21-APR Am. Bankr. Inst. J. 14

American Bankruptcy Institute Journal
April, 2002

Column
Last in Line

*14 SELLER BEWARE!
Are your Post-Petition Goods Deliveries Eligible for Administrative Priority?

Lisa S. Gretchko
Pepper Hamilton LLP; Detroit gretchkol@pepperlaw.com

Copyright (c) 2002 by American Bankruptcy Institute; Lisa S. Gretchko

Everyone is familiar with the ancient maxim "*caveat emptor*" (buyer beware!). However, the recent flurry of large bankruptcy filings has forced vendors to deal with their customers' bankruptcies more often than in recent memory. Thus, perhaps "seller beware!" is the more appropriate maxim because vendors (and their counsel) need to understand *how* to improve the chances that the vendor's post-petition deliveries to a customer in bankruptcy are eligible for administrative priority treatment.

Historically, many vendors believed that delivering goods to a debtor post-petition automatically gave rise to an administrative priority claim. These vendors presumed that the debtor accepting the goods post-petition constituted a "transaction with the debtor-in-possession (DIP)," and that the goods delivered were beneficial to the estate. However, at least one recent case indicates that it takes more than just delivering goods post-petition to create an administrative expense claim. The U.S. Bankruptcy Court for the Eastern District of Kentucky revisited this very issue in *In re Russell Cave Co.*, 249 B.R. 145 (Bankr. E.D. Ky. 2000), and held that a post-petition delivery of goods pursuant to a pre-petition contract did not give rise to an administrative expense claim on the facts of that case. *Russell Cave* underscores the complexities of dealing with DIPs and the need for vendor vigilance when dealing with a company in chapter 11.

In *Russell Cave*, the debtor conducted business under the name "The J. Peterman Co." (*i.e.*, Elaine's employer on NBC's *Seinfeld* show). Before filing bankruptcy, The J. Peterman Co. entered into contracts to purchase certain goods from *Monarch Marking Systems Inc.* Within days after the debtor filed chapter 11, Monarch delivered goods to the DIP, and the DIP accepted them. Based on the DIP accepting these post-petition deliveries, Monarch asserted an administrative expense claim. Monarch never served a reclamation demand.

The debtor objected to the priority of Monarch's administrative claim and argued that Monarch was not entitled to an administrative expense claim because it could not satisfy 11 U.S.C. §503(b)(1)(A) and because Monarch failed to file a timely reclamation demand.

The court's analysis discussed 11 U.S.C. §503(b)(1)(A), which states that, after notice and a hearing, an administrative expense claim will be allowed for "the actual, necessary costs and expenses of preserving the estate ...." Although the wording of 11 U.S.C. §503(b)(1)(A) might seem to require only a post-petition benefit to the estate in order to give rise to an administrative claim, some cases hold that 11 U.S.C. §503(b)(1)(A) requires that the claimant must satisfy a two-prong test in order to demonstrate that post-petition deliveries are entitled to an administrative expense claim, namely (1) that the debt arose from a transaction with the DIP, and (2) that the consideration supporting the debt was beneficial to the DIP. *See, e.g., In re O'Brien Environmental Energy*, 181 F. 3d. 527, 532-533 (3d. Cir. 1999); *In re Sunarhauserman Inc.*, 126 F. 3d 811 (6th Cir. 1977).

WESTLAW © 2016 Thomson Reuters. No claim to original U.S. Government Works.

When the court in *Russell Cave* applied this two-prong test to Monarch's alleged administrative claim, it held that Monarch could not satisfy the first prong because the claim arose under a *pre-petition* contract for delivery of goods and not pursuant to a contract with the DIP. The court also held that Monarch's *post-petition* delivery of goods under its pre-petition contract (and the DIP's accepting those goods) did not transform the contract into a post-petition contract, nor did it give rise to any administrative expense claim. After noting that Monarch would be entitled to an administrative claim if it had timely delivered a reclamation demand, the court found that the failure to do so left Monarch simply ineligible for administrative priority status.

Russell Cave contains several important lessons that vendors (and their counsel) must master to help ensure that the vendor will be eligible for administrative priority. First, to protect themselves, vendors must be aware of the customer's financial situation. Once a vendor learns that its customer has filed bankruptcy, the vendor must contact its own counsel immediately to determine whether the debtor has obtained an order permitting it to pay, in the ordinary course of its business *and as an administrative expense*, for all goods delivered post-petition pursuant to pre-petition contracts and purchase orders. Especially in large cases, it is not uncommon for the debtor to seek entry of such a court order as a first-day order to engender much-needed vendor support and supplies and to avoid burdening the debtor with the immediate onslaught of vendor demands for post-petition purchase orders. Thus, such a first-day order protects *both* the DIP and the vendors.

If no such order exists, vendors should obtain a post-petition purchase order from the DIP before delivering any additional goods. As counsel to any vendor in this situation, consider dusting off your Uniform Commercial Code and re-reading §2-609. You could advise your client to contact the customer to "declare insecurity" and demand adequate assurance of performance under UCC §2-609. As part of this adequate assurance of performance, vendors should *insist upon and obtain* a post-petition contract or purchase order with the DIP *before* making any post-petition deliveries. (Although getting the debtor to issue a post-petition purchase order to the vendor should comply with *Russell Cave*, it still might not provide the vendor with adequate assurance of payment if the customer's bankruptcy case proves to be administratively insolvent. Consequently, a vendor might also consider requiring security for future payments, such as a letter of credit, guarantee, lien, etc.)

If the goods are already in transit when a vendor learns of its customer's bankruptcy, the vendor must quickly analyze whether it ***18** can exercise its rights under UCC §2-705 to stop the goods in transit to give the parties "a breathing spell" to negotiate the adequate assurance of performance described above. Courts have held that a seller's right to stoppage in transit does not violate the automatic stay embodied in 11 U.S.C. §362, nor does it result in avoidable statutory liens. *See, e.g.*, *In re National Sugar Refining Co.*, 27 B.R. 565 (S.D.N.Y. 1983); *In re Julien*, 128 B.R. 987 (Bankr. W.D. Tenn. 1991).

Even if the vendor delivered the goods to the DIP before learning of the customer's bankruptcy, all is not lost *if* the vendor timely delivers the reclamation demand. The court in *Russell Cave* noted that a timely asserted reclamation demand can give the vendor administrative expense status.

Taken together, all of these steps can enhance the likelihood that vendors' post-petition deliveries will be eligible for administrative priority, rather than "last in line." Sadly, however, some vendors are reluctant to take advantage of these precautions because they are afraid that the debtor will start buying from competitors (who, ironically, will receive a post-petition purchase order) or because they don't want to seem harsh. For these vendors, I have one cautionary maxim: "Seller beware!"

21-APR AMBKRIJ 14

End of Document

© 2016 Thomson Reuters. No claim to original U.S. Government Works.