

■ CURRENT HOT CHAPTER 11 ISSUES FACING TRADE CREDITORS

Presentation for:

Rierner Conference 2018

Sponsored By Rierner Reporting Service

**Hyatt Centric French Quarter
New Orleans, LA**

April 26, 2018



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Section 503(b)(9) “20 Day” Administrative Priority Claims

- Administrative Claim for the Value of Goods Debtor Received Within 20 Days of Bankruptcy Filing
- 20 Day Goods Must be Sold to the Debtor in the Ordinary Course of Debtor’s Business
- Safety Net for Trade Creditors that Supply Goods Not Services!
 - Replaces reclamation as effective trade creditor remedy

Assertion of “20 Day” Goods Administrative Claims And Timing Of Payment

- General Rule – Section 503(b)(9) Request/Allowance Requires Notice and a Hearing
 - No automatic administrative claim without court approval
- No Federal Bankruptcy Rule Specifying Manner In Which To Assert Section 503(b)(9) Priority Claims
- *In re Richfield Equities*, Bankruptcy Court, Eastern District of Michigan Required Assertion of Section 503(b)(9) Priority Claim by Motion
 - Rejects assertion of Section 503(b)(9) claim via proof of claim
- Timing of Payment - Most Courts Have Rejected Immediate Payment Over Debtor’s Objection
 - Instead Payment Upon Confirmation of Plan or Earlier if Motion to Pay Section 503(b)(9) Claim is Filed

Deadline to Assert “20 Day” Goods Administrative Claims

- **No Deadline to Assert Section 503(b)(9) Claim in Statute**
 - **Local Bankruptcy Rules May Create Deadline**
 - U.S. Bankruptcy Court, Eastern District, Michigan
 - Local Bankruptcy Rule 3003-1 – Deadline to file proof of claim, or § 503(b)(9) motion in chapter 11 case: 90 days after first date set for Section 341 meeting of creditors
 - U.S. Bankruptcy Court, District of Massachusetts
 - Local Bankruptcy Rule 3002-1 – Deadline to file request for allowance of § 503(b)(9) claim: 60 days from first scheduled 341 meeting date

Deadlines/Assertion Re “20 Day” Goods Administrative Claims

- **Courts Are Also Setting Deadlines for Asserting Section 503(b)(9) Priority Claims**
 - One deadline to file claims that includes Section 503(b)(9) priority claims and all other general unsecured claims
 - Alternate deadline: Separate deadline for asserting Section 503(b)(9) claims
- **Courts Are Also Prescribing Manner of Asserting Section 503(b)(9) claims, either**
 - On the same claim form as the creditor’s general unsecured claim
 - most recent example: Toys “R” Us, Inc.
 - or-
 - On a special proof of claim form solely related to Section 503(b)(9) claims

One Of Section 503(b)(9)'s Most Frequently Litigated Issues: Meaning Of Receipt Of Goods

- Section 503(b)(9) does not define “Receipt”
- Actual Possession (UCC)?
 - UCC-2(103)(1)(c)
 - “Receipt of goods means taking physical possession of them”
- Constructive Possession?

One Of Section 503(b)(9)'s Most Frequently Litigated Issues: Meaning Of Receipt Of Goods

- Drop Shipment?
 - Creditor ships goods to third party at Debtor's instruction
 - Debtor's agent
 - Debtor's customer
 - Debtor never had actual physical possession of goods

Recent Decision of U.S. Court of Appeals For Third Circuit in *In re World Imports, Ltd.*: Goods “Received” Upon Physical Possession

- “Received” in Section 503(b)(9) Means Debtor’s or Its Agent’s Actual Physical Possession of Goods
 - Reversed lower court rulings that a debtor “received goods” upon delivery to common carrier based on FOB (Free on Board) port of shipment (in China)
 - Rejected applicability of Convention of Contracts for the International Sale of Goods

Recent Decision of U.S. Court of Appeals For Third Circuit in *In re World Imports, Ltd.*: Goods “Received” Upon Physical Possession

- Court Relied on Dictionary Definitions of “Receive”, Uniform Commercial Code Definition of “Receipt” and Old Third Circuit Case Law Dealing With How Reclamation Rights Required Physical Possession
- Receipt Does Not Occur Until Termination of Seller’s Ability to Stop Delivery of Goods
 - Upon debtor’s/agent’s actual physical possession of goods
 - Who qualifies as an agent? Common carrier?
- Third Circuit’s Ruling is Beneficial to Trade Creditors (Goods Sellers)
 - Delayed occurrence of “receipt” of goods might increase the amount of goods received within Section 503(b)(9)’s 20 day window, particularly for goods being imported from outside U.S.

■ Receipt Of Goods: Drop Shipment

- *In re Momenta, Inc.* – U.S. District Court New Hampshire affirming U.S. Bankruptcy Court Decision—
 - Receipt includes buyer’s physical **or** constructive possession of goods
 - Buyer does not obtain constructive possession of goods that are delivered to buyer’s customer under drop shipment arrangement
 - Constructive possession narrowly interpreted to occur upon proof of receipt of goods by buyer’s agent
 - Adopted Black’s Law Dictionary definition of “drop shipment delivery” as a “manufacturer’s shipment of goods directly to the consumer rather than initially to a wholesaler”

■ Receipt Of Goods: Drop Shipment

- *In re World Imports* – U.S. Bankruptcy Court, Eastern District of Pennsylvania
- Creditor “Drop Shipped” Goods to Debtor’s Customers
- Followed *Momenta* Decision In Holding That Debtor Did Not Receive Drop Shipped Goods
- Creditor’s Section 503(b)(9) Priority Claim re Drop Shipped Goods Denied

Recent Drop Shipment Decision Re: Receipt of Goods

- *SRC Liquidation LLC (f/k/a Standard Register)* – U.S. Bankruptcy Court, Delaware
- Court Denied Section 503(b)(9) Priority Status to Seller that Delivered Goods to a Common Carrier for Shipment to Debtor’s Customer During the 20 Days Before the Debtor’s Chapter 11 Filing
 - Court relied on Third Circuit’s *World Imports* ruling
 - Neither debtor nor debtor’s agent took physical possession of the goods
 - Common carrier was not debtor’s agent

Recent Drop Shipment Decision

- A Contrary View
- None of the Drop Shipment Decisions (*Momenta*, *World Imports* and *SRC Liquidation*) Considered Official Comment 2 to Section 2-705 of the Uniform Commercial Code Which States:

“[r]eceipt 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.”
- *In re ADI Liquidation Inc. (formerly known as Associated Wholesalers Inc./White Rose)* – Recent U.S. Bankruptcy Court, Delaware Decision Rejected This Argument in Analogous Case Involving Seller, Debtor Coop, and Coop Members

■ Receipt Of Goods: Drop Shipment

- Can “Receipt” Be Defined in Parties’ Agreement to Occur Upon Buyer’s Customer’s Receipt of the Goods?
- Suggested Language: “Receipt of any product by buyer shall immediately occur when buyer, buyer’s bailee or other agent or designee receives either actual or constructive possession of such product. Constructive possession shall include, without limitation, receipt by an entity or individual (including, without limitation, buyer’s customer) pursuant to a drop ship instruction or other delivery instructions from buyer. Constructive possession specifically does not require actual physical possession by the buyer.”
- No Reported Court Decision that Allows “Contracting Around” Definition of “Receipt”

■ Debtor’s Setoff Rights As A Defense To Section 503(b)(9) Priority Claims

- Chapter 11 Debtors Have Successfully Offset Pre-Petition Credits, Deductions, Chargebacks, Overpayments, Rebates, and Similar Claims Against a Creditor First In Reduction of the Amount Owed to a Creditor on their Section 503(b)(9) Priority Claims Instead of their Less Valuable General Unsecured Claims

Debtor's Setoff Rights As A Defense To Section 503(b)(9) Priority Claims

- *Circuit City Stores* (Bankruptcy Court, Eastern District of Virginia) and *In re ADI Liquidation, Inc.* (Bankruptcy Court, District of Delaware) Decisions
 - Debtor permitted to setoff pre-petition credit claims in reduction of Section 503(b)(9) priority claims
 - The courts invoked a little known Bankruptcy Code Section 558:
 - “The estate shall have the benefit of any defense available to the debtor...”
 - The Debtor could also offset pre-petition credits claims against creditors’ unpaid post-petition administrative claims — VERY DANGEROUS!
 - Post-petition credit should be conditioned on Debtor’s agreement not to deduct pre-petition credits and other related claims

Debtor's Setoff Rights As A Defense To Section 503(b)(9) Priority Claims

- Proposed Contractual Fixes
 - “Buyer waives right to assert pre-petition credits, deductions, chargebacks, overpayments, rebates and similar claims if buyer is “not in good standing” with Seller (i.e., Buyer is past due or otherwise in default; out of business)”
 - “Buyer waives the right to assert any right of setoff, recoupment or any other defense with respect to any credits, deductions, chargebacks, overpayments, rebates and similar claims that Seller owes Buyer to reduce Buyer’s indebtedness to Seller”

Debtor's Setoff Rights As A Defense To Section 503(b)(9) Priority Claims

- Proposed Contractual Fixes (continued)
 - “Seller shall be permitted to apply all credits, deductions, chargebacks, overpayments, rebates and similar claims owed to the Buyer in reduction of indebtedness owing by the Buyer to Seller as determined by Seller at its sole discretion.” (e.g., apply credits against oldest invoices first)
 - Enforceability of proposed provisions on screens 16 and 17 in bankruptcy? No reported decision addresses this
 - Note following caveat in AWI opinion:

“...I conclude that there is a presumption that the claimants’ prior course of dealing, industry standards and *contract* do not operate as a waiver of the Debtors’ equitable remedies. However, if a claimant believes that its course of dealing or contractual language provide a good faith basis for arguing that the Debtors have waived their equitable remedies, then the claimant shall have the right to a hearing on the merits of their claim to rebut the presumption.”

Preference Claim As Grounds For Disallowance Of Administrative Priority Claim (Section 502(d) of the Bankruptcy Code)

- The Courts Are Divided Over Whether a Preference Claim Can be Invoked to Disallow a Section 503(b)(9) Priority Claim
- One View: Preference Claim Not Grounds for Disallowance of Section 503(b)(9) Priority Claim
 - *In re Energy Conversion Devices, Inc. and Plastech Engineered Products, Inc.* – U.S. Bankruptcy Court, Eastern District of Michigan decisions
 - *In re TI Acquisition LLC* – U.S. Bankruptcy Court, Northern District of Georgia
 - *In re Momenta, Inc.* – U.S. Bankruptcy Court, New Hampshire
- Contrary View: Debtor could assert preference claim as basis for temporarily disallowing Section 503(b)(9) priority claim
 - *In re Circuit City* – U.S. Bankruptcy Court, Eastern District, Virginia

■ Preference: Elements Of Claim

- Any Transfer of an Interest of the Debtor in Property;
- To or for the Benefit of a Creditor;
- On Account of an Antecedent Debt Owed by Debtor Before Transfer;
- Made While the Debtor was Insolvent;
 - On or within 90 days before bankruptcy filing; or
 - Between 90 days and one year before bankruptcy filing for transfers to insider creditors; and
- That Enables Such Creditor to Receive More Than Such Creditor Would Receive if:
 - The case were a Chapter 7 case;
 - The transfer had not been made; and
 - Such creditor received payment to the extent provided by other provisions of Title 11.
 - The greater than liquidation recovery requirement

■ Preference Elements

- Cash-In-Advance Payment Not a Preference
 - No antecedent debt
- Letter of Credit (“L/C”) Payment Not From Property of Debtor
- Debtor’s Payment by Credit Card is From Property of Debtor and Subject to Preference Risk
- Creditor Fully Secured by Debtor’s Assets or Paid from Collateral Proceeds Not Subject to Preference Risk
- Creditor Whose Executory Contract or Unexpired Lease Was Assumed by Debtor Not Subject to Preference Risk
- Creditor Who Receives a Critical Vendor Payment or Other Frist Day Order Payment is Subject to Preference Risk

■ Preference Defenses: Contemporaneous Exchange For New Value (COD)

- Transfer was *Intended* by Debtor and Creditor to be Contemporaneous Exchange for New Value; and
- Transfer was Substantially Contemporaneous Exchange
- Examples:
 - COD transaction: check tendered for delivery of goods
 - Risk of bounced COD check; replacement payment not subject to this defense

■ Preference Defenses: New Value

- Creditor Extending Credit to Debtor After Payment, that was Not Secured and Not Paid by Otherwise Unavoidable Transfer
- Goods Shipped/Services Provided on Credit Terms Following Payment Reduce Preference Exposure
- New Value Cannot Be Applied to Subsequent Payments

■ Preference Defenses: Paid For New Value

- Paid for New Value May Count to Reduce Preference Exposure
- U.S. Circuit Courts of Appeal are Divided on Whether Paid New Value Counts, though Trend is Toward Allowing Paid New Value:
 - 4th, 5th and 9th say Yes!
 - 7th and 11th say No!
 - 3rd Circuit's prior "No" is now in question – Likely open
 - 8th goes both ways
 - Other Circuits open

■ Preference Defenses: Evolution Of Paid New Value Defense – 3rd Circuit

- U.S. Court of Appeals for 3rd Circuit in *In re Friedman's* Held Its Prior Statement in *New York City Shoes* that New Value Must Remain Unpaid Is Dicta and Not Binding
- Suggests 3rd Circuit is Open to Allowing Paid New Value

■ Delaware Decisions Allowing Paid For New Value

- *In re AFA Investment, Inc.* – U.S. Bankruptcy Court, Delaware Decision Allowed Paid New Value
- *In re Proliance International Inc.*
 - 2014 U.S. Bankruptcy Court, Delaware decision to allow paid new value as preference defense
 - Expanded new value defense by allowing paid new value without regard to the applicability of other preference defenses to the paid new value
- *In re Pillowtex Corporation*
 - 2009 U.S. Bankruptcy Court, Delaware decision that also allowed paid new value

■ Critical Vendor Preference Risk

- Does Critical Vendor's Receipt of Post-Petition Payment of *Pre-Petition* Claim Result in Loss of Section 547(c)(4) New Value Defense to Preference Claim?
 - U.S. Court of Appeals 3rd Circuit Decision – *In re Friedman's* counts new value paid post-petition pursuant to court order because new value is determined as of bankruptcy filing date – A snap shot as of the petition date.
 - Other U.S. Circuit Courts of Appeal have not ruled on this issue
 - Other lower courts have disqualified new value paid post-petition
 - Suggestion: Critical vendor order should either release preference claims against vendor or preserve new value defense
 - Might be hard to obtain, unless creditor has great leverage

Is Paid Section 503(b)(9) Claim Eligible As New Value?

- Yes: *In re Commissary Operations, Inc.* U.S. Bankruptcy Court, Middle District of Tennessee
 - New value window closes on bankruptcy filing date (same ground cited by 3rd Circuit court in *In re Friedman's*)
 - New value defense not impacted by post-petition payments of new value
 - Section 503(b)(9) claims impaired if excluded from new value defense

Paid Section 503(b)(9) Claim Is Not Eligible As New Value

- No: *In re Circuit City Stores* (U.S. Bankruptcy Court, Eastern District of Virginia) and *In re TI Acquisition LLC* (U.S. Bankruptcy Court, Northern District of Georgia)
- Paid Section 503(b)(9) Priority Claim Does Not Satisfy Section 547(c)(4)'s Requirement That "The Debtor Did Not Make An Otherwise Unavoidable Transfer To or For the Benefit of Such Creditor"
- Creditor Gets a Double Dip If It Can Use Fully Paid/Funded Section 503(b)(9) Claim As Part Of Its New Value Defense

New Value Paid By Third Party – e.g., Credit Insurance

- *Unsecured Creditors Committee of Sparrer Sausage Company vs. Jason's Food, Inc.*
- Bankruptcy Court, Northern District of Illinois Held Defendant's New Value Defense Was Not Reduced Where Credit Insurance Paid Down New Value Invoices

Impact Of Letter Of Credit Payment on New Value Defense

- *In re All American Semiconductor* – U.S. Bankruptcy Court, Southern District of Florida
 - Trustee asserted \$4.9 million preference claim against defendant Samsung Semiconductor
 - Samsung asserted approximately \$4.1 million new value defense
 - Shortly before bankruptcy filing, Samsung drew down on \$1 million L/C and applied proceeds as partial payment of claimed new value
 - L/C issuing bank applied \$1 million L/C payment against cash collateral securing payment of Debtor's reimbursement obligation on L/C

Impact Of Letter Of Credit Payment on New Value Defense

- *All American Semiconductor* court held that Samsung's New Value Defense Must Be Reduced By \$1 million L/C Payment
- Relied on 11th Circuit Court of Appeals' Precedent that New Value Must Remain Unpaid
- Net Effect Of Samsung's L/C Draw Left Debtor's Estate in Same Position as if No New Value Extended
 - Allowing new value in these circumstances confers an undeserved windfall on Samsung
- Suggestion:
 - Apply L/C draw proceeds against invoices not subject to new value or other defenses

Ordinary Course Of Business Preference Defense

- Transfer Was in Payment of a Debt Incurred by the Debtor in the Ordinary Course of Business or Financial Affairs of the Debtor and the Creditor; and
- Subjective Test – Made in the Ordinary Course of Business or Financial Affairs of the Debtor and the Creditor; OR
- Objective Test – Made According to Ordinary Business Terms
- Creditor Can Choose Most Beneficial (Subjective or Objective) Prong of Ordinary Course of Business Defense

Subjective Component of Ordinary Course of Business Defense

- Courts Have Been Inconsistent and Unpredictable in Applying Subjective Component of Ordinary Course of Business Defense
- Each Side Can Pick a Methodology to Support its Position
- Encourages Expensive Litigation

Ordinary Course of Business: Subjective – Litigated Issues

- Range of Views
 - How long of a payment history?
 - 1 Year?
 - 2 Years? Bankruptcy Court, Southern District, New York decision: *Quebecor World*
 - Longer?

Ordinary Course of Business: Subjective – Baseline for Comparing Preference vs. Prior Payment

- Range of Payments
 - All payments?
 - Modified range?
 - Payments only when Debtor is healthy? (*Circuit City* Bankruptcy Court decision in Eastern District, Virginia)
- *Sparrer Sausage Co.* – 7th Circuit U.S. Court of Appeals Decision
 - 7th Circuit rejected Bankruptcy Court's use of historical (pre-preference period) baseline of only 64% of invoices paid
 - Court accepted historical baseline of 88% of invoices paid (more generous to creditor)
 - Like *Circuit City*, did not overturn Bankruptcy Court's refusal to consider payments within 7 months of start of preference period when the Debtor was not "financially healthy"

Ordinary Course of Business: Subjective – Baseline for Comparing Preference vs. Prior Payments

- Comparison of Average Days to Pay/Days Late Prior to and During Preference Period
- *Archway Cookies* Bankruptcy and District Court decisions in Delaware –
 - Payments subject to subjective ordinary course defense, notwithstanding approximately 5 day difference in average days to payment during historical period (42.3 days) compared to preference period (47.2 days)
- Bucket Analysis – Examining Payments by Grouping – Accepted – *Quebecor World*, Bankruptcy Court, Southern District of New York
 - Risk of skewed analysis

Sierra Concrete Design Inc.; United States Bankruptcy Court, Delaware: Comparing Preference vs. Prior Payments

- *Quebecor World*, Bankruptcy Court, Southern District of New York – Subjective Ordinary Course of Business Defense Inapplicable
 - 30 days off average [27.56 average days outstanding prior to preference period vs. 57.16 average days outstanding during preference period] too much
 - Court relied on weighted average – not disputed
- *Sierra Concrete Design*, Bankruptcy Court, Delaware - Defendant Proved Subjective Ordinary Course of Business Defense After Trial
 - Did not matter that debtor paid invoices 27.9 days faster during preference period
 - Average days-to-pay prior to preference period was 55.22 days
 - Average days-to-pay during preference period was 27.3 days

First Time Transactions May Fall Within Subjective Ordinary Course of Business Defense

- Recent Decision of U.S. Court of Appeals for 10th Circuit – *In re C.W. Mining Co.*
 - Payment on account of first time transaction between debtor and creditor might satisfy the subjective part of ordinary course of business defense
 - Payment made 2 days before due date (within terms)
 - No evidence of creditor collection activity
- 6th, 7th and 9th Circuits Agree

Subjective Ordinary Course of Business Preference Defense – Facts That Defeat Subjective Ordinary Course of Business On the Numbers

- Consistency In Timing of Payments Prior to and During Preference Period Alone Might Not Be Sufficient to Prove Subjective Component of Ordinary Course of Business Defense
- Threats to Subjective Component
 - Change in the form of payment during preference period (regular check to wire, ACH, etc.)
 - Change in method of invoicing (electronic to paper)
 - Change in credit terms
 - Imposition of credit limit/enforcement of existing credit limit
 - Threats to stop shipment; imposition of credit holds
 - Change in mode of delivery (regular mail to Federal Express or hand delivery)

Ordinary Course Of Business Preference Defense – Ordinary Business Terms Alternative: Objective Component

- Proof Requirement Is Currently Evolving
- General Standard? Transfer Was Not So Unusual or Idiosyncratic As To Render It An Aberration In The Relevant Industry
- Which Industry to Consider?
 - Creditor's industry?
 - Debtor's industry?
 - Industry based on companies similar to creditor selling to companies similar to Debtor?
 - General business standards/sound business practice?

Ordinary Course Of Business Preference Defense – Ordinary Business Terms Alternative: Objective Component

- Includes Range of Industry Terms
 - No need to prove single set of business terms within an industry
 - Ordinary Business Terms may vary widely across industries
- Creditor's Changing of Business Terms Does Not Necessarily Result in Loss of Objective Ordinary Course of Business Defense
 - Are new terms frequently used in industry?

Ordinary Course Of Business: Objective (Ordinary Business Terms)

- Proper Methodology For Determining A Payment's Consistency with Industry Practices is Evolving
- Example: *In re Waterford Wedgewood, Inc.* (Bankruptcy Court, Southern District of New York)
 - Proper method for determining whether a payment is made in accordance with ordinary business terms: whether payment occurred within one standard deviation of the industry average
- Contrast with *Hayes Lemmerz International Inc.* (Bankruptcy Court, Delaware)
 - Court rejected expert testimony proffered by Trustee limiting industry practice to median range of payments for middle 50% of surveyed companies

■ Ordinary Business Terms Information Sources

- Credit Research Foundation – National Summary of Domestic Trade Receivables
- Risk Management Association
- S&P Capital IQ
- D&B Industry Reports
- CreditRiskMonitor (www.crmz.com)
- Trade Associations / Trade Credit Groups
- NACM Expert Witnesses
- American Society of Association Executives (www.asaenet.org)
- Thomson Reuters Expert Witness Services
- Outside expert witness services
- Lay witness with either:
 - Specific knowledge of industry practices, or
 - Objective information gained outside subjective experiences as employee of creditor/defendant.

■ Another Preference Defense

- Delaware Bankruptcy Court Decision: *Quantum Foods*
 - Court approved, apparently for first time, a creditor's setoff of its unpaid allowed Chapter 11 administrative expense claim for goods sold and delivered post petition to reduce creditor's preference liability on a dollar for dollar basis
 - Both creditor's administrative claim and preference claim against the creditor arose post-petition satisfying mutuality requirement for setoff
- Conflicting Holding Rejecting Setoff Preference Defense – *1984 Georgia Steel Holding* – Bankruptcy Court, Middle District of Georgia

■ Involuntary Bankruptcy Petition

- Three or More Petitioning Creditors Have Unsecured Claims
 - Not contingent
 - Not subject to a bona fide dispute as to
 - Liability or
 - Amount
 - Totalling not less than \$15,775 (for bankruptcy cases filed on and after 4/1/2016)
 - Debtor has 12 or more unsecured creditors
- If Debtor Has Fewer than 12 Unsecured Creditors, Excluding, Employees, Insiders, and Transferees of Voidable Transfers (e.g., Preference Claims) Only One Petitioning Creditor With Claim of At Least \$15,775 is Required

■ Involuntary Bankruptcy Petition

- Meaning of Bona Fide Dispute
 - Recent holding of U.S. District Court, Nevada in *In re Blixreth* – Petitioning Creditor’s Eligibility Requires that its Claim is Entirely Undisputed
- Petitioning Creditors Must Prove Debtor Generally Not Paying Debts as They Become Due
- Successful Petitioning Creditors Awarded Order For Relief and Can Seek Recovery of Fees (Subject to Court Approval)

■ Involuntary Petition Sanctions Upon Dismissal

- Unsuccessful Petitioning Creditors Could Be Directed to Pay Debtor's Costs and Attorneys' Fees in Defending Involuntary Petition
 - No bad faith prerequisite
- Petitioners' Bad Faith Filing Could Also Subject Them To:
 - Debtor's actual damages arising from involuntary bankruptcy filing
 - Punitive damages
 - Could be substantial dollars
- Discourages Creditors From Joining in an Involuntary Petition Without Doing Appropriate Diligence

■ When Is An Involuntary Petition The Preferred Tool?

- Means of Preserving Section 503(b)(9) Administrative Priority Claims for Goods a Debtor Received Within 20 Days of Bankruptcy Filing
- Means of Attacking Improper Sales on Eve of Bankruptcy Based on Fraudulent Conveyance Claim
 - E.g., Debtor recently sold business/significant assets at unreasonably low price
 - Sweetheart insider deal
- Preserve Fraudulent Transfer and Preference Claims (*E.g.*, *Caesars* Bankruptcy Case)
 - Dividends/Stock redemption payments within 2+ years
 - Large payments to insiders within expanded 1 year preference period
 - Large payments to favored trade creditor(s)
 - Secured lenders obtained additional collateral or fixed mistakes during 90 day preference period

■ Consignment

- A Transaction Where a Vendor, Consignor, Delivers Goods to a Buyer, Consignee, for Sale or Use:
 - Vendor/consignor retains title to goods until the buyer/consignee either sells or uses the goods
 - Generally, consignor issues an invoice, containing payment terms, to the consignee after consignee's reported sale or use
 - Requires UCC filing and compliance with UCC Article 9
 - Priority over prior perfected security interest in inventory by following rules for superpriority status
 - Signed consignment agreement
 - UCC Filing before consignee's receipt of goods
 - Authenticated written notification to prior secured inventory creditors
 - Good for 5 years

■ Consignment

- Delivery of Goods Having a Value of At Least \$1,000 to Merchant for Sale Provided:
 - No security interest created in consigned goods
 - Goods not consumer goods prior to delivery; and
 - Merchant deals in goods of that kind under name other than that of consignor, is not auctioneer and is *not generally not known by creditors to be substantially engaged in selling goods of others*

■ Consignment – Risks to Consignor

- Unperfected Consignment Does Not Have a Higher Priority Than Unsecured Trade Credit
- Failure to Follow UCC Article 9 Requirements For Obtaining Priority Status In Consigned Goods
 - Consignee's secured creditor with a prior perfected blanket security interest in consignee's inventory has interest in consigned goods
- Need to Monitor Consignee For Name Change, Merger, Change in Business Structure
- Must Monitor/Verify Consignee Sales and Payments
- Must Monitor Location of Consigned Goods
- Must Be Able to Identify Consigned Goods – Commingling Risk
- Identification of Cash Proceeds?

■ Risks to Consignor

- Consignment May Violate Consignee's Agreement With Secured Lender or Limit Availability on Secured Creditor Line
- Only Covers Future Shipments After Perfection, Not Prior Shipments
- Priority Status
 - Applies to only identifiable purchase money/consigned goods and "identifiable cash proceeds"
 - Does not apply to accounts as proceeds

Protecting Consignment Interest In Goods And Other Collateral When Debtor Files Bankruptcy – Automatic Stay

- Automatic Stay Prevents a Secured Creditor From:
 - Collecting pre-petition claim or
 - Recovering goods and other collateral subject to security interest
 - Unless the secured creditor obtains relief from the stay from the Bankruptcy Court

Protecting Consignment Interest In Goods And Other Collateral When Debtor Files Bankruptcy

- Section 552 – Post Petition Effect of Security Interest
 - (a) Security interest arising under pre-petition security agreement does not extend to debtor's post-petition assets
 - (b) Security interest arising under pre-petition security agreement extends to collateral in debtors' possession on petition date and to proceeds, products, offspring or profits
- Risk of Debtor's Use of Consigned Creditor's Goods and other Collateral in its Business Operations
- Risk of Loss of Consignment Interest Based on Debtor's Use of Consigned Goods Post-Petition

Protecting Interest In Consigned Goods When Debtor Files Bankruptcy

- Protected Priority Consignment Status Should Be Retained For Goods Delivered During Chapter 11 Cases
- Debtors Should Either Pay for Pre-Petition Consigned Goods Used/Sold by Debtor Post-Petition or Be Granted Replacement Lien Of Equivalent Value
- Bankruptcy Court Approval Necessary

Recent Consignment Issues In Bankruptcy: The *Sports Authority* Case

- Sports Authority Case Dealt With Consignments
- Most of Sports Authority's Inventory was Consigned Goods
- 170 Consignment Vendors
- Only a Handful of Consignment Vendors Had Validly Perfected Priority "Security Interests" in the Consigned Goods and Gave Required Notice for Priority Status
- At the Bankruptcy Court's insistence, Sports Authority Commenced Adversary Proceedings Against Each Consignment Vendor To Void Alleged Consignment Interest
 - Sports Authority's Term Lenders intervened in each adversary proceeding

■ Sports Authority Consignment Issues

- Sports Authority Sought to Sell Consigned Goods and Escrow Payments for the benefit of Consignment Vendors
 - Consignment vendors objected insisting that consignment vendors were to be paid immediately from sale proceeds
 - Objection by Term Lenders
- Court Granted Debtors' Motion to Sell Consigned Goods and Directed Payment to Consignment Vendors Pursuant to terms of Consignment Agreements
- Term Lenders Appealed and Sought Stay of the "Consignment Order"
- Both Bankruptcy Court and United States District Court Denied Term Lenders' Request for a Stay

■ Sports Authority Consignment Issues

- Sale of Debtors' Assets Under 11 U.S.C. 363 Continued While Appeals by Term Lenders and Consignment Vendors were Ongoing
- Appeals Sent to Mediation
- Most Consignment Creditors Settled

■ Sports Authority Consignment Issues

- Consignment Settlement Terms:
 - Most consignors received between 25% - 40% of the proceeds of the sale of their consigned goods due under their consignment agreements
 - A few consignors received 45% - 50% of proceeds due under their agreements
 - Release of preference claims against settling consignors

■ Sports Authority Consignment Issues

- Some Consignment Creditors Did Not Settle
- Bankruptcy Court Refused to Grant Judgment in Favor of Term Lenders
 - Issues of fact over existence of true consignment arrangement – whether Sports Authority was generally known to be selling the goods of others or term lenders knew of consignment arrangement, which would excuse UCC filing requirement
 - Litigation ongoing

■ Questions

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Bruce S. Nathan is a partner in Lowenstein Sandler's Bankruptcy, Financial Reorganization & Creditors' Rights Department. Bruce has over more than 35 years' experience in the bankruptcy and insolvency field, and is a recognized national expert on trade creditor rights and the representation of trade creditors in bankruptcy and other legal matters. Bruce has represented trade and other unsecured creditors, unsecured creditors' committees, secured creditors, and other interested parties in many of the larger Chapter 11 cases that have been filed. Bruce also handles letters of credit, guarantees, security, consignment, bailment, tolling, and other agreements for the credit departments of institutional clients.

Among his various legal recognitions, Bruce received the Top Hat Award in 2011, a prestigious annual award honoring extraordinary executives and professionals in the credit industry. He was co-chair of the Avoiding Powers Committee that worked with the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 and also participated in ABI's Great Debates at their 2010 Annual Spring Meeting, arguing against repeal of the special BAPCPA protections for goods providers and commercial lessors, and was a panelist for a session sponsored by the American Bankruptcy Institute. He is a frequent presenter at industry conferences throughout the country, as well as a prolific author regarding bankruptcy and creditors' rights topics in various legal and trade publications.



Education

- University of Pennsylvania School of Law (J.D., 1980)
- Wharton School of Finance and Business (M.B.A., 1980)
- University of Rochester (B.A., 1976), *Phi Beta Kappa*

Bar Admissions

- New York

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Partner, New York

RECENT PUBLICATIONS

- 1Q, 2018
[Trade Credit Insurance as Protection from Bankruptcy Preference Risk: Negotiating for the Broadest Coverage](#), *CRF News*
Bruce S. Nathan, James Stewart
- February, 2018
[A Chapter 11 Debtor's Right to Use Cash Collateral Trumps PACA Trust Rights](#), *Business Credit*
Bruce S. Nathan, Eric Chafetz
- January 2018
[The Subsequent New Value Preference Defense for Services: A Practical Approach](#), *Business Credit*
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- December 2017
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- September/October 2017
[Receipt under Section 503\(b\)\(9\) Means Physical Receipt: A Mixed Bag for Trade Creditors](#),
Business Credit
Bruce S. Nathan, Eric Chafetz

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Creditors' committees, trade creditors, and plan/liquidating trustees involved in complex bankruptcies regularly turn to Eric for strategic counsel on creditors' rights. He also represents secured creditors in connection with their use of cash collateral and related adequate protection issues, and he advises debtors on various phases of their reorganization efforts.

Eric frequently negotiates:

- Cash collateral and debtor-in-possession (DIP) financing orders
- Bid procedures, bid procedures orders, sale orders, and the underlying corporate transaction documents
- Plans of reorganization, liquidation trust agreements, plan supplements, plan support agreements, and rights offering procedures

Additionally, Eric advises clients on their rights associated with the assumption and assignment of executory contracts and the cure amounts associated therewith.

Eric is well-versed in all aspects of the claims resolution and reconciliation process. Clients benefit from his extremely successful track record in investigating and prosecuting actions against officers, directors, and lenders, as well as in prosecuting and defending hundreds of preference actions.

A leader in his field, Eric participated in the American Bankruptcy Institute (ABI) Commission's Avoidance Power Subcommittee's study of the aspects of the Bankruptcy Code involving preferences, creditors' reclamation rights, and creditors' rights under Section 503(b)(9). Eric is also a prolific author and has published numerous articles addressing various cutting-edge issues in journals geared toward trade creditors.



Education

- Brooklyn Law School (J.D. 2004), cum laude
- University of Michigan (B.A. 2000)

Bar Admissions

- New York
- New Jersey

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RECENT PUBLICATIONS

- February, 2018
[A Chapter 11 Debtor's Right to Use Cash Collateral Trumps PACA Trust Rights](#), *Business Credit*
Bruce S. Nathan, Eric Chafetz
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- September/October 2017
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Business Credit
Bruce S. Nathan, Eric Chafetz

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