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BY BRUCE S. NATHAN AND SCOTT CARGILL

### Circuit Ruling Expands Subsequent New-Value Preference Defense



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A recent decision of the U.S. Court of Appeals for the Eleventh Circuit has potential far-reaching implications concerning the extent of the new-value defense to preference liability. Whether a creditor can include, as part of its new-value defense, invoices for goods sold on credit terms prior to a debtor's bankruptcy filing that are subsequently paid by a debtor or trustee post-petition has divided courts across the country for more than a decade.

In *Auriga Polymers Inc. v. PMCM2 LLC*,<sup>1</sup> the Eleventh Circuit held that a creditor can use the goods or services provided on credit terms pre-petition both as a part of its § 503(b)(9) priority claim paid post-petition and as part of its subsequent new-value defense to reduce its preference exposure. The court's holding also has larger implications for preference defendants that receive any post-petition payment of their pre-petition claims from a debtor or trustee pursuant to a bankruptcy court order because the decision would also permit them to include such pre-petition claims as part of their new-value defense.

#### Preference Claims and the Subsequent New-Value Defense

A bankruptcy trustee can, based on reasonable due diligence under the circumstances and taking into account a creditor's known or reasonably knowable affirmative defenses, avoid and recover a preferential payment or other transfer under § 547(b) of the Bankruptcy Code. To do so, the trustee must prove that (1) the debtor transferred its property, such as by making a payment, to or for the benefit of a creditor; (2) the transfer was made on account of antecedent or existing debt that the debtor owed the

creditor; (3) the transfer was made when the debtor was insolvent, based on a balance-sheet definition of liabilities exceeding assets, which is presumed during the 90-day period prior to the debtor's bankruptcy filing date; (4) the transfer was made during the 90-day preference period with respect to a transfer made to a non-insider creditor of the debtor, such as a trade creditor; and (5) the transfer enabled the creditor to receive more from the transfer than the creditor would have received in a chapter 7 liquidation of the debtor's assets.

Once a bankruptcy trustee proves all of the above elements of a preference claim, a creditor then has the burden of proving one or more of the preference defenses contained in § 547(c) to reduce or eliminate its preference liability. The subsequent new-value defense is among the defenses contained in § 547(c)(4), stating as follows:

The trustee may not avoid under this section a transfer ... to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor ... *on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.*<sup>2</sup>

The subsequent new-value defense reduces a creditor's preference liability to the extent that the creditor replenished the debtor's bankruptcy estate by providing new goods and/or services on credit terms subsequent to receiving the preference payment. The new-value defense, like other preference defenses, is intended to encourage creditors to continue extending credit to their financially distressed customers and thereby reduce the risk of the customers' bankruptcy filing. The defense is premised on the lack of any harm to a debtor's

<sup>1</sup> 40 F.4th 1273 (11th Cir. 2022).

<sup>2</sup> Emphasis added.

other unsecured creditors when a preference payment is followed by the preference recipient's delivery of goods and/or provision of services on credit terms to the debtor. Courts have reached conflicting holdings over whether the subsequent new-value defense includes new value that a debtor or trustee paid post-petition.<sup>3</sup>

In *Auriga*, the debtor, Beaulieu Group LLC, was one of the largest carpet manufacturers in North America. The creditor, Auriga Polymers Inc., sold polyester resins and specialty polymers to Beaulieu that Beaulieu had used in the products it manufactured and sold.<sup>4</sup> Beaulieu filed its chapter 11 case on July 16, 2017 (the "petition date"), in the U.S. Bankruptcy Court for the Northern District of Georgia.<sup>5</sup>

During the 90 days before the petition date, Beaulieu paid approximately \$2.2 million to Auriga (the "transfers"). During the same 90-day preference period, Beaulieu purchased more than \$3.523 million of goods on credit terms from Auriga (the "goods").<sup>6</sup> The \$3.523 million of goods included at least \$694,502 that Beaulieu had received within 20 days of the petition date, making them eligible for administrative-expense priority status under § 503(b)(9). In the bankruptcy case, Auriga filed a general unsecured claim for \$3.596 million and a § 503(b)(9) priority claim for \$694,502.<sup>7</sup>

Beaulieu subsequently filed and confirmed a liquidation plan, which transferred all of Beaulieu's assets, including preference causes of action, to the PMCM2 LLC liquidating trust (the "trustee").<sup>8</sup> The trustee filed a complaint against Auriga in bankruptcy court seeking to avoid and recover the \$2.2 million in transfers that Auriga had received during the 90-day preference period.<sup>9</sup> Auriga and the trustee stipulated that the transfers were avoidable preferences, but that the new-value defense under § 547(c)(4) protected all but the final transfer, in the amount of \$421,119. Auriga contended that the final transfer should have been protected by its § 503(b)(9) priority claim because that claim was part of Auriga's new-value defense.<sup>10</sup>

The issue in the case is whether Auriga could include, as part of its new-value defense, a portion of its § 503(b)(9) priority claim that was paid post-petition. The trustee argued that Auriga's \$421,119 worth of goods could not be included in Auriga's § 547(c)(4) new-value defense *and* used as part of Auriga's § 503(b)(9) claim, which was fully reserved for post-petition. Auriga filed a counterclaim and sought declaratory judgment that its reliance on pre-petition invoices included in Auriga's § 503(b)(9) priority claim to support its new-value defense did not preclude Auriga from obtaining payment of the same invoices post-petition.<sup>11</sup>

The bankruptcy court held that Auriga could not be paid its § 503(b)(9) priority claim post-petition and assert the same claim as part of its new-value defense to reduce its preference liability. Relying on the reasoning contained in the bankruptcy court's prior 2020 decision in another preference lawsuit in the Beaulieu chapter 11 case,<sup>12</sup> the court concluded that Auriga's § 503(b)(9) priority claim did not qualify as new value since the post-petition payment of that claim was an "otherwise unavoidable" transfer within the meaning of § 547(c)(4).<sup>13</sup>

Auriga appealed the bankruptcy court's decision to the district court, which, finding that the appeal involved novel questions of law, permitted a direct appeal to the Eleventh Circuit.<sup>14</sup> The Eleventh Circuit framed the issue on appeal as whether the funds reserved to pay "Auriga's § 503(b)(9) request constitute an 'otherwise unavoidable transfer' that would offset Auriga's preference defense to the extent of that amount."<sup>15</sup> Bottom line: Did Auriga lose the benefit of the new-value defense because it could not satisfy § 547(c)(4)'s requirement that the new value was *not* paid by an otherwise unavoidable transfer when the trustee's reserve for Auriga's § 503(b)(9) priority claim was not avoidable?

The trustee relied on the Eleventh Circuit's earlier decision in *In re BFW Liquidation*, which held that the new-value defense does not require the new value to remain unpaid, but rather only that any new value must not be secured by an otherwise unavoidable security interest and the debtor must not have made an otherwise unavoidable transfer to or for the benefit of the creditor on account of the new value given. From this, the trustee argued that the new-value defense is reduced if, *at any time*, the debtor makes an "otherwise unavoidable transfer" to the creditor on account of the new value given.<sup>16</sup>

In *Auriga*, the Eleventh Circuit rejected the trustee's argument, concluding that an "otherwise unavoidable transfer" referenced in § 547(c)(4) must be paid prior to the petition date.<sup>17</sup> Accordingly, any post-petition payments that Auriga had received did not reduce Auriga's new-value defense. The Eleventh Circuit relied on six grounds.

First, the Eleventh Circuit rejected the bankruptcy court's refusal to read a pre-petition payment requirement into § 547(c)(4) because § 547(c)(4) does not contain a requirement that the "otherwise unavoidable transfer" occur pre-petition. The Eleventh Circuit instead took "a broader, contextual view when examining provisions of the Bankruptcy Code, and to not be guided by a single sentence or member of a sentence."<sup>18</sup>

Second, the Eleventh Circuit held that the term "transfer," as used in § 547(c)(4)'s "otherwise unavoidable transfer," must have the same meaning as the term "transfer" used in § 547(b). Section 547(b) states that a "transfer" subject to avoidance must have occurred pre-petition during the 90-day preference period.<sup>19</sup>

Third, the Eleventh Circuit concluded that a pre-petition limitation with respect to § 547(c)(4)'s reference to an "oth-

3 Compare, e.g., *In re Commissary Operations Inc.*, 421 B.R. 873 (Bankr. M.D. Tenn. 2010) (post-petition payment does not reduce new-value defense); *In re Friedman's Inc.*, 738 F.3d 547 (3d Cir. 2013); *In re Phoenix Rest. Grp. Inc.*, 373 B.R. 541 (M.D. Tenn. 2007); *In re Energy Coop. Inc.*, 130 B.R. 781 (N.D. Ill. 1991); *with In re Furr's Supermarkets Inc.*, 485 B.R. 672 (Bankr. D.N.M. 2012) (post-petition payments reduce new-value defense); *In re TI Acquisition LLC*, 429 B.R. 377 (Bankr. N.D. Ga. 2010); *In re Circuit City Stores Inc.*, 2010 WL 4956022 (Bankr. E.D. Va. 2010); *In re Circuit City Stores Inc.*, 515 B.R. 302 (Bankr. E.D. Va. 2014); *In re The Consolidate FGH Liquidating Trust*, 392 B.R. 648 (Bankr. S.D. Miss. 2008); *In re Login Bros. Book Co.*, 294 B.R. 297 (Bankr. N.D. Ill. 2003) (post-petition return of goods sold pre-petition); *In re MMR Holding Corp.*, 203 B.R. 605 (Bankr. M.D. La. 1996); *In re D.J. Mgmt. Grp.*, 161 B.R. 5 (Bankr. W.D.N.Y. 1993).

4 *Auriga*, 40 F.4th at 1277.

5 *Id.*

6 *Id.* at 1279.

7 *Id.*

8 *Id.* at 1277.

9 *Id.* at 1279.

10 *Id.* at 1280.

11 *Id.*

12 *In re Beaulieu Grp. LLC*, 616 B.R. 857 (Bankr. N.D. Ga. 2020).

13 *Auriga*, 40 F.4th at 1280.

14 *Id.* at 1281.

15 *Id.* at 1282.

16 *Id.*

17 *Id.*

18 *Id.* at 1284 (internal quotation omitted).

19 *Id.* at 1285.

erwise unavoidable transfer” is appropriate because § 547 is located in the Bankruptcy Code section titled “Preferences.” This section “concerns transactions occurring during the preference period, which is by definition pre-petition, *i.e.*, the 90 days before the filing of the petition.” This was further supported by the fact that post-petition transfers and avoidance actions are separately governed by § 549.<sup>20</sup>

Fourth, the Eleventh Circuit noted that even though § 547(c)(4) contains no express limitation on when a creditor may provide subsequent new value (pre-petition or post-petition), most courts have held that a creditor cannot include new value provided to a debtor post-petition as part of the creditor’s new-value defense. The court concluded that it would be illogical to exclude post-petition new value as part of a creditor’s new-value defense, then prevent the creditor from including invoices paid post-petition as part of such defense.<sup>21</sup>

Fifth, the statute of limitations for a trustee to commence a preference lawsuit begins to run on the bankruptcy filing date. The Eleventh Circuit noted that if a debtor’s post-petition payment of a creditor’s pre-petition invoices reduces the creditor’s new-value defense, the calculation of the creditor’s “preference liability could change depending on when the preference avoidance action was filed.” This is inconsistent with a statute of limitations beginning to run from the bankruptcy filing date.<sup>22</sup>

Sixth, the Eleventh Circuit recognized that competing policy goals are implicated by § 547(b) (*i.e.*, preventing creditors from racing to the courthouse to dismantle a distressed debtor and promoting equality of distribution among similarly situated creditors) and (c) (*i.e.*, encouraging creditors to continue to do business with a debtor according to usual business practices). The Eleventh Circuit rejected the bankruptcy court’s concern over allowing a “double payment” to a creditor by allowing the creditor to use the same invoices as part of both its § 503(b)(9) priority claim paid post-petition and its new-value defense. The court noted that “a new-value defense does not result in any payment to the creditor; it merely prevents disgorgement of monies previously paid.”<sup>23</sup> The court then explained that “equity of distribution does not mean equal distribution, as the Bankruptcy Code treats many kinds of creditors differently.”<sup>24</sup> The Eleventh Circuit held that a court’s role is not to “second-guess” how Congress balanced independent policy choices.<sup>25</sup> Accordingly, holding that post-petition payment on account of new value does not reduce the new-value defense (only pre-petition payments can reduce the defense) is consistent with overall bankruptcy policy.<sup>26</sup>

The Eleventh Circuit reversed the bankruptcy court’s order and remanded the case for further proceedings in *Auriga*’s preference lawsuit.<sup>27</sup> *Auriga* aligns the Eleventh Circuit with the Third Circuit, albeit based on a slightly different rationale. In *In re Friedman’s Inc.*, the Third Circuit held that the new-value defense is determined on the bank-

ruptcy filing date and only pre-petition payments of new value can reduce the new-value defense. Lower courts addressing the issue have been split. However, with the *Auriga* ruling, the Eleventh Circuit becomes the second circuit to hold that a debtor’s post-petition payments relating to new value do not impact the creditor’s new-value defense.

## Implications of the *Auriga* Ruling

The broad holding in *Auriga* is not limited to situations where the creditor both asserted its § 503(b)(9) priority claim as part of the creditor’s new-value defense and obtained payment of its § 503(b)(9) claim post-petition. Under *Auriga* and *Friedman*, the reason that a creditor received a post-petition payment from a debtor or trustee on account of the new value of goods and services that the creditor provided the debtor pre-petition is simply irrelevant to their holdings that such payments cannot be used to reduce the creditor’s § 547(c)(4) defense. Accordingly, in the Eleventh and Third Circuits, creditors can be assured that when they receive post-petition payments for pre-petition goods or services from a debtor or trustee, whether pursuant to a critical-vendor order, a reclamation-procedures order, an employee-wage order, an order authorizing payment of warehouses and common carriers, or a similar court authorization order, such payments cannot be used as a basis to reduce the creditor’s new-value defense.

## Conclusion

The *Auriga* decision is an unqualified win for preference defendants that received post-petition payments on account of some or all of the new value that comprise their § 547(c)(4) defense. The Eleventh Circuit’s thorough and well-reasoned opinion has the potential to influence future courts to rule in a similar manner. However, a fair number of other courts have reached a contrary holding, making this issue a potential candidate for final determination by the U.S. Supreme Court. **abi**

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<sup>20</sup> *Id.* at 1286.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 1288.

<sup>24</sup> *Id.*

<sup>25</sup> *See id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*