

**A Claim by Any Other Name:
Court Disallows 503(b)(9) Claims Under Section 502(d)**

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A new administrative-expense priority was added to the Bankruptcy Code as part of the 2005 bankruptcy reforms for claims based upon the value of goods received by a debtor from vendors in the ordinary course of business within 20 days of filing for bankruptcy. A dispute has arisen in the courts as to whether such “20-day claims” under section 503(b)(9) of the Bankruptcy Code are subject to disallowance (temporary or otherwise) under section 502(d) if the vendor is alleged to have been the recipient of a preference or other avoidable transfer. In a recent ruling in *In re Circuit City Stores, Inc.*, a Virginia bankruptcy court disagreed with a number of other courts in holding that 20-day claims held by avoidable transfer recipients must be disallowed under section 502(d), pending the return of prepetition payments that are the subject of avoidance litigation.

Sections 502(d) and 503(b)(9) of the Bankruptcy Code

Section 502(d) provides a tool for bankruptcy trustees or chapter 11 debtors in possession to deal with creditors who have possession of estate property on the bankruptcy petition date or are the recipients of pre- or post-bankruptcy asset transfers that can be avoided because they are fraudulent, preferential, unauthorized, or otherwise subject to forfeiture by operation of a bankruptcy trustee’s avoidance powers. Section 502(d) provides as follows:

Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of

this title.

The purpose of the provision is to promote the pro rata distribution of the bankruptcy estate's assets among all creditors and to coerce payment of judgments obtained by the trustee.

Section 503(b) of the Bankruptcy Code provides a nonexclusive list of nine categories of expenses that are entitled to administrative-expense status and consequent priority in any distribution to unsecured creditors under section 507(a)(2) of the Bankruptcy Code. In relevant part, section 503(b) provides that:

After notice and a hearing, there shall be allowed, administrative expenses . . . including . . . (9) 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.

Section 503(b)(9) was added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The provision gives added protection to a debtor's prepetition trade creditors over and above the potential availability of a traditional reclamation claim under section 546(c). Certain characteristics of 20-day claims differentiate them from other claims entitled to administrative status under section 503(b). Most of the administrative-expense categories enumerated in section 503(b), for example, represent postpetition liabilities, yet 20-day claims are, by their nature, prepetition claims. Also, among the categories of claims in section 503(b) that by their terms contemplate prepetition liabilities, only 20-day claims have wide application in most voluntary chapter 11 cases.

Prior Application of Section 502(d) to Administrative Expenses

Although some courts have held to the contrary, the majority of decisions addressing the interplay between sections 502(d) and 503(b) of the Bankruptcy Code have concluded that

administrative expenses cannot be disallowed under section 502(d). The reasoning of these cases was exemplified by the United States Court of Appeals for the Second Circuit in its 2009 ruling in *ASM Capital, LP v. Ames Department Stores, Inc.* In *Ames*, an investor in distressed debt that had acquired almost \$400,000 in postpetition administrative-expense claims under section 503(b)(1)(A) of the Bankruptcy Code appealed a ruling denying its request for an order directing immediate payment of the administrative expenses, pending repayment of funds that were allegedly transferred preferentially by the debtor to the creditor that originally held the debt.

The Second Circuit vacated the ruling and remanded the matter to the bankruptcy court, holding that section 503(b) administrative expenses may not be disallowed under section 502(d).

Acknowledging that section 502(d) provides for the temporary disallowance only of certain “claims,” the court of appeals addressed at the outset whether administrative expenses under section 503(b) are “claims” at all. The court recognized that the Bankruptcy Code’s definition of the term “claim,” found in section 101(5), does not distinguish between prepetition and postpetition rights to payment and appears to encompass administrative-expense liabilities. Nevertheless, focusing on the Bankruptcy Code’s definition of “creditor,” which is limited to holders of prepetition claims (and certain postpetition claims deemed to be prepetition claims), and distinctions between claims and administrative expenses drawn elsewhere in the Bankruptcy Code, notably in section 348(d) (addressing the impact of conversion of a case), the Second Circuit determined that administrative expenses are not claims of the type that may be disallowed by section 502(d).

According to the *Ames* court, “[T]he express exclusion of administrative expense claims from section 348(d), and the exclusion of administrative claim holders from the definition of ‘creditor,’ lend ‘support to the view that administrative expense claims are claims that are separate and apart from pre-petition, or deemed pre-petition, creditor claims.’ ” In conjunction with section 501, the court explained, section 502 provides a procedure for the allowance of claims that is “entirely separate from the procedure for allowance of administrative expenses under section 503.” Accordingly, the court concluded that the administrative-expense claims could not be disallowed under section 502(d).

In several other recent cases, courts have applied analysis similar to that articulated in *Ames* in concluding that neither 20-day claims nor other administrative-expense claims can be disallowed under section 502(d). In its 2008 decision in *In re Plastech Engineered Products, Inc.*, for example, a Michigan bankruptcy court agreed that the allowance-of-claims provisions under section 502 apply only to claims filed under section 501, and thus, they are entirely separate from the provisions governing allowance of administrative expenses under section 503. The court stated that “[t]he fact that [20-day claims] happen to be a kind of administrative expense that is comprised of pre-petition obligations does not detract from the analysis” of the line of cases holding that administrative expenses are not subject to disallowance under section 502(d).

In 2009, in *Southern Polymer, Inc. v. TI Acquisition, LLC (In re TI Acquisition, LLC)*, a Georgia bankruptcy court came to a similar conclusion. The court was concerned, however, by the possibility that immediate payment of the 20-day claim held by the recipient of an avoidable transfer might prejudice the rights of other creditors in the event that, for example, the transferee

was unable to satisfy any judgment eventually entered in favor of the debtor in the avoidance action. Accordingly, despite holding that section 502(d) was no barrier to allowance of the creditor's 20-day claim, the court ordered payment of the administrative expense to be delayed pending resolution of the debtor's avoidance proceeding.

The Ruling in *Circuit City*

In *Circuit City*, the debtors filed omnibus objections to certain 20-day claims on grounds that each claim was subject to temporary disallowance under section 502(d) of the Bankruptcy Code up to the amount potentially recoverable in a preference action. A large number of claimants filed responses, arguing, among other things, that 20-day claims cannot be disallowed under section 502(d).

Citing Fourth Circuit precedent in *Durham v. SMI Industries*, in which it was held that section 502(d) could not be employed to bar the assertion of the affirmative defense of prepetition setoff, the bankruptcy court agreed with *Ames* that section 502(d) can be used to disallow only those claims that are filed under section 501(a). With respect to 20-day claims in particular, however, the court's analysis diverged from that of *Plastech* and *TI Acquisition* because, according to the court in *Circuit City*, 20-day claims, "unlike other [section] 503(b) administrative expenses, must be filed under [section] 501(a) of the Bankruptcy Code."

The *Circuit City* court quoted Rule 3002(a) of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"), which mandates, with certain exceptions not applicable here, that "[a]n unsecured creditor . . . must file a proof of claim . . . for the claim . . . to be allowed," and Bankruptcy Rule 3003(c), which requires that "[a]ny creditor . . . whose claim . . . is not

scheduled or [is] scheduled as disputed, contingent, or unliquidated shall file a proof of claim.”

As in *Ames*, the bankruptcy court also invoked the Bankruptcy Code’s definition of “creditor” as an “entity that has a claim against the debtor that arose at the time of or before the order for relief.” In this case, however, the court noted that the holder of a 20-day claim appears to fit squarely within the definition of “creditor” and, in fact, each of the implicated claimants had filed a proof of claim under section 501 with respect to their 20-day claims.

The court disagreed with *Plastech* insofar as it “ignored the fact that nothing in the Bankruptcy Code makes [sections] 501, 502 and 503 mutually exclusive.” Given its determination that holders of 20-day claims are “creditors,” the *Circuit City* court reasoned that Bankruptcy Rules 3002(a) and 3003(c) render the allowance of 20-day claims a two-stage process, implicating both sections 502 and 503. According to the court, because 20-day claims must be filed under section 501, and a request for payment of such claims must be made under section 503, they may be disallowed under section 502(d). Echoing the policy concerns raised in *TI Acquisition*, the court added that its conclusion is supported by the bankruptcy goals of equitable distribution and efficiency because temporarily disallowing 20-day claims held by an entity that is a defendant in avoidance litigation “and holding [such claims] in abeyance until the preference litigation takes place would allow this Court to adjudicate these issues together and ensure that Claimants do not receive windfalls to the detriment of other creditors.”

Finally, in ruling that a 20-day claim should be temporarily disallowed pending the resolution of preference litigation, the bankruptcy court in *Circuit City* observed that temporary disallowance of the claim until the preference litigation is resolved “would allow this Court to adjudicate these

issues together and ensure that Claimants do not receive windfalls to the detriment of other creditors.” The court characterized a preference defendant’s recourse to the “new value” defense after receiving payments postpetition from the estate as a “windfall” or “double recovery.” This statement suggests the court’s view that postpetition payments could preclude recourse to the subsequent new-value-preference defense under section 547(c)(4).

Section 547(c)(4) shields from avoidance as a preference any transfer to the extent to which “after such transfer, such creditor gave new value to or for the benefit of the debtor” that is “not secured by an otherwise unavoidable security interest” and “on account of which the debtor did not make an otherwise unavoidable transfer” to or for the benefit of the creditor. The court acknowledged that “[t]here is no controlling case law in this jurisdiction on the issue of whether creditors may assert a claim under § 503(b)(9) for goods sold to the debtor and use those same goods as the basis for asserting a new value defense under § 547(c)(4).” Its observations in *dicta* concerning the new-value defense are arguably contrary to the view taken on this issue by some other courts, which have read section 547(c)(4) to mean that a postpetition payment under section 503(b)(9) does not constitute a transfer by the *debtor* and consequently should not be considered an “otherwise unavoidable” transfer that renders the subsequent new-value defense inapplicable. The court’s statements in *dicta* regarding this defense are also seemingly at odds with the only other decision addressing the effect that payment of a 20-day claim has on the creditor’s ability to invoke the new-value defense. In *In re Commissary Operations, Inc.*, a Tennessee bankruptcy court ruled in January 2010 that “[t]he possibility that a debtor may pay a creditor’s § 503(b)(9) claim does not negate the value represented by the claim that the creditor provided to the debtor.”

Outlook

In practical terms, the holding in *Circuit City* may not represent a sea change in the fortunes of 20-day claimants, even though the court expressly disagreed with, and held contrary to, earlier decisions addressing the application of section 502(d) to 20-day claims. Prior to *Circuit City*, even some courts taking the opposite position expressed concern that the premature payment of 20-day claims would prejudice the rights of other creditors in the event the debtor was unable to recover a judgment obtained against the claimant in the avoidance action. This concern, for example, led the *TI Acquisition* court to exercise its power to deny immediate payment of the 20-day claim at issue, despite holding that the claim could not be disallowed temporarily under section 502(d). Accordingly, the distinction between *Circuit City* and its predecessors, in terms of practical impact, may rest on the difference between temporary disallowance and delayed payment of 20-day claims.

The U.S. Supreme Court recently had an opportunity to weigh in on this issue but declined to do so when it denied a petition for a writ of certiorari in the *Ames* case on February 22, 2010. The debtor's petition cited the split between the Second Circuit in *Ames* and the Eighth Circuit's 1973 decision in *In re Colonial Services Co.*, where the court ruled that section 57g of the Bankruptcy Act of 1898 (a predecessor of section 502(d)) mandates disallowance of an administrative claim asserted by a preference defendant until "surrender of the preference" to the estate. The debtor also asserted that "[the] issue arises in virtually every chapter 11 case and continues to spawn confusion and diverse opinions from multiple lower courts." That confusion persists.

In re Circuit City Stores, Inc., 426 B.R. 560 (Bankr. E.D. Va. 2010).

ASM Capital, LP v. Ames Department Stores, Inc. (In re Ames Department Stores, Inc.), 582 F.3d 422 (2d Cir. 2009), *cert. denied*, 130 S. Ct. 1527 (2010).

Durham v. SMI Industries Corp., 882 F.2d 881 (4th Cir. 1989).

In re Plastech Engineered Products, Inc., 394 B.R. 147 (Bankr. E.D. Mich. 2008).

Southern Polymer, Inc. v. TI Acquisition, LLC (In re TI Acquisition, LLC), 410 B.R. 742 (Bankr. N.D. Ga. 2009).

In re Colonial Services Co., 480 F.2d 747 (8th Cir. 1973).

Commissary Operations v. DOT Foods, Inc. (In re Commissary Operations, Inc.), 421 B.R. 873 (Bankr. M.D. Tenn. 2010).