SELECTED TOPIC

Bruce Nathan, Esq. and
Michael Papandrea, Esq.

Eleventh Circuit Approves Paid New Value Defense to Preference Liability

Prudent trade creditors may rightly be wary of continuing to sell goods or provide services on credit to distressed customers that are headed toward bankruptcy. The risk of nonpayment is worrisome enough, but the added risk of having to return payments, received after painstaking collection efforts, as a preference is simply unpalatable.

Luckily, trade creditors can take comfort from a recent decision by the United States Court of Appeals for the Eleventh Circuit (the "Eleventh Circuit"), *In re BFW Liquidation, LLC ("BFW")*, that allowed paid as well as unpaid new value as a defense to a preference claim. The Eleventh Circuit's holding will likely significantly reduce preference risk in many cases and is a solid win for the trade!

Preference Claims & Defenses

Pursuant to Section 547(b) of the Bankruptcy Code, a trustee can avoid and recover a transfer as a preference by proving all of the following:

- The debtor transferred its property to or for the benefit of a creditor. The transfer of any type of property can be avoided, but the most frequent type of transfer is the debtor's payment from its bank account to a creditor [Section 547(b)(1)];
- The transfer was made on account of antecedent or existing indebtedness, such as outstanding invoices for goods sold and delivered and/or services rendered, that the debtor owed to the creditor [Section 547(b)(2)];
- The transfer was made when the debtor was insolvent [Section 547(b)(3)], which is based on a balance sheet test of the debtor's liabilities exceeding its assets and is presumed during the 90-day preference period;
- The transfer was made within 90 days of the debtor's bankruptcy filing in the case of a transfer to a non-insider creditor, such as a trade creditor [Section 547(b)(4)]; and
- 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)].

A creditor can assert multiple affirmative defenses contained in Section 547(c) of the Bankruptcy Code to reduce its preference exposure. One of these defenses is the "ordinary course of business defense," which insulates a preference defendant from liability to the extent the payment in question was on account of a debt incurred by the debtor in the ordinary course of business, and it was either made in the ordinary course of business between the debtor and the defendant or was made according to ordinary business terms.

Another preference defense, which was at issue in the *BFW* case, is the "subsequent new value" defense contained in Section 547(c)(4). Section 547(c)(4) states that a preference payment may not be clawed back by a bankruptcy trustee where a creditor gave new value to or for the benefit of the debtor after a preference payment and (a) such new value was not secured by an otherwise unavoidable security interest and (b) the debtor did not make an otherwise unavoidable transfer to or for the benefit of the creditor on account of such new value. The new value defense reduces a creditor's preference liability dollar for dollar based on the creditor's sale and delivery of goods and/or provision of services to the debtor on credit terms after the debtor's receipt of an alleged preference payment.

Congress enacted these preference defenses to encourage creditors to continue doing business with, and extending credit to, financially struggling companies. The legislative purpose behind the preference defenses is both illustrated in, and upheld by, the *BFW* decision.

Factual Background

Bruno's Supermarkets, LLC (the "Debtor"), a grocery store chain with more than 60 stores throughout Ala-

bama and Florida, was engaged in a business relationship with Blue Bell Creameries, Inc. ("Blue Bell"). Blue Bell had agreed to sell and deliver ice cream and related products on credit to the Debtor. The Debtor generally remained current with Blue Bell based on the Debtor's twice-a-week payments to Blue Bell. However, in August 2008, the Debtor began experiencing liquidity problems, resulting in a slowdown of the Debtor's payments to once a week to Blue Bell, and the Debtor also began holding checks payable to Blue Bell.

Between Nov. 7, 2008 and Feb. 5, 2009 (the "Preference Period"), the Debtor made 13 separate payments in the aggregate amount of $563,869.37 to Blue Bell. At least $250,000 was for products Blue Bell had delivered to the Debtor prior to the Preference Period. During the Preference Period, Blue Bell delivered $435,705.65 of ice cream and other goods to the Debtor, making approximately 1,700 separate deliveries.

On Feb. 5, 2009, the Debtor filed its Chapter 11 bankruptcy case in the United States Bankruptcy Court for the Northern District of Alabama (the "Bankruptcy Court"). Several months later, the Bankruptcy Court confirmed the Debtor's plan of liquidation and a liquidating trustee (the "Trustee") was appointed to oversee the Debtor's bankruptcy estate. In January 2011, the Trustee commenced a lawsuit against Blue Bell seeking to avoid and recover the $563,869.37 the Debtor had paid to Blue Bell during the Preference Period.

Blue Bell asserted a full defense to the preference litigation based on the ordinary course of business and subsequent new value defenses. The Bankruptcy Court rejected the applicability of the ordinary course of business defense.

The Bankruptcy Court partially allowed Blue Bell's new value defense only to the extent the new value had remained unpaid on the Petition Date. The Bankruptcy Court relied on the Eleventh Circuit's earlier statement in *In re Jet Florida System, Inc. ("Jet Florida")* that one of the requirements of the Bankruptcy Code's new value defense is that the new value must remain unpaid. Accordingly, the Bankruptcy Court ruled the Trustee could avoid and recover approximately $438,500 of the approximately $564,000 that the Debtor had paid to Blue Bell during the Preference Period. The Bankruptcy Court did not count Blue Bell's invoices, that the Debtor had paid, as new value to reduce Blue Bell's preference liability.

Blue Bell had appealed the Bankruptcy Court's decision to the Eleventh Circuit. Blue Bell argued for a reversal of the Bankruptcy Court's limitation of the new value defense to only unpaid new value. Blue Bell asserted that Section 547(c)(4) does not limit the new value defense to only unpaid new value, and the Eleventh Circuit's earlier statement in the *Jet Florida* case that only unpaid new value is eligible for the protection of the new value defense is merely dictum and not binding on the Bankruptcy Court.

The Trustee argued the *Jet Florida* case was binding precedent that limited the new value defense to only unpaid new value. The Trustee also asserted that policy considerations weighed in favor of limiting the new value defense to unpaid new value, even if the *Jet Florida* decision was not binding on the Bankruptcy Court.

The Trustee's final argument hinged upon the Bankruptcy Code's requirement that the relevant payments of new value made to Blue Bell must not be "otherwise unavoidable" in order for Blue Bell to avail itself of the new value defense. The Trustee asserted that a creditor could include payments of new value as part of the creditor's preference defense if the payments are avoidable under another avoidance statute, such as Bankruptcy Code Section 548 dealing with fraudulent transfers, and not under the preference statute. As a result, Blue Bell did not satisfy the requirements of the new value defense because the Debtor's payments of the new value were not fraudulent transfers and, as such, were not an "otherwise unavoidable transfer."

The Eleventh Circuit's Decision

The Eleventh Circuit held that its prior statement in *Jet Florida*, that new value must remain unpaid, is dictum and not binding on the Bankruptcy Court. The Eleventh Circuit noted, "dictum" is a term used to describe statements that neither constitute, nor are necessary to, the holding of the case. Such statements are not binding on subsequent court decisions. The Eleventh Circuit noted its earlier statement in *Jet Florida*, that subsequent new value must "remain unpaid" to offset preference liability, was not dispositive or relevant to its decision in *Jet Florida* denying the creditor's new value defense. Instead, the *Jet Florida* decision was premised on the fact that the creditor had not provided any new value to the debtor in the first place.

The Eleventh Circuit, therefore, felt free to rely on its own interpretation of Section 547. The Eleventh Circuit held that the plain and unambiguous language of Section 547(c)(4) does not require new value be unpaid. Section 547(c)(4) limits the new value defense in that (1) any new value the creditor provides must not be secured by an otherwise unavoidable security interest, and (2) the debtor must not have made an otherwise unavoidable transfer to or for the creditor's benefit on account of the new value provided to the debtor. Section 547(c)(4) contains no blanket requirement that new value must remain unpaid to be eligible as a defense to a preference claim.

The Eleventh Circuit's analysis could have stopped there because, as the court noted, there is no need to examine or look to any other interpretive resources in order to determine the meaning of a statute if the plain language of the statute is unambiguous. Nevertheless, the Eleventh Circuit explained that not only does Section 547(c)(4) contain no requirement that new value remain unpaid, Section 547(c)(4)'s legislative history indicates Congress had intentionally omitted such a requirement from the new value defense. While the predecessor statute to Section 547(c)(4) states that creditors could offset only "new credit remaining unpaid", Section 547(c)(4) specifically eliminated the "remaining unpaid" provision from the new value defense.

Moreover, and perhaps most importantly, the Eleventh Circuit rejected the Trustee's position that policy considerations weigh in favor of imposing the "remaining unpaid" requirement on the new value defense. Instead, the Eleventh Circuit found policy considerations favored including both paid and unpaid new value as part of a creditor's new value defense.

The Eleventh Circuit noted allowing paid new value promotes one of the principal policy objectives underlying the preference provisions of the Bankruptcy Code—encouraging creditors to continue extending credit to financially troubled debtors. The Eleventh Circuit recognized imposing a "remaining unpaid" requirement would induce a sensible vendor to immediately cut off its distressed customer, which would likely hasten the customer's bankruptcy filing and financial demise. Not only would the trade creditor face the risk of nonpayment, but any payments the creditor received on account of goods shipped within 90 days of a bankruptcy filing would be recoverable as a preference and the creditor would be barred from using the new value paid by the preference payments to reduce its liability. The creditor would, therefore, be in a worse position continuing selling on credit to its financially distressed customer than if the creditor had ceased doing business with its customer as soon as the creditor sensed financial troubles. On the other hand, allowing paid new value would *incentivize* trade creditors to continue providing goods and/or services on credit to their financially distressed customers. The bankruptcy estate would almost always be better off if a creditor continues to supply the debtor with goods to sell and/or services, and the new value defense, as interpreted by *Blue Bell*, would encourage the creditor to do so.

Finally, the Eleventh Circuit rejected the Trustee's argument that Section 547(c)(4) requires that a payment made on account of new value must be "otherwise unavoidable" under another avoidance statute (and not the preference statute), such as statutes dealing with the fraudulent transfers. The Eleventh Circuit concluded that this requirement would eviscerate the new value defense because a creditor would only be able to avail itself of the new value defense for new value that was paid by a fraudulent transfer, which is unlikely.

The Eleventh Circuit also held that a creditor could not include paid new value as a defense to a preference claim where the payment of the new value is unavoidable as a preference for reasons other than the Section 547(c)(4) new value defense. Thus, where the payment of the new value is subject to Section 547(c)(2)'s ordinary course of business or Section 547(c)(1)'s contemporaneous exchange for new value defenses, the payment would be an unavoidable transfer that disqualifies the creditor from including the paid new value as part of the creditor's new value defense.

Conclusion

Trade creditors should be comforted by the Eleventh Circuit's *BFW* decision. By holding that paid new value counts as a preference defense and new value does not need to remain unpaid to be included as part of a creditor's new value defense, the Eleventh Circuit has joined the Fourth, Fifth, Eighth and Ninth Circuits in significantly reducing the risk of preference liability in many cases.

Bruce Nathan, Esq., is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy, Financial Reorganization & Creditors' Rights Group and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM, a former member of the board of directors of the American Bankruptcy Institute and a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached via email at bnathan@lowenstein.com.

Michael Papandrea, Esq., is an associate in Lowenstein's Bankruptcy, Financial Reorganization & Creditors' Rights Department. Prior to joining the firm, Michael held multiple clerkship positions in the United States Bankruptcy Court, serving as a judicial law clerk to The Honorable Jerrold N. Poslusny, Jr., D.N.J., The Honorable Ashely M. Chan, E.D. Pa., and The Honorable Gloria M. Burns, C.J., D.N.J.

**This is reprinted from* Business Credit *magazine, a publication of the National Association of Credit Management. This article may not be forwarded electronically or reproduced in any way without written permission from the Editor of* Business Credit *magazine.*