

How Bankruptcy Courts Address Goods, Services In 503(b)(9)

By **Sara Abner** (June 9, 2022)

In the bankruptcy world, not all claims are created equal.

Rather, certain special categories of claims have priority status and are not only paid ahead of other claims, but are also often paid in full.

One such category of claims is found in Section 503(b)(9) of the Bankruptcy Code, which grants priority claim status for goods which were sold in the ordinary course of business and received by a debtor within the 20-day window leading up to the bankruptcy filing.



Sara Abner

However, the code section is very clear: The claim must be for the sale of goods.[1] Many contracts and sales unfortunately do not fall cleanly within the categorization of goods only.

Many transactions are of a hybrid nature, with the seller providing a combination of goods and services. This has led to much discussion and analysis over the years since the adoption of Section 503(b)(9) in 2005, as to what exactly comes within its scope.

The Bankruptcy Code, unfortunately, does not provide much assistance in this endeavor, as it does not define the term "goods." As a result, bankruptcy courts faced with the issue have traditionally turned to the Uniform Commercial Code for guidance, as it does include a generally accepted definition of the term "goods" and it has been adopted on an almost nationwide basis.[2]

The UCC's definition of "goods" is found in Section 2-105(1), and includes all things "which are movable at the time of identification to the contract for sale" with the exception of "money in which the price is to be paid, investment securities (Article 8 [of the UCC]), and things in action."

The confusion arises when the delivery of a good is accompanied by a service. In that instance, the bankruptcy court is called upon to determine whether all the costs associated with the sale and delivery of the good are entitled to priority status under Section 503(b)(9), whether none of the costs are entitled to priority status or whether an apportionment of the costs is warranted.

In making that determination, the bankruptcy courts have been faced with a choice of applying the predominant purpose test or the apportionment test.

Under the predominant purpose test, the court looks to the primary purpose of the transaction. If the supplier provided more goods than services, then the primary purpose of the transaction was the sale of goods, and thus, would qualify for priority claim status under Section 503(b)(9).

If, however, the primary purpose of the transaction was in the nature of services and the goods were peripheral to the services, then it would not qualify for priority claim status under Section 503(b)(9). The U.S. Bankruptcy Court for the Eastern District of Virginia applied the predominant purpose test in *In re: Circuit City Stores Inc.* in 2009 when faced with the issue.[3]

By comparison, if the apportionment test is used, the court must apportion the amount attributable to the goods from the amount attributable to services. Specifically, each element of the invoice, item by item, must be evaluated to determine if it should be characterized as a good or a service.

The amount attributable to goods is entitled to priority claim status under Section 503(b)(9), while the amount attributable to services is not. The primary purpose of the transaction does not matter under this test.

Bankruptcy courts which have followed this approach include the U.S. District Court for the Eastern District of Michigan, the U.S. District Court for the Western District of Wisconsin, the U.S. District Court for the District of Massachusetts and the U.S. District Court for the Northern District of Texas.[4]

The issue was once again addressed in March by the U.S. Bankruptcy Court for the District of Colorado in *In re: Sklar Exploration Company LLC*. In that case the creditor, NexTier Completion Solutions Inc., provided acidizing services on the debtor's oil and gas wells. Those services included the use of certain chemicals, including nitrogen and acid.

While there was no dispute that the chemicals constituted goods, that the goods were sold in the ordinary course of business and were delivered to the debtor within the required 20-day window, the debtor took the position that the transaction did not fall within the scope of Section 503(b)(9)'s priority claim status.

Specifically, the debtor argued that the predominant purpose test should apply, requiring the supplier to have supplied more goods than services. In support of its position, the debtor cited to *Circuit City*. [5]

The Sklar court rejected *Circuit City*'s application of the UCC's predominant purpose test. The court noted that the predominant purpose test, like the definition of goods, is pulled from the UCC.

The court, however, distinguished the situation in which the UCC applies the test from the situation under Section 503(b)(9). For purposes of the UCC, the test is utilized to determine when Article 2 of the UCC, governing the sale of goods, should apply to an entire transaction.

By contrast, "[t]here is nothing in Section 503(b)(9) that requires a claimant to prove its contract with the debtor falls within the 'transaction in goods' limitation found in ... the UCC." [6]

Section 503(b)(9) does not require this broad of a focus: "Instead, when a hybrid contract provides for both the sale of goods and the sale of services, the court need only separate out the costs of each and give priority only to the cost of goods sold." [7] Thus, the court held that the predominate purpose test is not applicable, and applied the apportionment test instead.

The Sklar court went on to apply its holding to the hypothetical scenario of a plumber who in providing plumbing services also provides pipes, fixtures or other materials needed for the plumbing job.

The court noted that the plumber has provided both goods and services. The cost of the

goods would be entitled to priority claim status under Section 503(b)(9), while the services would not. The plumber would simply have a general unsecured claim for the services, lacking priority status.

In reaching this holding, the bankruptcy court in the District of Colorado joins with the bankruptcy courts in the Eastern District of Michigan, the Western District of Wisconsin, the District of Massachusetts, and the Northern District of Texas.[8] None of the U.S. district courts or circuit courts have yet weighed in on the matter.

As a practice pointer, it is important for suppliers to carefully delineate the portions of their bills attributable to goods, and to be able to provide documentary support for the delineation in the event it is needed when asserting a priority Section 503(b)(9) claim.

Sara Abner is a member at Frost Brown Todd LLC.

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[1] 11 U.S.C. § 503(b)(9) provides that "[a]fter notice and a hearing, there shall be allowed administrative expenses ... [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).

[2] In re Escalera Resources Co., 563 B.R. 336 (Bankr. D. Colo. 2017); In re The Great Atlantic & Pacific Tea Company, Inc., 498 B.R. 19 (Bankr. S.D.N.Y. 2013); In re Ne OPCO, Inc., 501 B.R. 233 (Bankr. D. DE 2013); In re Grede Foundaries, Inc., 440 B.R. 791 (Bankr. W.D. Wis. 2010); In re Circuit City Stores, Inc., 416 B.R. 531 (Bankr. E.D. Va. 2009); In re Goody's Family Clothing, Inc., 401 B.R. 131 (Bankr. D. Del. 2009).

[3] 416 B.R. at 531.

[4] In re Plastech Eng'rd Prod., Inc., 397 B.R. 828 (Bankr. E.D. Mich. 2008); GFI Wis., Inc. v. Reedsburg Utility Comm'n, 440 B.R. 791 (W.D. Wis. 2010); In re Erving Indus., Inc., 432 B.R. 354 (Bankr. D. Mass. 2010); In re Pilgrim's Pride Corp., 421 B.R. 231 (Bankr. N.D. Tex. 2009).

[5] 416 B.R. 531 (Bankr. E.D. Va. 2009).

[6] 2022 WL 784988 at *3.

[7] Id.

[8] In re Plastech Eng'rd Prod., Inc., 397 B.R. 828 (Bankr. E.D. Mich. 2008); GFI Wis., Inc. v. Reedsburg Utility Comm'n, 440 B.R. 791 (W.D. Wis. 2010); In re Erving Industries, Inc., 432 B.R. 354 (Bankr. D. Mass. 2010); In re Pilgrim's Pride Corp., 421 B.R. 231 (Bankr. N.D. Tex. 2009).