UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

In re:	)	Chapter 11
	)	
VALLEY MEDIA, INC.,	)	Case No. 01-11353 (PJW)
	)	
Debtor.	)	

MEMORANDUM OPINION

Robert J. Dehney
Eric D. Schwartz
Michael G. Busenkell
Morris, Nichols, Arsht & Tunnell
1201 North Market Street
P.O. Box 1347
Wilmington, DE 19899-1347

Edward DeFranceschi
Jason Bell
Edward DeFranceschi, PC
6 Beacon Street, Suite 515
Boston, MA 02108

Counsel for Valley Media, Inc., Debtor and Debtor-In-Possession

Charles F. Arris, Jr.
Jeffrey S. Ogilvie
Commonwealth of Massachusetts
Department of Revenue
Litigation Bureau
P.O. Box 55486
51 Sleeper Street
Boston, MA 02205-55486

Counsel for Massachusetts Department of Revenue

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Walsh, J.

Before the court is Valley Media, Inc.'s ("Valley") objection (Doc. # 1287) to the proof of claim of the Massachusetts Department of Revenue ("MDOR"). For the reasons set forth below, I will sustain Valley's objection and disallow that portion of MDOR's claim arising out of drop shipment transactions.

BACKGROUND

Valley, with its principle place of business in Woodland, California, was a wholesale distributor of music and video products ("Products") that conducted business through various channels, including sales to various independent internet retailers ("Internet Retailers"). On November 20, 2001, Valley filed a voluntary petition under chapter 11 of title 11 of the United States Code, 11 U.S.C. §§ 101 et seq. (the "Bankruptcy Code").

Prior to the filing of Valley's bankruptcy petition, MDOR had conducted an audit of Valley's books and records relating to the period between January 31, 1997 and December 31, 2000. MDOR claims that Valley owes unpaid sales or use taxes, which allegedly should have been collected by Valley when Massachusetts residents purchased Products. Valley has stipulated that it is responsible to MDOR for some back taxes, however, certain taxes assessed by MDOR are still in dispute. Specifically, Valley objects to that portion of MDOR's claim relating to transactions where Valley acted as a drop shipper for its Internet Retailers.

The drop shipment transactions at issue are fairly straight forward. Massachusetts consumers visited the web sites of Internet Retailers where they purchased music and video products. Those Internet Retailers then purchased Products from Valley. To streamline the delivery process, on instructions from the Internet Retailers, Valley caused the Products to be shipped directly to the Massachusetts consumers with the Internet Retailers' customized invoices enclosed in the shipments. The Products were shipped by way of a common carrier selected by the Internet Retailers. No contractual relationship existed between Valley and the consumers, and the consumers dealt directly with the Internet Retailers in making payment. In addition to the cost of the Products, the Internet Retailers also paid Valley for the handling and shipping costs to get the Products to the retail customers. The procedures for those drop shipments were governed by agreements between Valley and the Internet Retailers ("Order Agreements"). Because of Valley's role under the Order Agreements, MDOR is claiming that Valley is responsible for certain commonwealth sales or use taxes on the drop shipped Products. Valley disputes MDOR's claim and contends that it is not liable for such taxes because it did not "deliver" Products or make sales to consumers in Massachusetts.

DISCUSSION

I. MDOR's Claim for Sales Tax

The applicable sales tax statute is Massachusetts General

Laws ch. 64H, § 2 which provides that "[a]n excise is hereby imposed upon *sales at retail* in the commonwealth, by any vendor, of tangible personal property or of services preformed in the commonwealth at the rate of five percent of the gross receipts of the vendor from all such sales of such property or services, except as otherwise provided in this chapter." MASS. GEN. LAWS ch. 64H, § 2 (2004) (emphasis added). Valley contends that it is not liable to MDOR for sales tax on the drop shipments because those shipments were not "sales at retail."

Massachusetts General Laws ch. 64H, § 1 defines "sale at retail" in relevant part as:

> [A] sale of services or tangible personal property or both for any purpose other than resale in the regular course of business. The *delivery* in the commonwealth of tangible personal property by an owner or former owner thereof, or by a factor, or agent of such owner, former owner or factor, if the delivery is to a consumer or to a person for redelivery to a consumer, pursuant to a retail sale made by a retailer not engaged in business in the commonwealth, is a retail sale in the commonwealth by the person making the delivery. He shall include the retail selling price of the property in his gross receipts.

MASS. GEN. LAWS ch. 64H, § 1 (2004) (emphasis added).

Valley maintains that it never made a "sale at retail" because it did not "deliver" tangible personal property in Massachusetts. Delivery is not defined in Massachusetts General Laws ch. 64H, § 1, therefore, I look to other relevant provisions of the Massachusetts general laws and to relevant case law.

Commercial law principles provide guidance on the meaning of "delivery" and the place of delivery. See The Neiman Marcus Group, Inc. v. Comm'r of Revenue, ATB Docket No. F245638, 2001 WL 1590444, at *4 (Mass. App. Tax Bd. January 24, 2001) (referring to Uniform Commercial Code to determine where the passage of title occurred for sales tax purposes); Steelcase, Inc. v. Crystal, 238 Conn. 571, 586 (Conn. 1996) (referring to Uniform Commercial Code for the meaning of delivery as used in the Connecticut sales tax statute); Eusco, Inc. v. Huddleston, 835 S.W.2d 576, 579 (Tenn. 1992) (explaining that for sales tax purposes, place where title is transferred is determined under applicable provisions of Uniform Commercial Code); see also MASS. REGS. CODE tit. 830, § 64H.6.7 (3) (referring to Uniform Commercial Code in a sales tax context).

Massachusetts's version of the Uniform Commercial Code allows parties to agree where delivery of shipments will occur. MASS. GEN. LAWS ch. 106, § 2-308.[1] The Order Agreements contain transfer of title and risk of loss provisions stating that all shipments will be made F.O.B. Valley's shipping facility in California. "It is widely accepted that [F.O.B. factory] means that delivery takes place when the seller places the goods into the possession of a common carrier at the seller's place of business."

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[1] "*Unless otherwise agreed* (a) the place for delivery of goods is the seller's place of business or if he has none his residence . . . ." MASS. GEN. LAWS ch. 106, § 2-308 (2004) (emphasis added).

Steelcase, 238 Conn. at, 588; MASS. GEN LAWS ch. 106, § 2-319. The Order Agreements specify that, "[t]itle and risk of loss with respect to all such shipments will pass to [the Internet Retailer] upon delivery of the products to the carrier at the point of shipment." (Doc. #1592, Ex. C-1 to C-23.)

MDOR claims that other portions of the Order Agreements eviscerate the title and risk of loss provisions and demonstrate that Valley did make sales at retail in Massachusetts. MDOR argues that Valley had a continuing obligation to be involved with the Massachusetts consumers directly in two ways: by providing replacement product in the event of loss, defect, or damage, and by maintaining a customer service e-mail and account representative. I find MDOR's argument to be unpersuasive. First, Internet Retailers play a significant role under the product return provision, which states that an "[Internet Retailer] may direct its customers to return defective or damaged Product" to Valley and that Valley "will ship replacement Product to such customers....." (Doc. # 1603, Tab 2 at 9.) Accordingly, it is the Internet Retailers who control the replacement of Products. Second, Valley has no relationship with the Massachusetts buyer. In the event of a product return, Valley may credit the Internet Retailer's account. Valley may also charge Internet Retailers a processing fee, a restocking fee, and a refurbishing fee for a product return. Valley does not issue any credits or charge any fees directly to

Massachusetts consumers for a product return. Third, the dedicated e-mail box and account representative that MDOR refers to are provided to Internet Retailers so that they may follow up on their orders with Valley. The Order Agreements do not indicate that Internet Retailers' Massachusetts customers can contact Valley through the dedicated e-mail box and account representative. Essentially, therefore, the Product returns provision pertains to the transaction between Valley and Internet Retailers. The Massachusetts buyers are not a party to the Order Agreements. Indeed, the Order Agreements contain a no third party beneficiary provision. Thus, under the drop shipment arrangement, the economic consequences to Valley as a wholesaler were essentially the same as with a conventional sale to a retailer followed by a resale to a customer with delivery by the retailer.

I find that Valley's drop shipment Products were delivered to the Internet Retailers in California, not the Internet Retailers' consumers in Massachusetts. Because Valley did not "deliver" goods in Massachusetts, it did not make a "sale at retail" within Massachusetts. Therefore, Valley is not responsible for sales tax on the Products that it drop shipped to Massachusetts consumers.

My holding here is consistent with the conclusions of the Connecticut Supreme Court which reached the same result under similar facts in Steelcase, 238 Conn. at 571. In Steelcase, an out

of state manufacturer of office furniture challenged a sales tax which had been levied against it by the Connecticut Commissioner of Revenue. Steelcase, Inc. sold furniture "to independent retailers, who were not located or registered in Connecticut." Steelcase, 238 Conn. at 574. The retailers then sold those products to customers who were located in Connecticut, and "in each of the transactions at issue, the retailer directed Steelcase to send the [furniture] . . . directly to the retailer's customer . . . ." Id. The Steelcase furniture was transported via a common carrier that loaded the goods from a location outside of Connecticut. Id. "[T]he goods were shipped 'F.O.B. factory,' and title to the goods passed from Steelcase to the retailer upon delivery to the carrier....." Id. "Steelcase was not a party to the sales contracts between the retailers and their customers," the relevant Connecticut laws were substantially similar to the applicable Massachusetts statutes, and the Steelcase decision turned on the meaning of the word "delivery" in the definition of "sales at retail." Steelcase, 238 Conn. at 574, 575, 588. The Connecticut Supreme Court found that Steelcase had not "delivered" goods within Connecticut and therefore had not made a retail sale. Because Steelcase had not made a retail sale it could not be held liable for sales tax on the goods it had shipped to Connecticut consumers. Steelcase, 238 Conn. at 588.

Valley also argues that a portion of Massachusetts

General Laws ch. 64H, § 1 is unconstitutional. Valley contends that the definition of "sale at retail" violates the Commerce Clause of the United States Constitution. Because I have decided the issue before me on more narrow grounds, I need not reach Valley's constitutional argument.

II. MDOR's Claim for Use Taxes

As an alternative to the sales tax claim, MDOR asserts that Valley is subject to a use tax obligation. I find that MDOR's claim for use taxes fails for two reasons, the relevant Massachusetts statute is inapplicable and Supreme Court precedent stands in opposition. Massachusetts General Laws ch. 64I, § 4 provides that "[e]very vendor engaged in business in the commonwealth and making sales of tangible personal property or services for storage, use or other consumption in the commonwealth . . . shall at the time of making the sales . . . collect the tax from the purchaser . . . ." Mass. Gen. Laws ch. 64I, § 4 (2004). Because I find that Valley's drop shipment arrangement is not equivalent to Valley making sales to consumers in the commonwealth, I conclude that Valley was not responsible for collecting use taxes on behalf of Massachusetts.

Two separate contractual arrangements are at work in the Valley drop shipments. One contract extends between the Massachusetts consumer and the Internet Retailers, and the second contract encompasses the relationship between the Internet

Retailers and Valley. MDOR argues that I should somehow combine the two transactions. However, MDOR cites no case involving a drop shipment arrangement that supports its position. And, as demonstrated above, ownership transferred to the Internet Retailers when Valley completed delivery in California. Because the relationship between Valley and the Massachusetts consumers is tenuous at best, I reject MDOR's argument and hold that Valley is not responsible for Massachusetts use tax on the drop shipments.

Two alternative scenarios for these transactions support the holding that imposing the use tax on Valley is inappropriate. For example, suppose that instead of drop shipping, Valley forwarded all Products to the Internet Retailers for them to repackage and make shipment to their Massachusetts customers. In that instance, neither Valley nor the Internet Retailers would have been responsible for the collection of Massachusetts use taxes. Valley would not have sold or sent Products to Massachusetts consumers; and under Supreme Court precedent, it is extremely unlikely that the Internet Retailers could have been taxed. See, Quill Corp. v. North Dakota, 504 U.S. 298 (1992) (holding that for a state to impose a sales/use tax collection responsibility upon the retailer, the retailer must have substantial nexus through physical presence, such as employees or property, in the taxing state). If MDOR could not have taxed Valley if Valley sent Products to the Internet Retailers for reshipment, then MDOR should

not be able to tax Valley based on the drop shipment arrangement. The drop shipment arrangement was nothing more than a means of reducing the handling cost (and presumably reducing the customers' purchase price), and it strikes me as anomalous to allow such an arrangement to trigger a tax liability that otherwise would not exist.

Alternatively, suppose that an Internet Retailer directed Valley to send all Products to a mailing service/shipper who then repackaged the Products and forwarded them to the appropriate Massachusetts consumers. Neither the Internet Retailer, Valley, nor the mailing service/shipper would be subject to the Massachusetts use tax. The Internet Retailer and Valley could not be taxed because of the reasons noted above, and Massachusetts could not impose its use tax on a mailing service/shipper that was simply making deliveries in that commonwealth.

It appears that MDOR is pursuing its claim against Valley because Supreme Court precedent prevents it from levying against the Internet Retailers directly. See, e.g., Quill Corp. v. North Dakota, 504 U.S. 298 (1992). In Quill, the Supreme Court reaffirmed its allegiance to Commerce Clause jurisprudence which holds that "vendors are free from state-imposed duties to collect sales and use taxes" when the vendor's only connection with a taxing state is by common carrier or United States mail. Quill, 504 U.S. at 315. The Quill case involved an attempt by the State

of North Dakota to impose a use tax upon an out-of-state mail-order house. The Court found that the mail-order house had "insignificant or nonexistent" connections with North Dakota and, therefore, North Dakota could not constitutionally levy its use tax upon Quill.

Presumably the matter before me reflects the problem that all states are having with enforcement of sales and use taxes. The difficulties posed to the states by catalog merchants and the Supreme Court's decision in Quill have only grown with the explosion of vendors onto the internet. Although these developments pose an obstacle for state departments of revenue, it is not a problem that can be solved in a court. In Quill the Supreme Court observed that Congress was free to change the law to enable states to collect the tax from such out of state businesses. Id. at 318.

CONCLUSION

For the foregoing reasons, an order will be entered sustaining Valley's objection to the portion of MDOR's claim that relates to the drop shipment transactions. Counsel for Valley should submit an order on notice.