

Signed, Sealed and Delivered... but not Received?

Reconsidering the Definition of “Receipt” Under Section 503(b)(9) of the Bankruptcy Code in Drop-Shipping Cases

Gina M. Young

“Drop-Shipping” and Its Appeal

“Wholesaler” supplies goods to “Online Retailer,” who in turn sells those goods to end consumers. To save on costs, Online Retailer does not keep all of the goods it sells stocked in its own warehouses. Instead, when a customer goes to Online Retailer’s website to order Wholesaler’s product, Online Retailer notifies Wholesaler who fulfills the order by sending the product directly to the customer.

In this transaction, Online Retailer paid Wholesaler, the customer bought the goods from Online Retailer, then Wholesaler shipped the goods to the customer. Or, in the alternative, the Online Retailer might pay the Wholesaler after the Wholesaler has shipped the goods to the customer. These are typical “drop-shipping” arrangements, and while the concept has been around for over half a century, its popularity has exploded in the last 10 years.

Drop-shipping is a major boon to the retail industry because it is profitable for all parties. Wholesaler has more exposure in selling its goods and Online Retailer does not have to incur the cost of warehousing hundreds of thousands of products or even physically handle many of the goods it sells.

Section 503(b)(9) of the Bankruptcy Code and Drop-Shipping

Section 503(b)(9) of the Bankruptcy Code 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.” (emphasis added).

Restated, a wholesaler receives administrative priority payment for goods delivered to a bankrupt retailer in the 20 days prior to the retailer’s bankruptcy petition. That wholesaler will, in most cases, receive 100% payment for those “20-day” goods, when it will likely receive pennies on the dollar on the rest of what it might be owed by the retailer.

So, if a wholesaler in Lexington ships a good to a retailer in Oakland in the 20 days prior to the retailer’s bankruptcy, the wholesaler is likely to get paid in full for those goods, even if the retailer ships them back to a consumer in Louisville. This is basic and non-controversial.

Here is the catch for drop-shipping: if the wholesaler ships the goods directly from Lexington to the end consumer in Louisville in the 20 days prior to the retailer’s bankruptcy,

without routing them through Oakland, that wholesaler *does not* have a section 503(b)(9) claim, and instead will only be paid pennies on the dollar for the value of those goods.

Under current case law, our Wholesaler has no recourse under section 503(b)(9) because the Online Retailer never took physical possession of the goods, and courts have found that physical possession is necessary for a 503(b)(9) claim. The only way Wholesaler could qualify for priority status is if every time a customer bought a product from Online Retailer, Wholesaler would re-route the shipment to make a pit stop at one of Online Retailer’s physical locations before continuing the journey to the customer. This outcome could diminish the appeal of the drop-shipping arrangement, and it does not align with Congress’s purpose of enacting section 503(b)(9), which was meant to offer more protection—and incentive—to trade creditors who provide goods to distressed companies.

As drop-shipping becomes more popular with the continued takeover of e-commerce, the application of section 503(b)(9) may need to be reevaluated to account for these unique debtor-creditor relationships. Without a course correction, drop-shippers could be forever excluded from section 503(b)(9) protection.

“Received” Under Section 503(b)(9)

Although section 503(b)(9) seems to be a simple statute, courts have had increasing difficulty interpreting its meaning when applied to drop-shipping agreements. Specifically, courts grapple with whether goods that a creditor, upon the debtor’s instruction, delivers to a third party in a drop-shipping transaction are deemed “received” by a debtor in determining whether the creditor has satisfied section 503(b)(9)’s requirements for obtaining priority status.

The definition of “received” has been widely analyzed by courts in relation to drop-shipping relationships. Because the term “receive” is not defined in the Bankruptcy Code, courts have interestingly hung their hats on certain sections of the Uniform Commercial Code (UCC) to determine its meaning.

“Receipt” Under the Uniform Commercial Code and Case Law

The UCC defines “receipt” with respect to goods as “taking physical possession of them.” Comment 2 to section 2-103 of the UCC expands on the definition of “receipt” by explaining that:

‘[R]eceipt’ must be distinguished from

delivery particularly in regard to the problems arising out of shipment of goods, whether or not the contract calls for making delivery by way of documents of title, since the seller may frequently fulfill his obligations to ‘deliver’ even though the buyer may never ‘receive’ the goods.

World Imports

The Third Circuit in *In re World Imports, Ltd.*, 862 F.3d 338, 346 (3d Cir. 2017) held that “receipt” in section 503(b)(9) requires physical possession of the goods by buyer or its agent. While not a drop-shipping case, the *World Imports* decisions has been instructive in such cases.

The creditors in *World Imports* shipped goods via common carrier from China to the debtor in the United States. The parties agreed that the goods were shipped and in the physical possession of the common carrier more than 20 days before the bankruptcy filing. The parties also agreed that the debtor took physical possession of the goods within the 20-day period. The parties disagreed over whether the debtor “received” the goods under section 503(b)(9) when the goods were placed on the common carrier or when the goods were delivered to the debtor within the 20-day period.

The bankruptcy and district courts held that the common carrier was an agent of the debtor and therefore the debtor constructively received the goods when the common carrier took physical possession of the goods. Because the common carrier took physical possession of the goods more than 20 days before the bankruptcy case was filed, the bankruptcy and district courts held that the creditors were not entitled to an administrative expense claim under section 503(b)(9).

In overruling the bankruptcy and district courts, the Third Circuit held that once the seller delivered the goods to the common carrier, the “receipt of the goods by a common carrier is not deemed constructive possession by a buyer, but rather is deemed to be possession by the common carrier.” Based on this analysis, the Third Circuit ultimately held that “received” in section 503(b)(9) requires physical possession by the buyer or his agent.

In re SRC Liquidation, LLC

Three days after the *World Imports* decision, the U.S. Bankruptcy Court for the District of Delaware analyzed the archetypal drop-shipping and section 503(b)(9) situation in *In re SRC Liquidation, LLC*, 573 B.R. 537 (Bankr. D. Del. 2017). In *In re SRC Liquidation, LLC*, the debtor and creditor had a “normal” buyer-seller relationship and a drop-shipping

relationship whereby the creditor sometimes shipped goods directly to the debtor, but other times, the creditor shipped goods directly to the debtor’s customers—at the debtor’s direction and by way of the debtor’s own United Parcel Service (UPS) account. The parties agreed that the creditor’s 503(b)(9) claim for the goods shipped directly to the debtor should be given priority.

The court, however, denied the creditor’s request for 503(b)(9) priority for the drop-shipped goods and held that a common carrier like UPS does not qualify as an agent of the debtor, and goods that are shipped directly to the debtor’s customer by its supplier using a common carrier were never physically possessed by the debtor or its agent. The court drew a bright line rule that only physical possession by either the debtor or its agent would suffice for granting section 503(b)(9) priority status.

The court analyzed and relied on sections 2-103(1)(c) (definition of “receipt”), 2-702 (reclamation rights) and 2-705 (stoppage rights) of the UCC in reaching its holding, but it interestingly ignored comment 2 of section 2-705, which defines “receipt by the buyer” to include receipt by the buyer’s sub-purchaser (more on this later).

An Alternative Interpretation of the UCC

There is an official comment in the UCC, however, that could be interpreted to permit “receipt” by a buyer that does not require physical possession. According to the UCC, although receipt means “taking physical possession,” comment 2 of section 2-705 of the UCC also allows the person taking physical possession to be either the buyer or the buyer’s bailee, designated representative, or sub-purchaser:

“Receipt by the buyer” includes receipt by the buyer’s designated representative, the sub-purchaser, when shipment is made direct to him and the buyer himself never receives the goods. It is entirely proper under this Article [Chapter] that the seller, by making such direct shipment to the sub-purchaser, be regarded as acquiescing in the latter’s purchase and is thus barred from stoppage of the goods as against him.

Because the UCC permits both actual, physical possession and constructive possession, it would stand that the application of section 503(b)(9) could be expanded and inclusive enough to protect creditors in drop-shipping agreements. However, the current case law on

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Demonstrate Your Support for Proposed Amendment to KRPC 8.4

The Louisville Bar Association’s Gender Equity Committee is pleased to announce that the KBA Rules Committee unanimously voted to approve proposed language to modify Rule 8.4 to address discrimination and harassment in the legal profession. The KBA Board of Governors will vote next month on the proposed rule change. If you would like to demonstrate your support for this important initiative, please [CLICK HERE](#) or e-mail lanspach@loubar.org to sign a letter of support or contact the KBA directly. ■

this issue ignores this language in the UCC and takes a much more restrictive approach to the definition of “receipt.”

Clarifying the Analysis of Section 503(b)(9) and Drop-Shipping Arrangements

Courts’ exclusive interpretation of section 503(b)(9) in drop-shipping arrangements directly conflicts with the purpose of the statute in protecting trade creditors. Although the Bankruptcy Code does not define “receive,” courts may have been too quick to apply only select sections of the UCC while ignoring more informative comments and avoiding the sections that create unreasonable outcomes.

For example, section 2-310(a) of the UCC governs payment terms in a sale transaction and provides that “payment is due at the time and place at which the buyer is to receive the goods...” (emphasis added). Applying the definition of “received” from past case law to this statute would lead to the curious conclusion that debtors in drop-shipping arrangements have no obligation under the UCC to pay suppliers for goods because the debtors never physically possess the goods. This outcome does not make sense and further supports a more inclusive interpretation of section 503(b)(9).

Instead of relying solely on the UCC, bankruptcy courts could perhaps create their own common-sense, blackline rule for these situations. For example, goods are deemed received by the debtor in drop-shipping arrangements when the customer receives the goods. This example can be universally applied to all drop-shipping arrangements, and the result is fair and equitable to both the debtor and the creditor.

If the courts continue to rely on the UCC provisions, all sections and comments should be considered, especially section 2-310(a) and comment 2 of section 2-705. Most courts ignore these provisions in their analyses even though they could provide direction in drop-shipping cases. Under comment 2 of section 2-705, customers would most likely be considered sub-purchasers of debtors and the outcome would be the same as suggested above—goods are deemed received by the debtor when the customer receives the goods.

Policy Implications

Courts have cited several policy reasons for their narrow interpretation of section 503(b)(9), including that a broad interpretation of the statute would create a new and potentially very large class of priority creditors that risks completely undermining the Bankruptcy Code’s general equitable principle that all unsecured creditors should be treated fairly and in the same manner. The case law that has spawned from this reasoning, however, creates a marked difference between “normal” trade creditors who are granted priority under section 503(b)(9) and drop-shipping creditors who

are excluded simply because their methods may not have been considered when Congress enacted section 503(b)(9). This outcome does not promote the principal of all similarly situated creditors being treated the same.

Courts also favor a narrow interpretation of section 503(b)(9) because it could favor reorganization. They reason that if the debtor must set aside a larger amount of money for priority claims, the debtor’s prospects for confirming a plan of reorganization would be diminished by a larger class of 503(b)(9) creditors. Again, this concern simply creates an outcome that does not treat similarly situated creditors fairly. Section 503(b)(9) was enacted to protect—and possibly provide an incentive—to those creditors that take the risk of extending credit to financially distressed buyers. The current case law does not support these ends.

J. C. Penney Company Inc.

The issue of priority treatment of drop-shippers is having practical effects on pending cases and the way they are being administered. In 2020, J. C. Penney Company, Inc., and its affiliates (J. C. Penney) filed for chapter 11 bankruptcy protection in the U.S. Bankruptcy Court for the Southern District of Texas, Corpus Christi Division, case no. 20-20182 (DRJ). While the case is still pending, several issues have arisen surrounding J. C. Penney’s drop-shipping program with a number of its suppliers.

Early in the case, J. C. Penney requested that it be allowed to continue its drop-shipping program and pay related pre-petition obligations. The court granted this relief, but interestingly, J. C. Penney later filed one of several omnibus objections to claims where it sought to reclassify several of its drop-shipping creditors’ 503(b)(9) claims from priority claims to general unsecured claims. Several creditors filed responses to these objections, but as of the writing of this article, the court has not ruled on these issues.

Conclusion

As drop-shipping arrangements become more popular, this issue will continue to resurface, and courts may need to clarify or reevaluate their analysis. If courts continue to rely on the UCC in these situations, all applicable sections of the UCC should be considered to reach more practical and equitable outcomes. Although it may make sense in theory to distinguish drop-shipping agreements from normal supply agreements, there is no equitable reason to exclude drop-shippers from section 503(b)(9) protection.

Gina M. Young is a member of Dentons Bingham Greenebaum’s Bankruptcy and Restructuring Group and Vice-Chair of the LBA’s Bankruptcy Section. ■



Louisville Association of Paralegals

Check out upcoming educational programs and special events on the Louisville Association of Paralegals website at www.loupara.org. The LAP offers joint membership with the Louisville Bar Association for voting members and joint LAP/LBA members may attend most LBA CLE programs at the discounted rate of \$15. To learn more about the benefits of LAP membership, visit www.loupara.org. ■

Women Lawyers Association

Women Lawyers Association will host a lunch meeting on Thursday, March 11 at noon. The meeting will be held over Zoom, due to the pandemic. Louisville Metro Councilman Anthony Piagentini will share and discuss his work with the Louisville Metro Council and what issues are likely to be before the Council in the upcoming year. There is no cost for the Zoom luncheons. Please send your RSVP to womenlawyersassociation@gmail.com. ■



LBA Section Meetings

HEALTH LAW SECTION HAPPY HOUR

Thursday, March 4 | 5:30 PM

Please join the LBA Health Law Section for this virtual happy hour, where section members will be able to get to know one another and discuss the hot topics we’ve been encountering in our practices. Attendees are encouraged to make their best cocktails or mocktails for this virtual event and share their recipes. In true Bluegrass fashion, cocktail recipes for this happy hour must include bourbon as an ingredient, while mocktails can include any non-alcoholic ingredients. At the end of the meeting, the section will vote on who brought the best mocktail or cocktail, and the winner will take home bragging rights and a small prize. See everyone there!

Section Chair: **Joshua Lee Stearns**, Steptoe & Johnson

Vice-Chair: **Patricia C. Le Meur**, Phillips Parker Orbersen & Arnett

FAMILY LAW SECTION HAPPY HOUR

Tuesday, March 9 | Noon

Join your colleagues for a time of networking and community during your lunch hour. Meeting will be held virtually on Zoom. A link will be e-mailed the morning of the meeting.

Agenda:

- I. Introduction, why we’re here
- II. Guest speaker Tom Mulhall with an overview of Warning Order Attorneys. Tom has been a Warning Order Attorney since 2008 and is on the Jefferson Circuit Court Clerk’s Training Committee
- III. What topics do family law attorneys want to know more about with co-chairs ideas?
- IV. What speakers would you like to hear from with examples of our ideas?
- V. What public services would they like to see the family law section participate in for 2021.
- VI. How often would they like to have section meetings?
- VII. Would they like to partner with another section and do a CLE with them? What sections?
- VIII. Questions or suggestions that were not covered

Section Chair: **Laura P. Russell**, Eddins Domine Law Group

Vice-Chair: **Macauley J. Campbell**, Kellner Green

PROBATE & ESTATE LAW SECTION

Tuesday, March 16 | Noon

Please join the LBA’s Probate & Estate Section for a meet and greet with the current Jefferson District Court probate judges. Our presenters include Judge Jessica A. Moore and Judge Kristina M. Garvey.

This virtual presentation will be held over Zoom. Judges will discuss the changes to the probate docket in wake of the COVID-19 pandemic, the “do’s” and “don’ts” of probate currently and will be taking questions from the section. Hope to see you there!

Section Chair: **Maria Tipton**, Stock Yards Bank & Trust

Vice-Chair: **Phillip A. Pearson**, Seiller Waterman

For a link to the meeting, register online at www.loubar.org or e-mail lanspach@loubar.org.

Guests are welcome to attend a meeting before joining the section. For reservations or to join a section, call (502) 583-5314 or visit www.loubar.org. ■