have superior (or co-equal) interests in the cash being escrowed. This procedure necessarily reduces the amount of cash for the debtor’s ongoing operations. It also subjects the debtor to claims at the end of the case by other unpaid administrative claimants asserting rights to the escrowed funds.

Ultimately, the dilemma will have the unfortunate effect of preventing some small to midsized companies from reorganizing. They simply will not have the cash available to pay 503(b)(9) administrative claims at the outset of the case or generate sufficient cash to pay these claims during the case. In the end, a debtor’s ability to find acceptable exit financing to emerge from a Chapter 11 proceeding will be even more difficult with the increased cash requirements created by Section 503(b)(9).