THIRD CIRCUIT CONCLUSIVELY ANSWERS QUESTION WHETHER POST-PETITION PAYMENTS ON PRE-PETITION DEBT REDUCE A CREDITOR'S "SUBSEQUENT NEW VALUE" PREFERENCE DEFENSE

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Critical Vendors & 503(b)(9) Claimants Receive a Nice Christmas Present from the Third Circuit!

Addressing an issue that we have argued in preference litigation many times for clients, the U.S. Court of Appeals for the Third Circuit gave creditors a nice Christmas present on December 24, 2013, when it decided—conclusively—that post-petition payments on pre-petition debt do not reduce the amount of a creditor's "subsequent new value" defense. Prior court decisions across the country have split on this issue.[i] While the Third Circuit had strongly hinted in two prior decisions that it might decide this issue in the way it ultimately did,[ii] its Christmas Eve decision in *Friedman's Liquidating Trust v. Roth Staffing Companies LP (In re Friedman's Inc.),* No. 13-1712 (3rd Cir. Dec. 24, 2013) eliminates any doubt where the Third Circuit stands.

Because the Third Circuit encompasses Delaware, this decision is of major import to larger businesses nationwide, which may often have customers or suppliers who file bankruptcy in Delaware. This decision constitutes controlling precedent on this preference issue in all Delaware bankruptcy cases.

The Facts in Friedman's

Prior Third Circuit cases did not present facts squarely posing the question of post-petition payments. The *Friedman's* case did.

In *Friedman's*, creditor Roth Staffing provided contract employees for the Debtor's business. Roth received a payment of $81,997.57 during the 90 days preceding the bankruptcy filing. After receiving that payment and before the bankruptcy case was filed, Roth provided additional services to the Debtor valued at $100,660.88. Pursuant to a "first day order" authorizing payments to employees of pre-petition debts, the Debtor paid Roth $72,412.71 on account of the pre-petition staffing services Roth had provided.

After the Debtor's business was sold, a liquidating trust received the right to pursue all preference claims[iii] of Friedman's, for the benefit of its general unsecured creditors. The trustee promptly sued Roth for the $81,997.57 paid during the preference period. Roth claimed it was entitled to the "subsequent new value" defense in the full amount ($100,660.88) of services it had provided in the interim between receipt of the preference payment and the bankruptcy filing. If Roth was correct, it had no liability to the trustee. The trustee, however, argued that since Roth was paid, albeit post-petition, for $72,412.71 of those unpaid pre-petition services, its defense was limited to only the $28,248.17 amount remaining unpaid ($100,660.88 - $72,412.71) and so Roth owed the trustee $53,749.40 ($81,997.57 - $28,248.17). The U.S. Bankruptcy Court for the District of Delaware decided in favor of Roth's, finding the Third Circuit's prior decision in *New York City Shoes* persuasive, and concluding the cut-off for calculating the "subsequent new value" defense was the date of the bankruptcy filing. The trustee appealed to the District Court. Agreeing with the trustee that the language in both *New*

York City Shoes and *Winstar* could both be considered dicta,[iv] the District Court nonetheless was reluctant to disagree with dicta twice-stated by the Third Circuit and affirmed.

The Third Circuit's Decision

At the outset, the Third Circuit agreed that the language in its two prior decisions was dicta, as neither case involved post-petition payments. And despite the split in prior court decisions, the Third Circuit concluded the statutory language was not ambiguous.[v] The Court rejected Roth's argument that the word "transfer" is limited by its context to the bankruptcy filing date and the 90 days before filing. Similarly, the Court rejected Roth's argument that the word "debtor" in the preference statute must be considered as the pre-petition debtor, which is considered a separate legal entity from the post-petition debtor in possession or post-petition debtor's bankruptcy estate.

Instead, the Court based its decision on the context of the Bankruptcy Code as a whole. The Court observed there are numerous contextual indicators that the provisions in the preference statute concern the 90 days before the bankruptcy filing. The Court further noted that "the vast majority of courts" have concluded that the filing date cuts off the consideration of "subsequent new value" provided by a creditor, in cases where creditors were not allowed to count as subsequent new value their unpaid administrative claims resulting from insolvent estates unable to pay post-petition debt.[vi] Symmetry, it seems, carried the day. (Certainly we have argued many times that debtors and trustees should not have it both ways, cutting off subsequent new value calculations at the petition date to exclude unpaid administrative claims of the creditor, while counting the payments made post-petition to reduce the amount of the defense.)

The Third Circuit also considered that the policy of the subsequent new value defense is to encourage creditors to continue to deal with debtors in financial trouble rather than cutting off credit. The Court rejected the notion that all unsecured creditors are to be treated equally; such a rule could hardly exist given the many exceptions (such as traditional first day orders, executory contracts and unexpired leases, protection of certain claims under 11 U.S.C. § 503(b)(9)). The Court also rejected the notion that preferences are intended to replenish the estate, as overshadowed by the policy of encouraging creditors to continue to deal with financially struggling debtors.

Conclusion

Creditors most likely to benefit from this decision are those who may qualify under any of the myriad "critical vendor" type first day orders, including those supplying goods in the 20 days before bankruptcy who may get paid on their claim under 11 U.S.C. § 503(b)(9).

Most of the larger bankruptcy cases in the country are filed in Delaware, with the Southern District of New York (encompassing New York City, and in the Second Circuit) coming in a close second. This Third Circuit decision will be binding precedent whenever this issue arises in bankruptcy cases filed in Delaware, and thus stands as a significant decision in favor of creditors who continue to assist struggling debtors on their slide into bankruptcy and who are significant enough to receive payments post-petition on their pre-bankruptcy debts by virtue of a first day order or assumption of an executory contract. While this precise issue may still be in play in some courts outside the Third Circuit, the decision also provides a persuasive voice in favor of creditors.

[i] *Compare, e.g., Phoenix Restaurant Group, Inc. v. Proficient Food co. (In re Phoenix Restaurant Group, Inc).,* 373 B.R. 541, 547 (M.D. Tenn. 2007) (holding that post-petition payments made pursuant to Critical Vendor Order could not be used to offset pre-petition new value); *In re Schabel,* 338 B.R. 376, 381 (Bankr. E.D. Wis. 2005) (holding that new value must remain unpaid at time of filing of bankruptcy petition); *In re Schwinn Bicycle Co.,* 205 B.R. 557, 568 (Bankr. N.D. Ill. 1997) ("the subsequent new value must remain unpaid as of the petition date"); *In re Thurman Construction, Inc.,* 189 B.R. 1004, 1014 (Bankr. M.D. Fl. 1995) (finding that new value must remain unpaid as of petition date, rather than date court adjudicates preference action); *In re Braniff, Inc.,* 154 B.R. 773, 784-85 (Bankr. M.D. Fl. 1993) (following "majority rule" stated in *New York City Shoes* that new value remain unpaid as of petition date); and *Energy Cooperative, Inc. v. Cities Service Co. (In re Energy Cooperative, Inc.),* 130 B.R. 781, 789 (N.D. Ill. 1991) (citing *New York City Shoes* for principle that post-bankruptcy payments by debtor do not limit new value defense); *In re Jesperson*, 67 B.R. 415, 417 (Bankr. D. S.D. 1986) (subsequent new value must remain unpaid "as of the date of the filing of the petition"); *In re Almarc Manufacturing, Inc.,* 62 B.R. 684, 686 (Bankr. N.D. Ill. 1986) ("additional post-preference unsecured credit must be unpaid in whole or in part as of the date of the petition"); *with, e.g., In re Furr's Supermarkets, Inc.,* 485 B.R. 672, 733-34 (D. N.M. 2012) (holding that cutting off preference calculation at petition date "makes no economic sense"); *In re TI Acquisition, LLC*, 429 B.R. 377, 381 (Bankr. N.D. Ga. 2010) (any post-petition payment reduces the subsequent new value defense); *In re Circuit City Stores, Inc.,* 2010 WL 4956022 at *9 (Bankr. E.D. Va. 2010) (creditor may have either a 503(b)(9) claim or reduce its preference liability by that amount, but not both); *In re Login Bros. Book Co.,* 294 B.R. 297, 300 (N.D. Ill. 2003) ("[B]oth the plain language and policy behind the statute indicate that the timing of a repayment of new value is irrelevant."); *In re MMR Holding Corp.,* 203 B.R. 605, 609 (Bankr. M.D. La. 1996) ("An unavoidable post-petition transfer on account of new value extended subsequent to a preference should limit the use of § 547(c)(4) by the amount of the unavoidable transfer, as without a reduction in the new value offset, the transferee would be receiving double use of the new value…"); and *In re D.J. Management Group,* 161 B.R. 5, 8 (Bankr. W.D.N.Y. 1993) (holding that post-petition payments on new value must be considered under § 547(c)(4)).

[ii] *See, e.g., In re New York City Shoes, Inc.,* 880 F.2d 679, 680 (3rd Cir. 1989) (outlining three requirements for proving the new value defense, stating as the third element that the debtor must not have fully compensated the creditor for the new value as of the date of bankruptcy); *In re Winstar Communications, Inc.,* 554 F.3d 382, 402 (3rd Cir. 2009) (in *Winstar,* the Court referred to the language in *New York City Shoes* as a holding).

[iii] Under 11 U.S.C. § 547(b), any transfer of an interest in property of the debtor made to a creditor in the 90 days before bankruptcy may be attacked as an alleged "preferential transfer." To constitute a preference, there must have been a transfer of an interest in property of the debtor (usually, a payment), to or for the benefit of the creditor, on account of a pre-existing debt, and the payment must have enabled the creditor to receive more than it otherwise would have if bankruptcy had ensued and the creditor had not received the challenged payment. These elements are usually easy to satisfy with respect to almost all payments made to unsecured or under-secured creditors during the 90 days before bankruptcy.

Creditors, of course, have to defend either on one or more of the elements of § 547(b) or upon any of the defenses enumerated in § 547(c). The most common of those defenses are the "ordinary course of business" defense in § 547(c)(2) and the "subsequent new value" defense stated in § 547(c)(4).

[iv] Language that is not critical to a court's decision is termed "dicta" and is not entitled to precedential effect.

[v] For authority on this point the Court pointed to its prior holdings that just because courts are divided in their interpretations of a particular statute doesn't mean the provision is ambiguous. *See, e.g., In re Price,* 370 F.3d 362, 369 (3rd Cir. 2004). The Court noted the U.S. Supreme Court has urged courts to look to the provisions of the whole law, its object and policy, *quoting Kelly v. Robinson,* 479 U.S. 36, 43 (1986), and that statutory construction is a "holistic endeavor." [Citations omitted.]

[vi] *See, e.g., In re Bellanca Aircraft Corp.,* 850 F.2d 1275, 1284-85 (8th Cir. 1988); *In re Rocor Int'l, Inc.,* 352 B.R. 319, 333 (Bankr. W.D. Okla. 2006); *In re George Transfer, Inc.,* 259 B.R. 89, 96 (Bankr. D. Md. 2001); *In re Sharoff Food Serv., Inc.,* 179 B.R. 669, 678 (Bankr. D. Co. 1995); *In re D.J. Mgmt. Group,* 161 B.R. 5, 6 (Bankr. W.D.N.Y. 1993); *In re Jolly "N," Inc.,* 122 B.R. 897, 909-10 (Bankr. D.N.J. 1991); *In re Vunovich,* 74 B.R. 629, 632 (D. Kan. 1987); *see also* 4 Norton Bankruptcy Law and Practice 3d § 66:36 (2013) ("[P]ostpetition extensions of unsecured credit to the debtor are not encompassed by § 547(c)(4) and may not be utilized to protect prior preferential transfers.").