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## Another Preference Victory for the Trade: New Value Paid Post-Petition Does Count!

**W**hile trade creditors continue to grapple with the scourge of preference litigations, they have been able to use the subsequent new value defense, arising under Section 547(c)(4) of the Bankruptcy Code, to reduce their exposure. Trustees have challenged new value that was paid post-petition pursuant to a court order approving payment of either pre-petition claims, such as critical vendor claims, or allowed Section 503(b)(9) priority claims.<sup>1</sup>

The United States Bankruptcy Court for the District of Delaware, in *Friedman's Inc. v. Roth Staffing Companies L.P.*, recently ruled that a creditor can include new value, provided pre-petition and paid post-petition

The *Friedman's* holding is helpful to the trade creditor community by increasing the amount of new value available to reduce preference liability. Other courts that follow the ruling in *Friedman's* should count new value, despite the debtors' post-petition payment of such new value as part of an allowed Section 503(b)(9) priority claim or pursuant to a critical vendor or other order approving payment of a creditor's pre-petition claim.

However, other courts have not agreed with Judge Sontchi's holding in the *Friedman's* case. The United States Bankruptcy Courts for the Eastern District of Virginia, in the *Circuit City Stores* case, and for the Northern District of Georgia, in the *TI Acquisition* case, refused to include a trade creditor's Section 503(b)(9) priority claim that was fully paid or funded post-petition, as part of the creditor's new value defense. Other courts have similarly disqualified new value that was provided pre-petition and paid post-petition pursuant to a critical vendor or other order.

Stated bluntly, a creditor's exposure to preference liability could depend on whether or not the court follows the *Friedman's* holding.

### Preference Claims and the New Value Defense

A trustee can recover a preference by proving that the debtor had transferred its property, such as by tendering a payment, to or for the benefit of a creditor (Section 547(b)(1)); the transfer was made on account of antecedent or existing indebtedness the debtor owed the creditor (Section 547(b)(2)); the transfer was made when the debtor was insolvent, based on a balance sheet

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pursuant to a court order, as part of the creditor's subsequent new value defense. Bankruptcy Judge Christopher Sontchi determined new value as of the bankruptcy filing date. As such, the court included all new value extended pre-petition and unpaid on the bankruptcy filing date as part of the new value defense, regardless of the debtor's post-petition payment of such new value. By the same token, a creditor gets no new value credit for any post-petition new value provided to the debtor.

definition of liabilities exceeding assets, which is easy for a trustee to prove because it is presumed during the 90-day preference period (Section 547(b)(3)); the transfer was made within 90 days of the debtor's bankruptcy filing, in the case of a transfer to a non-insider creditor, and within one year of bankruptcy for a transfer to an insider, such as the debtor's officers, directors, controlling shareholders and affiliates (Section 547(b)(4)); and the creditor received more from the payment or other transfer than in a Chapter 7 liquidation of the debtor, which can be rebutted by proof that the creditor was fully secured by the debtor's assets, received payment from the proceeds of the creditor's collateral, or would have recovered 100% of its claim in the debtor's Chapter 7 case (Section 547(b)(5)).

When a debtor or trustee satisfies all of Section 547(b)'s preference requirements, the burden shifts to the preference defendant to prove one or more of the preference defenses contained in Section 547(c) of the Bankruptcy Code. The Section 547(c)(4) subsequent new value defense is one such preference defense. The new value defense reduces a creditor's preference liability to the extent the creditor had provided new goods and/or services on credit terms subsequent to the preference for which the creditor did not receive an otherwise unavoidable transfer. The new value defense is supposed to encourage creditors to continue doing business with, and extending trade credit to, their financially distressed customers and promote equality of treatment of creditors holding similar claims.

In the *Friedman's* case, the court grappled with whether a creditor loses the ability to assert the new value defense for any new value that was paid post-petition pursuant to court order. Read on to hear the answer!

## Background

On January 22, 2008 (the petition date), an involuntary Chapter 7 bankruptcy petition was filed against the debtor, Friedman's Inc. Prior to the petition date, Roth Staffing Companies L.P. provided staffing services to Friedman's. During the 90-day preference period prior to the petition date—November 1, 2007 through January 4, 2008—Friedman's made payments totaling \$81,977.57 to Roth. During the preference period, following the alleged preference payments, Roth provided staffing services worth \$100,660.88, on credit terms, to Friedman's that Roth had asserted as new value to reduce its preference exposure. Friedman's did not pay for these services prior to filing bankruptcy at which time it had owed the sum of \$100,660.88 to Roth. Roth would have had an undisputed complete new value defense to preference liability if the story ended here.

Friedman's filed a first-day motion seeking authorization to pay Roth's pre-petition unsecured claim for staffing services. Friedman's asserted that unless it immediately paid its employees, including Roth's staffers, Friedman's would suffer "an epidemic of employee departures," and "a significant deterioration in morale...with a devastating impact on [Friedman's], their customers, the value of their assets and business

and their ability to reorganize." The court approved the motion and Friedman's paid the sum of \$72,412.71 to Roth on account of Roth's pre-petition claim.

In February 2009, Friedman's filed a complaint against Roth seeking to recover the \$81,997.57 Roth had received during the preference period. Roth asserted a full new value defense to the preference claim based on the \$100,660.88 of pre-petition staffing services it had provided to Friedman's subsequent to the alleged preference payments that remained unpaid on the petition date. Friedman's moved for partial summary judgment for a ruling that its post-petition payment of \$72,412.71 to Roth reduced the amount of Roth's new value defense from \$100,660.88 to \$28,248.17, leaving a net preference claim of \$53,749.40 (instead of no preference liability if Roth could assert a full new value defense for the \$100,660.88 of unpaid staffing services owing on the petition date).

## New Value Paid Post-Petition Counts in Reducing Preference Liability

The *Friedman's* court denied Friedman's motion for partial summary judgment and accepted all \$100,660.88 of the new value Roth had asserted as a defense to preference liability, including the \$72,412.71 of new value that Friedman's had paid Roth post-petition pursuant to court order. The court pointed out that Roth had no preference liability when Friedman's filed for bankruptcy because, prior to the petition date, Roth had provided new value consisting of staffing services worth \$100,660.88 that exceeded the preference claim.

The court relied on the definition of new value that the Third Circuit Court of Appeals had articulated in the *New York City Shoes* case and reaffirmed in the *Winstar Communications* case. The Third Circuit stated that a creditor seeking to prove subsequent new value must, among other things, show that the debtor did not fully compensate the creditor for the new value *as of the date the debtor had filed its bankruptcy petition*. Based on the Third Circuit's holdings, the Friedman's court determined new value as of the petition date, and concluded that Friedman's post-petition payment of new value provided by Roth pre-petition and/or Roth's post-petition provision of new value to Friedman's had no impact on Roth's new value defense. As such, Friedman's post-petition payment of \$72,412.71 of the \$100,660.88 of pre-petition new value Roth had provided subsequent to the alleged preference payments had no impact in determining Roth's new value defense.

However, not all courts have reached the same holding as the *Friedman's* court. The bankruptcy court in *Circuit City* focused on the meaning of that part of the Section 547(c)(4) subsequent new value defense contained in Section 547(c)(4)(B). That provision limits the new value defense to only new value for which "the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor." The *Circuit City* court concluded that the creditor did not satisfy this new value requirement because Circuit City's post-petition establishment of a reserve fund to assure the full payment of the creditor's Section 503(b)(9) priority claim, as ultimately allowed by the court, was an "otherwise unavoidable transfer."

The creditor can be credited only once for the goods it had delivered to Circuit City within 20 days of Circuit City's bankruptcy filing date. The creditor could either obtain payment for these goods as part of the creditor's allowed Section 503(b)(9) priority claim or include the goods as part of the creditor's Section 547(c)(4) new value preference defense—not both! The *Circuit City* court also followed those court decisions that consider post-petition transfers in determining whether a debtor's repayment of new value is an “otherwise unavoidable transfer.”

The *Circuit City* court relied on the *TI Acquisition* court's holding that a creditor cannot use the same goods as the basis for obtaining payment of its Section 503(b)(9) priority claim and as part of the creditor's Section 547(c)(4) new value defense to preference liability. The *TI Acquisition* court concluded that a creditor could not assert the new value defense for goods that were subject to a fully paid Section 503(b)(9) priority claim because the debtor and its bankruptcy estate did not benefit from the creditor's sale and delivery of these goods. The *TI Acquisition* court also noted that the dual policy considerations underlying Section 547(c)(4)—encouraging creditors to extend credit to financially troubled companies and promoting equality of treatment among creditors—are fostered by allowing a creditor to either obtain payment of its Section 503(b)(9) priority claim or include the same goods comprising that claim as part of the creditor's new value defense, but not both. Otherwise, the creditor would receive a double recovery by receiving payment for goods that are part of its fully paid or funded Section 503(b)(9) priority claim and using those same goods as part of its new value defense to reduce its preference exposure.<sup>2</sup>

## Conclusion

The trade creditor community has benefitted from the *Friedman*'s holding that includes all new value paid post-petition as part of a creditor's new value defense to a preference claim. The *Friedman*'s ruling clearly applies to new value paid post-petition pursuant to a critical vendor order. It would not be a stretch to argue that the court's holding also allows invoices, that make up a creditor's Section 503(b)(9) “20 day goods” priority claim, as part of the creditor's new value defense, even where the claim is paid post-petition pursuant to court order.

Unfortunately, other courts have ruled in a contrary manner and refused to allow new value provided pre-petition but paid post-petition pursuant to court order. The trade creditor community, therefore, anxiously awaits the next court ruling on this issue. ●

and the determination of new value on the bankruptcy filing date, and refuses to consider any post-petition payment of new value provided pre-petition. Other courts have reached similar holdings, allowing new value paid post-petition pursuant to a critical vendor order.

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1. Goods sellers have an administrative priority claim under Section 503(b)(9) of the Bankruptcy Code for the value of the goods they had sold to the debtor in the ordinary course of business that the debtor received within 20 days of bankruptcy.

2. It should be noted that the United States Bankruptcy Court for the Middle District of Tennessee, in *Commissary Operations*, held that a trade creditor could assert its fully paid Section 503(b)(9) priority claim as part of its new value defense. The *Commissary* court followed the view approved by the *Friedman*'s court that closes the preference window