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Hooray for Delaware— A Tale of Two Decisions

Paid for New Value Counts as a Preference Defense and Section 503(b)(9) 20-Day Goods Priority Claim Issues

SELECTED TOPIC

The holidays will have passed by the time this article is published, so here is my belated holiday present to all of you: the United States Bankruptcy Court in Delaware recently issued two decisions that will please trade creditors defending against preference exposure and asserting their Section 503(b)(9) “20-day goods” priority claims.

Bankruptcy Judge Kevin Carey, in *In re Pillowtex Corporation*, ruled that a preference defendant may rely on paid new value as part of its Bankruptcy Code Section 547(c)(4) new value defense to a preference claim. The most important aspect of the *Pillowtex* holding is Judge Carey’s statement that the United States Third Circuit Court of Appeals, in *New York City Shoes, Inc.*, actually never addressed the applicability of paid new value as a preference defense, even though the decision has been frequently cited as limiting the new value defense to only unpaid new value on the bankruptcy filing date.

The new value preference defense, arising under Section 547(c)(4) of the Bankruptcy Code, was at issue in *Pillowtex*.

Trade creditors, relying on the *Pillowtex* decision, have reason to hope that paid new value will be included in determining their new value defense, significantly reducing their exposure in preference actions brought

in Delaware and other bankruptcy courts in the Third Circuit, and possibly the Seventh and Eleventh Circuits, where paid new value had previously been rejected as a preference defense.

And there is more interesting news out of Delaware. Bankruptcy Judge Brendan Linehan Shannon, in *In re SemCrude L.P.*, recently dealt with trade creditors’ Section 503(b)(9) “20-day goods” priority claims. Bankruptcy Code Section 503(b)(9), added by the 2005 bankruptcy amendments, grants trade creditors an administrative priority claim for the value of the goods they had sold and delivered to the debtor in the ordinary course of the debtor’s business that the debtor had received within 20 days of the bankruptcy filing. The *SemCrude* court ruled that Section 503(b)(9) creditors did not have to file motions for allowance of their priority claims because *SemCrude* had previously acknowledged their claims as valid, pursuant to court-approved procedures for the assertion, reconciliation and determination of these claims. The court also relied on the creditors’ invoice or purchase price in determining the allowed amounts of their Section 503(b)(9) priority claims, and construed the meaning of Section 503(b)(9)’s terms that are not defined in the Bankruptcy Code, such as “goods,” “receipt” and “sales in the ordinary course of business,” by relying on Article 2 of the Uniform Commercial Code (UCC) concerning sales of goods.

What a way to start the year!

The Elements of a Preference Claim and the New Value Defense

A trustee can recover a preference by satisfying all of the following requirements:

(a) The debtor transferred its property to or for the benefit of a creditor [Section 547(b)(1)]. The most frequent type of transfer is the debtor's payment to a creditor. Based on the 1992 United States Supreme Court decision in *Barnhill v. Johnson*, it is settled law that a debtor's payment by check occurs when the check clears, in determining whether a payment is a preference;

(b) The transfer was made on account of antecedent or existing indebtedness that the debtor owed the creditor [Section 547(b)(2)];

(c) The transfer was made when the debtor was insolvent [Section 547(b)(3)]. Insolvency is based on a balance sheet definition: liabilities exceeding assets. The debtor's insolvency within the 90-day preference period is also presumed, which makes it easier for the trustee to prove insolvency. The creditor has the burden to present some evidence of the debtor's solvency to rebut this presumption, in which event, the burden shifts back to the trustee to prove the debtor's insolvency;

(d) 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 the bankruptcy filing for a transfer to an insider of the debtor, such as the debtor's officers, directors, controlling shareholders and affiliated companies [Section 547(b)(4)]; and

(e) The transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor [Section 547(b)(5)]. This "greater than Chapter 7 liquidation recovery" requirement is always satisfied unless the debtor's unsecured creditors receive full payment of their claims; the creditor receiving the payment is fully secured by the debtor's assets; or the creditor receives payment from the proceeds of its collateral.

There are several defenses that reduce or eliminate recovery on a preference claim. The new value preference defense, arising under Section 547(c)(4) of the Bankruptcy Code, was at issue in *Pillowtex*. The new value defense reduces a creditor's preference exposure to the extent the creditor had replenished the debtor, by providing new goods or services, subsequent to the preference. This defense applies to all sales and deliveries of goods, or provisions of services, on credit terms to the debtor subsequent to the preference. The defense includes the requirement that the new value *cannot be paid by an otherwise unavoidable transfer to or for the creditor's benefit*. The *Pillowtex* court considered this element of the new value defense in determining whether paid for new value can ever count as a preference defense.

The Pillowtex Case

Pillowtex Corporation and related companies filed for Chapter 11 on July 30, 2003. Pillowtex's and its creditors' committee's joint liquidating Chapter 11 plan was approved by the bankruptcy court and became effective on June 29, 2007.

Prior to confirming their plan, Pillowtex and its creditors' committee had filed numerous preference litigations that were ultimately taken over by the liquidating trust established under the confirmed Chapter 11 plan. Two preference defendants moved for partial summary judgment on whether a defendant in a preference litigation can rely on the Section 547(c)(4) new value defense where the debtor had repaid the new value. The court held that paid new value can be counted as part of the new value preference defense where the payment is not subject to another preference defense, such as the ordinary course or contemporaneous exchange (COD) defenses.

The *Pillowtex* court ruled that paid new value counts as a preference defense if the payment was itself an avoidable preference not subject to any other preference defense.

The importance of the *Pillowtex* court's allowance of paid new value in substantially reducing trade creditors' preference exposure is demonstrated by the following example:

Date	Alleged Preference Payment	New Value Given	Preference Exposure (Paid New Value)	Preference Exposure (Unpaid New Value)
1. 1/10/09	\$1,000		\$1,000	\$1,000
2. 1/20/09		\$1,000	\$0	\$0
3. 1/30/09	\$1,000		\$1,000	\$2,000
4. 2/10/09		\$1,000	\$0	\$1,000
5. 2/20/09	\$1,000		\$1,000	\$3,000
6. 3/1/09		\$1,000	\$0	\$2,000

If paid and unpaid new value count, the creditor's preference exposure is 0. If only unpaid new value counts, the creditors' preference exposure is \$2,000. Clearly, the applicability of paid new value as a preference defense in the right circumstances will reduce preference risk!

There is a recognized split among the United States Courts of Appeal (the federal courts immediately below the U.S. Supreme Court) on whether paid new value counts as part of the new value defense. These courts have interpreted the

meaning of Section 547(c)(4)'s language that the new value cannot be paid by an *otherwise unavoidable transfer to or for the benefit of the creditor*. The Third Circuit Court of Appeals (covering New Jersey, Pennsylvania, Delaware and the Virgin Islands), in *New York City Shoes, Inc.*; the Seventh Circuit Court of Appeals (covering Illinois, Indiana and Wisconsin), in *Matter of Prescott*; and the Eleventh Circuit Court of Appeals (covering Alabama, Florida and Georgia) in *In re Jet Florida Systems, Inc.*, have been cited as holding that new value must remain unpaid in order to be eligible as a defense to a preference claim under Section 547(c)(4). The Fourth Circuit Court of Appeals (covering Maryland, North and South Carolina, Virginia and West Virginia), in *JKJ Chrysler-Plymouth*; the Fifth Circuit Court of Appeals (covering Louisiana, Mississippi and Texas) in *Matter of Toyota of Jefferson, Inc.*; and the Ninth Circuit Court of Appeals (covering Arizona, California, Idaho, Montana, Nevada, Oregon and Washington), in *In re IRFM, Inc.* held that paid for new value reduces preference exposure as long as the new value was not paid by an "otherwise unavoidable transfer." The Eighth Circuit Court of Appeals (covering Arkansas, Iowa, Minnesota, Missouri, Nebraska, and North and South Dakota) has reached conflicting decisions on the applicability of paid new value as a preference defense.

So shouldn't this be a slam dunk win for the plaintiff? Only unpaid new value counts as a part of the new value preference defense since Delaware is in the Third Circuit and the Third Circuit only considers unpaid new value? Not so fast! The *Pillowtex* court ruled that paid new value counts as a preference defense if the payment was itself an avoidable preference not subject to any other preference defense. The court noted that the Third Circuit's decision, in *New York City Shoes*, did not address whether paid new value could ever count as a preference defense under Section 547(c)(4). The court just considered whether the creditor had provided new value after receipt of a preferential transfer. According to the *Pillowtex* court, the two other Delaware cases that rejected paid new value as a preference defense, *In re Discovery Zone* and *In re U.S. Interactive Inc.*, also never fully analyzed the circumstances in which new value can be paid and still count as a preference defense, but, like *New York City Shoes*, only considered whether the creditor had provided new value after receipt of a preferential transfer. The *Pillowtex* court also considered another Delaware decision, *In re Hechinger Investment Co. of Delaware, Inc.*, that upheld the applicability of paid new value as a preference defense. The *Hechinger* court distinguished the Third Circuit's *New York City Shoes* holding as involving only one transfer during the preference period, instead of a "running account" or "rolling account" between the debtor and creditor in *Hechinger*, and in other paid new value cases involving trade creditors.

The *Pillowtex* court concluded that it was required to follow the plain language of Section 547(c)(4) to allow paid new value. Section 547(c)(4) states that new value cannot be repaid with an *otherwise unavoidable transfer*. That means paid new value can count as part of the new value preference defense to the extent the payment for the new value is subject to avoid-

ance as a preference and not subject to the ordinary course, contemporaneous exchange or other preference defenses.

Allowing paid new value is also consistent with the purposes of the Section 547(c)(4) new value defense. First, it encourages trade creditors to continue extending credit to financially troubled debtors, that would assist the debtor in avoiding bankruptcy altogether. It also fairly treats those creditors that had replenished the debtor's bankruptcy estate with new value after having received a preference.

In re SemCrude L.P.

On September 15, 2008, the bankruptcy court in Delaware approved an order establishing procedures for the resolution of trade creditors' Section 503(b)(9) "20-day goods" priority claims asserted against SemCrude L.P., a Chapter 11 debtor (the "Procedures Order"). The Procedures Order created a streamlined mechanism for determining and allowing Section 503(b)(9) priority claims against SemCrude and discouraging thousands of SemCrude's trade creditors from filing motions with the bankruptcy court for allowance and payment of priority claims totaling hundreds of millions of dollars.

Pursuant to the Procedures Order, SemCrude filed Schedule E to its Schedules of Assets and Liabilities. Schedule E contained a list of the estimated amounts of SemCrude's Section 503(b)(9) priority claims. Thereafter, the bankruptcy court set March 3, 2009 as the deadline for the filing of proofs of claim, including Section 503(b)(9) priority claims, in SemCrude's Chapter 11.

After the claims bar date, pursuant to the Procedures Order, SemCrude filed a notice (the "Notice of Allowed Section 503(b)(9) Claims") listing (a) all 20-day goods priority claims for which SemCrude had received a proof of claim; (b) the amount, if any, that SemCrude determined to be valid Section 503(b)(9) priority claims; and (c) the amount, if any, of each such priority claim that SemCrude disputed. The Procedures Order granted Section 503(b)(9) claimants 20 days to file objections to the amount and treatment of their priority claims in the Notice of Allowed Section 503(b)(9) Claims. In the absence of a timely objection, all Section 503(b)(9) priority claims listed on the Notice of Allowed Section 503(b)(9) Claims were deemed allowed and resolved in the manner provided for in the Notice.

Bank of America, N.A. ("B of A"), as agent for SemCrude's pre-petition and post-petition secured lenders and numerous other parties, objected to all Section 503(b)(9) priority claims referenced in the Notice of Allowed Section 503(b)(9) Claims. The court ultimately considered these objections in determining the allowance of approximately 234 Section 503(b)(9) priority claims in the face amount of approximately \$151 million.

First, the *SemCrude* court addressed whether Section 503(b)(9) claimants had to file motions for allowance of their Section 503(b)(9) priority claims where their claims were already

addressed in the Notice of Allowed Section 503(b)(9) Claims. B of A argued that the Section 503(b)(9) claimants had to file motions that prove all the requirements of Section 503(b)(9), including that the vendor had sold goods to SemCrude in the ordinary course of SemCrude's business, and its goods were received by SemCrude within 20 days of its bankruptcy filing. The Section 503(b)(9) claimants argued that they had satisfied their burden of proving their priority claims where their claims were already included as valid claims in the Notice of Allowed Section 503(b)(9) Claims in accordance with the Procedures Order.

The court ruled that all Section 503(b)(9) claimants, whose claims were allowed in the Notice of Allowed Section 503(b)(9) Claims, had satisfied the burden of proving their priority claims without having to file motions for allowance of their claims. The Procedures Order established procedures for the assertion, analysis and determination of Section 503(b)(9) priority claims in order to avoid a flood of trade creditor motions on thousands of Section 503(b)(9) priority claims. Section 503(b)(9) claimants should not have to start from "square one" and file motions to prove their priority claims where SemCrude had already spent a year reconciling their claims under the Procedures Order and filed a Notice of Allowed Section 503(b)(9) Claims that listed valid and disputed priority claims, and trade creditors were afforded the opportunity to object to the amount and treatment of their priority claims.

The Procedures Order stated that all Section 503(b)(9) priority claims listed as valid in the Notice of Allowed Section 503(b)(9) Claims are deemed allowed in much the same way that undisputed, non-contingent and liquidated claims listed in SemCrude's schedules, and properly filed proofs of claims that are not objected to, are deemed allowed. The burden then shifts to B of A to produce sufficient evidence to defeat these claims.

The *SemCrude* court then considered the value of the Section 503(b)(9) priority claims. The Section 503(b)(9) claimants argued that the amount of their allowed priority claims should be based on their invoice or purchase price. B of A argued that the amount of allowed Section 503(b)(9) claims should be based on the resale price of the goods previously sold, and for unsold goods, the current market value of the goods on the plan effective date. The court ruled that the Section 503(b)(9) creditors had produced ample evidence to support the presumption that the amount of their priority claims is equal to the invoice or purchase price of the goods. B of A could rebut this presumption with evidence showing that under the facts and circumstances of a particular transaction, the goods are worth less than the invoice or purchase price.

Finally, the court ruled that UCC Article 2, dealing with sales of goods, governs the meaning of many of Section 503(b)(9)'s terms, such as the meaning of "goods," "receipt" and "sold in the ordinary course of business," that are not defined in the Bankruptcy Code. By way of example, the court considered natural gas and oil to be goods eligible for priority status. The court's

reliance on UCC Article 2 in construing Section 503(b)(9) should go a long way toward clarifying some of the currently litigated issues concerning Section 503(b)(9) priority claims.

The outcome of these litigations will determine the amount of trade creditors' Section 503(b)(9) priority claims and their ability to recover on these claims.

Conclusion

The *Pillowtex* decision is great news for trade creditors facing preference exposure in Delaware and other courts in the Third Circuit (and possibly the Seventh and Eleventh Circuits) where paid new value had previously been rejected as a preference defense. Trade creditors might now be able to include paid new value to substantially reduce their preference liability in pending preference actions in these Circuits.

And the *SemCrude* decision further demonstrates the many issues currently being litigated in connection with Section 503(b)(9) priority claims. The outcome of these litigations will determine the amount of trade creditors' Section 503(b)(9) priority claims and their ability to recover on these claims.

So, well done Delaware: keep up the good work in 2010! ●

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