Fall 2022

AVOIDANCE ACTION REPORT

A Bi-Annual Report on the Latest Case Law Relating to Avoidance Actions and Other Bankruptcy Issues

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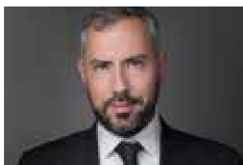

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New Value For Which Creditor Received A § 503 (b)(9) Can Offset Preference Liability in the Eleventh Circuit

Auriga Polymers Inc. v. PMCM2, LLC as Tr. for Beaulieu Liquidating Tr., 40 F.4th 1273 (11th Cir. 2022)

Beaulieu Group, LLC ("Beaulieu") filed for bankruptcy under Chapter 11 of the Bankruptcy Code. PMCM 2, LLC was appointed as the liquidating trustee. The liquidating trustee sued Auriga Polymers Inc. ("Auriga"), a provider of polyester resins and specialty polymers, to avoid approximately $2.2 million paid to Auriga within 90 days prior to the bankruptcy filing. Auriga moved for summary judgment arguing that goods it provided to Beaulieu within twenty days prior to the bankruptcy filing reduced its exposure pursuant to the "subsequent new value" defense under § 547(c)(4) of the Bankruptcy Code. The bankruptcy court agreed with the trustee and held that Auriga could not use the same value to seek payment under § 503(b)(9) of the Bankruptcy Code and to offset its preference liability under § 547(c)(4) of the Bankruptcy Code. Auriga filed a notice of appeal to the district court which stayed the case pursuant to 28 U.S.C. § 158(d)(2)(A) for a direct appeal to the Eleventh Circuit since the case involved a novel question of law.

Bankruptcy code § 547(c)(4) states that providing subsequent new value to a debtor is an affirmative defense to a preference, so long as on account of such new value, "the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor." Auriga argued that there had been no "transfer" on account of such new value because the trustee was holding the funds to pay Auriga's § 503(b)(9) claim in reserve and no payment had actually occurred yet. Auriga further argued that even if there was a "transfer" by virtue of the funds being held in reserve to pay the § 503(b)(9) claim, only prepetition transfers on account of the new value could be used to negate the new value defense under § 547(c)(4). The trustee argued that even though the debtor did not actually pay the § 503(b)(9) claim, it had the funds to do so held in reserve, and, therefore, it was as good as paid by an "otherwise unavoidable transfer." The trustee further argued that when Congress intended to impose a temporal limitation in other statutes, Congress did so by explicitly pinpointing to a specific timeframe like in § 547(c)(5) of the Bankruptcy Code which provides a defense from preference liability for a creditor with a floating lien. Thus, since Congress intentionally omitted a temporal limitation from § 547(c)(4) of the Bankruptcy Code, such as a requirement that the otherwise unavoidable transfer be made prepetition, no such limitation existed.

The court agreed with Auriga. While the court emphasized that funds held in reserve should be considered "transfers" within the meaning of § 547(c)(4)(B) because the Bankruptcy Code defines "transfer" broadly as including "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with – (i) property; (ii) or an interest in property" under 11 U.S.C. § 101(54)(D), it held that the statute's silence on the timing of the

"otherwise unavoidable transfer" is not dispositive. The court noted that the word "transfer" in an "otherwise unavoidable transfer" should bear the same meaning as in the first two uses of this word in § 547(c)(4) of the Bankruptcy Code which refer to pre-petition transfers. And since the otherwise unavoidable transfer had not occurred prepetition, the Eleventh Circuit reversed the bankruptcy court's order denying summary judgment to Auriga.

COMMENTARY

In re Auriga underscores that creditors who ship goods to a bankrupt company within 20 days of the petition date could "double dip" by getting paid on their administrative claim and using the same administrative claim to reduce preference exposure through a subsequent new value defense. However, both plaintiffs and defendants should be mindful of the law in their particular jurisdiction on this issue, as it is unsettled and may vary from place to place.

Earmarking Does Not Apply If The Transfer Diminished The Debtor's Estate

In re Chuza Oil Co., 639 B.R. 586 (B.A.P. 10th Cir. 2022)

Chuza Oil Company ("Chuza"), a petroleum production company, filed for bankruptcy under Chapter 11 of the Bankruptcy Code with a Chapter 11 plan being confirmed shortly after the filing. Under the plan, unsecured creditors were to be paid in full before insiders with unsecured claims. After the confirmation, Chuza had to rely on new insider loans to continue operating and to pay creditors under the confirmed plan. Repayment of the insider loans was subordinated to payment to general unsecured creditors under the plan. In contradiction to the plan, Chuza used some of the insider loan money to pay off $46,885 owing to insiders on their unsecured claims, even though not all non-insider claimants had been paid by then. Chuza failed to stay afloat after the confirmation, and an involuntary Chapter 7 petition was filed against Chuza. Phillip Montoya was appointed the chapter 7 trustee. The trustee sued insiders to avoid $46,885 as preferential transfers under 11 U.S.C. § 547(b), as actual fraudulent transfers under 11 U.S.C. § 548(a)(1)(A), and as constructive fraudulent transfers under 11 U.S.C. § 548(a)(1)(B). The insiders raised a variation of the "earmarking" defense arguing that the transfers were not transfers of estate property because the transferred funds were loaned by a third party (the insiders) and "earmarked" to be used for specific purposes, and the debtor could not do as it wished with the funds. The bankruptcy court agreed with the insiders and held that the transfers did not constitute a transfer of an interest of the debtors in property. The trustee appealed to the BAP.

The trustee argued that the earmarking doctrine has no place in determining whether funds are property of the estate or not. The trustee stated that because the loaned funds were in Chuza's bank account, giving Chuza full control of the funds, they were property of the estate. The insiders argued that Chuza did not have full control over the account and had to use the money in accordance with certain guidelines.

While the BAP held that Chuza did not have full control of the account, the funds were nevertheless property of the estate. The court opined that while the Tenth Circuit had "impliedly" adopted earmarking doctrine, the key factors determining whether the debtor transferred "property of the estate" were the "dominion and control" and the "diminution of the estate" tests. The court noted that the Tenth Circuit had not previously ruled whether both tests must be met to conclude that something was property of the estate, or the presence of one was enough. The court held that under the dominion and control test it would not be considered property of the estate because Chuza did not have control over the funds. Nevertheless, the court sided with the trustee because under the diminution of the estate test, each transfer diminished the size of the estate's interests in the funds. Thus, the court reversed the bankruptcy court's decision.

COMMENTARY

In re Chuza emphasizes that the debtor's lack of full control over funds does not absolutely shield a creditor from a preference action when the debtor's estate is diminished by the transfer. At this time it is unknown whether the court's holding In re Chuza withstands the pending appeal to the Tenth Circuit filed by the insiders.

The New Amendment To Section 547(b) Does Not Require Debtors To Plead Creditor's Affirmative Defenses

In re Ctr. City Healthcare, LLC,
641 B.R. 793 (Bankr. D. Del. 2022)

Center City Healthcare ("Center City"), LLC filed for bankruptcy under Chapter 11 of the Bankruptcy Code. Center City sued McKesson Plasma & Biologics LLC and McKesson Medical-Surgical, Inc. (together with McKesson Plasma & Biologics LLC, "McKesson") to avoid approximately $853,284 paid to McKesson within 90 days prior to the bankruptcy filing. McKesson moved to dismiss the complaint arguing that the amendment to section 547(b) of the Bankruptcy Code added a new element to a preference claim which required that Center City allege in detail what due diligence efforts Center City made, including Center City's analysis of McKesson's affirmative defenses.

Center City argued that the amendment to § 547(b) that requires a trustee to do "reasonable due diligence in circumstances of the case" and to take "into account a party's known or reasonably knowable affirmative defenses under subsection (c) before a trustee files a preference claim" did not create a new pleading element for a preference claim. Thus, Center City argued that it adequately pled a claim for avoidance of a preference in its complaint. Center City further argued that even if it was a new element that must be pled under § 547(b) of the Bankruptcy Code, it did not impose an obligation on Center City to plead why affirmative defenses were not available to McKesson. McKesson argued that Center City failed to satisfy a new element in a preference claim because the threadbare statement in Center City's complaint that Center City conducted an inquiry regarding McKesson's affirmative defenses is insufficient to satisfy that additional element.

The court sided with Center City and agreed that even if the amendment to § 547(b) of the Bankruptcy Code added a new element of a claim for an avoidable preference, Center City had adequately pled factual allegations to satisfy that element. The court noted that Center City alleged in its complaint that it conducted an analysis of the preference period transfers and whether they were protected by any applicable defenses. The court further noted that Center City sent a demand letter to McKesson prior to filing the complaint asking McKesson to provide information regarding any potential defenses with respect to the preference period transfers. Thus, the court concluded that Center City alleged sufficient facts to state a plausible claim and to meet the added requirement of § 547 of the Bankruptcy Code. The court further concluded that the new amendment did not require Center City to plead how the affirmative defenses were not available to McKesson.

COMMENTARY

In re Ctr. City Healthcare sheds light on what is required under the new amendment to § 547(b) of the Bankruptcy Code at the pleading stage. While debtors and trustees are not required to plead how affirmative defenses are not available to creditors, debtors and trustees should analyze creditors' potential affirmative defenses to the preference action before filing an avoidance action to survive a motion to dismiss.

Creditor's Prevalence On The Subjective Ordinary Course Of Business Defense May Be Defeated If The Evidence Shows A Shift In Collection Activity

In re hhgregg, Inc., No. 17-01302-JJG-11, 2022 WL 370279 (Bankr. S.D. Ind. Jan. 13, 2022)

hhgregg, Inc. ("hhgregg"), a multi-region retailer of appliances, consumer electronics and home products, filed for bankruptcy under Chapter 11 of the Bankruptcy Code. The United States Trustee appointed the Official Committee of Unsecured Creditors of Gregg Appliances, Inc. ("the Committee"). The Committee sued D & H Distributing Company ("D & H"), a distributor of consumer electronics, to avoid approximately $4,687,308.20 paid to D & H within 90 days prior to the bankruptcy filing. The Committee moved for summary judgment and successfully established all of the elements of a preference under § 547(b) of the Bankruptcy Code. However, the court reserved for trial whether the preference period transfers were shielded by the subjective ordinary course defense provided by § 547(c)(2)(A) of the Bankruptcy Code.

The Committee argued that the court should "truncate" the 10-month period immediately prior to the preference period to establish a baseline for the companies' dealings as a period in which

hhgregg was not financially healthy. The Committee further argued that the comparison of the "days to payment, (i.e., the interval between the invoice date and payment date) during the preference period and truncated historical period showed that hhgregg's payments during the preference period were considerably faster than those made during the truncated historical period, and, thus, outside the ordinary course. The Committee further argued that hhgregg prioritized payments to D & H during the preference period because D & H consistently sought payments from hhgregg through communications with senior management, D & H threatened to withhold shipments unless payments were made, and D & H reduced its credit limit with hhgregg from $10 million to $1 million within 3 years of the bankruptcy filing date. D & H argued that the court should analyze the entire historical period before the start of the preference period without truncation. D & H further argued that a "days late" analysis (i.e., the amount of time between the due date and the payment date) was that proper analyses, and under such analysis, the timing of the preference period payments to D & H during the preference period and the truncated and non-truncated historical periods were consistent. D & H also emphasized that it never withheld shipments to hhgregg, sought guarantees from hhgregg, threatened to turn over hhgregg's accounts to collections, or threatened litigation against hhgregg. Moreover, D & H pointed out that it increased business with hhgregg during the preference period.

The court agreed with D & H that the days-late analyses was more appropriate in this instance because the credit terms changed several times before the start of the preference period. And while it agreed that a 10-month truncated period was the correct historical baseline period, it sided with D & H that under such analyses, the payments in the preference period were consistent with the payments in the pre-preference period. Nevertheless, the court ultimately sided with the Committee and concluded that D & H did not prove by a preponderance of the evidence that the preference period transfers were subjectively ordinary. The court agreed with the Committee that certain of the emails from hhgregg to D & H immediately before and during the preference period reflected a shift in collection activity. While the court noted that there was no evidence that these emails prompted any of the preference period transfers, the court pointed out that there was additional evidence in the record showing that hhgregg prioritized payments to D & H during the preference period because hhgregg's senior vice president of consumer electronics often advocated in favor of payments to D & H. Thus, the court concluded that the evidence presented by D & H in support of its subjective ordinary course defense was insufficient, and found that the preference period transfers (but for $1,169,503.14 credit for "new value") were avoidable as preferential.

COMMENTARY

In re hhgregg underscores that a supplier who chased the debtors for payment and received the payments on time may not successfully assert the subjective ordinary course defense if the evidence shows that the debtors prioritized paying this supplier over other creditors. Suppliers should be mindful that collection activities they undertake may impact their ability to rely on the subjective ordinary course of business defense as a shield from preference exposure.