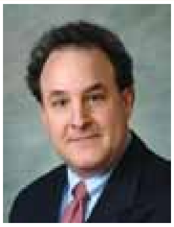

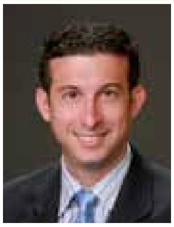

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Creditors Beware: Post-Petition Standby Letter of Credit Payments May Reduce New Value Defense

Blah—yet another preference claim to contend with comes in! The good news is trade creditors can rely on several defenses, including the subsequent new value defense contained in Bankruptcy Code Section 547(c)(4) to reduce or eliminate preference liability. While at first glance the subsequent new value defense may seem straightforward, oftentimes it is difficult to prove. This is particularly the case where the defense implicates both pre- and post-petition transactions between a debtor and a creditor and the alleged new value is paid by third-party funds, such as a bank's payment on a standby letter of credit. An example of this complexity can be found in the US Bankruptcy Court for the District of Delaware's recent decision in *Pirinate Consulting Group, LLC, as Liquidation Trustee of the NP Creditor Liquidation Trust* (the "trustee") *v. Styron LLC,* another preference litigation in the *NewPage* Chapter 11 case.

The *NewPage* court was asked to determine whether a creditor can include pre-petition invoices, paid by a creditor's post-petition draw on a standby letter of credit, as part of the creditor's subsequent new value defense. The court refused to grant summary judgment, thereby enabling the preference litigation to proceed. The *NewPage* court raised several issues that creditors should be cognizant of when deciding whether and how to deal with a financially distressed customer both before and after a bankruptcy filing. The issues include the potential impact of a creditor's post-petition draw on a standby letter of credit on that creditor's subsequent new value defense.

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Preference Claims and the New Value Defense

A trustee is required to satisfy all of the requirements of Bankruptcy Code Section 547(b) as a prerequisite to recovering a preference claim. In turn, a creditor can assert one or more defenses to a preference claim under §547(c). One of the most frequently invoked defenses is the subsequent new value defense. A creditor can rely on the new value defense to reduce its preference liability, on a dollar-for-dollar basis, to the extent the creditor had provided new goods and/or services on credit terms to the debtor subsequent to the receipt of a preference.

The subsequent new value defense protects a creditor from preference liability because the new goods and/or services the creditor had provided to the debtor after the payment replenished the debtor's assets that were otherwise diminished by the alleged preference. The new value defense is also supposed to encourage creditors to continue extending credit to financially troubled companies and promote equality of treatment among creditors.

One of the requirements of the subsequent new value defense, contained in §547(c)(4)(B), is that a creditor's new value was not paid for by an otherwise unavoidable transfer by the debtor to or for the creditor's benefit. New value is paid by an otherwise unavoidable transfer where payment of the new value is subject to another preference defense, such as the ordinary course of business defense. So what is the impact of a creditor's receipt of payment of its asserted new value invoices by drawing on a standby letter of credit after its customer's bankruptcy filing?

How Standby Letters of Credit Work

Standby letters of credit are a tool that trade creditors frequently rely upon to protect themselves from the risk of nonpayment of their invoices by a financially troubled customer. A letter of credit transaction involves three parties and three independent contracts.

The first contract oftentimes involves a sale of goods or provision of services between a seller and a buyer. In order to obtain additional credit protection, however, the seller may require that a buyer cause a bank to issue a letter of credit in the seller's favor as a condition to the seller extending credit or otherwise doing business with a buyer.

The second discrete contract is between the buyer, as the letter of credit applicant, and the bank issuing the letter of credit. The buyer agrees to repay the bank for the bank's payments made to the beneficiary upon the presentation of conforming documents, and the buyer's reimbursement and other obligations to the bank are frequently secured by the buyer granting a security interest in all of the buyer's assets in favor of the bank.

The final contract is the standby letter of credit that the bank issues in favor of the seller as beneficiary. When the beneficiary submits conforming documents to the issuing bank, the bank's only duty is to examine the documents and determine whether they are consistent with the documentary requirements set forth in the letter of credit. After the bank determines that the beneficiary has presented all of the required documents, the bank must pay the amount requested by the seller as beneficiary.

The bank's obligation to honor a conforming draw on a letter of credit is independent of the beneficiary's/seller's performance of the underlying contract for which the letter of credit was issued and the bank's ability to recover its reimbursement claim against the letter of credit applicant/buyer. The bank is required to pay the beneficiary upon the presentation of all of the documents required by a letter of credit, regardless of any contractual dispute between the seller and buyer and/or the bank's inability to obtain payment of its reimbursement claim from the buyer.

> The bank's obligation to honor a conforming draw on a letter of credit is independent of the beneficiary's/seller's performance of the underlying contract.

The Facts of the *NewPage* Case

Styron LLC ("Styron")started doing business with NewPage Corporation and NewPage Wisconsin Systems Inc. (the "debtors") in June 2010, after Styron had purchased a division of Dow Chemical that had a preexisting relationship with the debtors. On September 15, 2010, Styron became the beneficiary of a $2 million letter of credit (the "LC") the debtors had caused to be issued by Wells Fargo Bank, NA ("Wells Fargo")[1] on July 20, 2009. The amount of the LC was subsequently increased to $3 million.

As of June 30, 2011, Wells Fargo had $101 million of undrawn outstanding letters of credit that were issued for the debtors' account. When Wells Fargo honored a letter of credit draw, Wells Fargo would immediately notify the debtors of the drawing and they would reimburse Wells Fargo for the amount of the letter of credit payment. Wells Fargo's reimbursement claim with respect to all letters of credit, including the LC, was secured by a first priority lien on all of the debtors' and their affiliates' cash, receivables and inventory, and the court noted that Wells Fargo's reimbursement claim against the debtors was likely fully collateralized. As part of Styron's drawing on the LC, Styron would present to Wells Fargo a statement of past due invoices for which Styron demanded payment.

> The debtors' post-petition payment of a creditor's pre-petition invoices pursuant to a court-approved wage order did not preclude the creditor from relying on the same invoices as part of its subsequent new value defense.

Between April 2010 and August 26, 2011 (14 months before the preference period), the debtors paid Styron's invoices on average 14 days after invoice date. On August 26, 2011 (during the preference period), Styron allegedly changed the debtors' payment terms to cash in advance. Around the same time, the $3 million LC was reduced to $2.8 million. From August 30, 2011 to September 6, 2011 (one day before the debtors' bankruptcy filing), the debtors made three cash-in-advance payments, totaling $3,303,924.34, to Styron for goods that Styron had thereafter sold and delivered to the debtors, as well as other payments of outstanding invoices with payment terms.

The debtors and other affiliates filed for bankruptcy on September 7, 2011 (the "petition date"). On the petition date, the debtors owed Styron $1,920,769.35. Subsequent to the petition date, Styron twice drew on the LC to pay this claim, which included invoices that Styron also had sought to include as part of its subsequent new value defense.

The NewPage debtors had successfully exited Chapter 11 by obtaining court approval of their Chapter 11 plan of reorganization, which went effective on December 21, 2012. A liquidating trust was created under the plan and a liquidating trustee was appointed to, for among other matters, prosecute and collect preference claims. On October 29, 2013, the liquidating trustee filed an adversary proceeding to recover $11,788,000.85 of allegedly preferential payments that the debtors had made to Styron between June 9, 2011 and September 6, 2011 (the "preference period").

Styron and the trustee each filed motions for partial summary judgment in connection with Styron's new value defense. Styron primarily relied on the US Third Circuit Court of Appeal's decision, in *Friedman's Liquidating Trust v. Roth Staffing Companies LP*, that the debtors' post-petition payment of a creditor's pre-petition invoices pursuant to a court-approved wage order did not preclude the creditor from relying on the same invoices as part of its subsequent new value defense. Styron relied on the *Friedman's* decision in arguing that its unpaid new value included all unpaid invoices as of the Petition Date that were paid by Styron's post-petition draws of the LC. The trustee argued that Styron's new value defense did not include any invoices that Wells Fargo had paid as part of Styron's drawings on the LC. The trustee claimed the debtors had realized no benefit from the paid new value in light of the debtors' fully secured obligation to reimburse Wells Fargo for all LC payments.

> The new value defense still applied, irrespective of the post-petition payments, because the new value analysis must be determined as of the date of the debtor's bankruptcy filing.

The *Friedman's* Decision

In *Friedman's,* the debtor made payments, totaling $82,000, to the defendant, Roth Staffing Companies LLP ("Roth"), during the preference period. After the debtor's bankruptcy filing, the bankruptcy court approved an order authorizing the post-petition payment of certain pre-petition wages (the "wage order"). Pursuant to the wage order, the debtor paid Roth $72,412.71.

The liquidating trustee in *Friedman's* filed a preference action against Roth seeking the recovery of an alleged preference claim totaling $81,997.57. Roth asserted a subsequent new value defense in the amount of $100,660.88. The defense included the $72,412.71 paid post-petition pursuant to the wage order. Roth argued that the new value defense still applied, irrespective of the post-petition payments, because the new value analysis must be determined as of the date of the debtor's bankruptcy filing. The trustee argued that Roth's subsequent new value defense did not include the $72,412.71 because it would allow Roth to improperly double dip by counting Roth's invoices paid under the wage order as new value.

The Third Circuit rejected the trustee's position and held that the post-petition payment made pursuant to the wage order did not preclude Roth from relying on the $72,412.71 as part of its subsequent new value defense. The Third Circuit held that: (a) a debtor's estate can be replenished even when a post-petition payment is for new value that was provided pre-petition; (b) any evaluation of new value must be made as of a debtor's bankruptcy filing date; and (c) determining the new value defense as of the petition date would not interfere with the equal treatment of all creditors because the bankruptcy court supervises the debtor's operations and the bankruptcy court, creditors, the creditors' committee and the US Trustee all have the opportunity to scrutinize the debtor's post-petition conduct.

The Parties' Arguments and the *NewPage* Court's Decision

Styron relied on the Third Circuit's decision in *Friedman's* in arguing that its subsequent new value defense included all of the invoices that remained unpaid as of the petition date even though they were subsequently paid by Wells Fargo as a result of Styron's post-petition draws on the LC. Styron argued that it satisfied the new value defense because: (a) it had sold and delivered goods to the debtors on an unsecured basis; (b) these new sales and deliveries of goods occurred after the alleged preferential transfers were made; and (c) the LC that was used to pay for the goods was not the debtor's property.

The trustee argued that the facts of the *NewPage* case differ from those of *Friedman's.* In *Friedman's:* (a) Roth, unlike Styron, did not, during the preference period, change the payment terms governing the parties' pre-petition relationship; (b) the debtors' post-petition payment to Roth was a court-approved critical vendor payment; and (c) Styron did not seek court approval to obtain payment on the LC.

The *NewPage* court acknowledged that the rule in the Third Circuit after *Friedman's* is that new value is determined on a debtor's bankruptcy filing date. However, the *Friedman's* court also recognized that "unique circumstances" might alter this rule. In particular, the court questioned the applicability of the *Friedman's* holding where Styron had an indirect security interest in the debtors' assets by virtue of Styron's status as a beneficiary of a fully collateralized standby LC. As a result, Styron's draws on the LC to pay its new value invoices immediately triggered the debtors' fully secured reimbursement obligation to Wells Fargo. Styron's asserted new value did not replenish the debtors because it was paid by Wells Fargo, who in turn reimbursed itself from its collateral and, thereby diminished the debtors' available assets. The *NewPage* court also noted (without any real discussion) that summary judgment was inappropriate because Styron's "diligence" in changing payment terms from 14 days to cash in advance during the preference period might have undermined its ability to assert the subsequent new value defense.

> Determining the new value defense as of the petition date would not interfere with the equal treatment of all creditors because the bankruptcy court supervises the debtor's operations.

Conclusion

Although only decided in the context of a summary judgment motion, the implications of the *NewPage* decision could be far reaching and impact parties' assessment of preference risk and ultimately creditors' willingness to continue doing business with financially distressed customers both before and after their bankruptcy filing. The decision appears to have limited the *Friedman's* holding to allow only new value paid post-petition pursuant to a court-approved wage or critical vendor order. That calls into question whether other post-petition payments of new value, including a payment made on account of a creditor's drawing on a standby LC, or payment of an allowed Section 503(b)(9) 20-day goods priority claim[2], counts as new value.

The *NewPage* decision also questioned the impact of a creditor's change of payment terms during the preference period on the subsequent new value defense. It is unclear why the court considered a change in payment terms (a concept generally considered in analyzing the ordinary course of business defense) if Styron had already satisfied the elements of the new value defense. It is also unclear whether the *NewPage* court's refusal to grant summary judgment allowing Styron's asserted new value paid post-petition was based on Wells Fargo's payment of Styron's new value invoices as part of Styron's draw on the LC fully collateralized by the debtors' assets or on Styron's change of payment terms shortly before the debtors' bankruptcy filing. A later trial will answer this question!

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1. The LC was initially issued to the debtors by Wachovia Bank, N.A., which subsequently merged with Wells Fargo.

2. Section 503(b)(9) grants goods sellers an administrative priority claim 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."

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