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AVOIDANCE ACTION REPORT

A Quarterly Report on the Latest Case Law Relating to Avoidance Actions and Other Bankruptcy Issues

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Goods that Will Be Paid for Under Section 503(b)(9) of the Bankruptcy Code Cannot Be Used as New Value

Siegel v. Sony Electronics, Inc. (In re Circuit City Stores, Inc.), 2014 WL 4428344 (Bankr. E.D.Va. Sept. 8, 2014)

In *Siegel v. Sony Electronics, Inc.*, the trustee for the Circuit City Stores Liquidating Trust commenced an action against Sony Electronics to recover, among other things, certain alleged preferential transfers pursuant to Bankruptcy Code section 547. Bankruptcy Code section 547 allows a trustee or debtor in possession to avoid a transfer made by a debtor while insolvent to or for the benefit of a creditor on account of an antecedent debt within 90 days (or one year in the case of an "insider") of the petition date, where such transfer enables the creditor to receive more than it would have received in a chapter 7 liquidation. The trustee subsequently amended his complaint after the statute of limitations to add an additional alleged preferential transfer. The trustee and the defendant filed cross-motions for summary judgment which sought, among other things, determinations as to (i) whether the trustee's avoidance of the additional preferential transfer was barred by the statute of limitations or it "related back" to the date of the filing of the original complaint and (ii) whether defendant is entitled to assert "new value" credit under section 547(c)(4) of the Bankruptcy Code in connection with invoices to be paid pursuant to defendant's allowed section 503(b)(9) administrative expense claim. Section 547(c)(4) of the Bankruptcy Code provides a defense to a preference action based upon new value provided by the defendant after receiving the avoidable transfers. Section 503(b)(9) of the Bankruptcy Code grants parties that provided goods that the debtor received within 20 days prior to the bankruptcy filing with an administrative expense priority claim for the value of the such goods.

The court examined whether the trustee's claim to recover an additional $8 million transfer should be dismissed as time-barred by the applicable two-year statute of limitations for preference actions set forth in section 546 of the Bankruptcy Code. In addressing this issue, the court observed that prior to the petition date, the debtor and the defendant were parties to a certain dealer agreement which governed all sales of products by the defendant to the debtor. The court noted that the original complaint alleged that during the ninety-day preference period the defendant received preferential transfers "in an amount not less than $192,482,117.46." The court concluded that the additional transfer related back to the date of filing of the original complaint pursuant to Rule 15(c) of the of the Federal Rules of Civil Procedure (as incorporated into the Federal Rules of Bankruptcy Procedure) because it "arose out of the conduct, transaction, or occurrence set out – or attempted to be set out – in the original pleading." To that end, the court pointed out that (i) the transfer was made pursuant to the dealer agreement, (ii) the trustee set out an intention to recover all preferential transfers

made to the defendant under the dealer agreement and put defendant on notice of such intention via the complaint and (iii) the additional transfer represented a small portion of the overall claim.

The court next addressed the defendant's argument that shipments received during the twenty-day period prior to the petition date may be simultaneously asserted as new value under section 547(c)(4) of the Bankruptcy Code and as an administrative claim under section 503(b)(9) of the Bankruptcy Code. The court reiterated its prior holding in *Circuit City Stores, Inc. v. Mitsubishi Digital Electronics America, Inc. (In re Circuit City Stores, Inc.)*, 2010 WL 4956022 (Bankr. E.D. Va. Dec. 1, 2010) that payment under section 503(b)(9) is an "unavoidable transfer," which precludes goods paid for by such transfer from being deemed new value for purposes of section 547(c)(4), which requires that "the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor" on account of the new value.

The court concluded that defendant cannot utilize invoices slated to be paid pursuant to section 503(b)(9) as new value to offset its liability for preferential transfers. The court noted that the plain language of section 547(c)(4)(B) of the Bankruptcy Code requires this result as it requires that new value not be paid by an otherwise unavoidable transfer and a payment under section 503(b)(9) is unavoidable. The court further held that a contrary interpretation would result in inequitable treatment of creditors by allowing certain creditors to essentially "double-dip" by receiving both new value credit and direct payment on account of the same invoices.

In so concluding the court declined to follow the Third Circuit's decision in *Friedman's Liquidating Trust v. Roth Staffing Cos. (In re Friedman's, Inc.)*, 738 F.3d 547 (3d Cir. 2013) which allowed new value credit for invoices paid pursuant to a critical vendor order and further distinguished *Friedman's* based on the *Friedman's* court's stated intent not to address reclamation claims (which section 503(b)(9) essentially codified) in that decision.

COMMENTARY

Practitioners should examine the full circumstances surrounding any later discovered transfer as it may relate back to a timely filed complaint. As case law concerning the interplay of section 503(b)(9) administrative claims and the new value defense to preferences continues to evolve, practitioners should be cognizant of the developments and their impact on matters pending in various districts.

Presumption Against Extraterritoriality Limits Trustee's Ability to Recover Foreign Transfers

Securities Investor Protection Corporation v. Bernard L. Madoff Investment Securities LLC (In re Madoff Securities), 2014 WL 2998557 (S.D.N.Y. July 6, 2014)

In *Securities Investor Protection Corporation v. Bernard L. Madoff Investment Securities LLC*, the trustee appointed under Securities Investor Protection Act (SIPA) to administer the estate of the broker-dealer commenced an action under 550(a)(2) of the Bankruptcy Code to recover transfers to certain foreign "feeder funds" that were avoided under Bankruptcy Code section 548 from the ultimate recipients of the funds, the feeder funds' investors. Bankruptcy Code section 548 states that a trustee may avoid actual or constructively fraudulent transfers of property of the debtor made within two years prior to the petition date. Bankruptcy Code section 550(a)(2) allows a trustee to recover a fraudulent transfer from any "immediate" or "mediate" transferee of the initial transferee. An immediate transferee receives the transfer from the initial transferee, while a mediate transferee receives the transfer later in the chain. The defendants moved to dismiss the actions on the basis that Bankruptcy Code section 550(a)(2) does not apply extraterritorially.

The defendants did not invest funds directly with Madoff Securities; rather they invested through certain feeder funds, most notably, Fairfield Sentry Limited which in turn invested 95% of its assets in Madoff Securities and is currently involved in its own liquidation proceeding in the British Virgin Islands. The trustee alleged that the defendants received recoverable subsequent transfers as customers of the feeder funds. The defendants moved to dismiss the complaints and the court addressed the following issue on a consolidated basis: whether SIPA and/or the Bankruptcy Code apply extraterritorially to recover

avoided transfers from initial, immediate, or mediate foreign transferees.

The court concluded that (i) application of section 550(a)(2) would constitute extraterritorial application of the statute and (ii) Congress did not clearly intend such application. Citing *Morrison v. Nat'l Australia Bank Ltd.*, 561 U.S. 247 (2010), the court focused on the longstanding principle of American law that legislation of Congress is not intended to apply extraterritorially unless such intent is expressly stated. The court concluded that the suggested application of section 550(a)(2) in this setting would be extraterritorial, as the mere connection to a U.S. debtor is too tangential to deem such application domestic. Specifically, the court determined that the transaction regulated under section 550(a)(2) is the transfer of property to the subsequent transferee (not the relationship of that property to a U.S. debtor) and, therefore, the application of the statute would be extraterritorial. The court next examined whether such extraterritorial application was intended by Congress and determined that the language of the statute does not evince an intent for it to apply extraterritorially. The court also looked at surrounding Bankruptcy Code provisions, and in particular, section 541 of the Bankruptcy Code which references debtor's property "wherever located." In examining section 541, the court noted that property recovered pursuant to the trustee's avoidance powers is separately included in Bankruptcy Code section 541(a)(3). The court concluded that the inclusion of this subparagraph indicates that property is not considered property of the estate until it is actually recovered. Based on the foregoing, the court held that Bankruptcy Code section 541 does not evince congressional intent to apply the provisions of section 550(a)(2) extraterritorially. Finally, the court noted that international comity concerns would provide a separate basis to preclude the trustee from recovering transfers made outside the United States to foreign transferees.

COMMENTARY

Practitioners should pay careful attention to a debtor's international transactions in assessing whether transfers made outside the United States could be avoided. In addition to difficulties effectuating service and enforcing foreign judgments, presumption against extraterritorial application of the Bankruptcy Code may serve as a bar to recovery.

Use and Occupancy Paid for Post-Petition Cannot Be Used as New Value

Wiscovitch-Rentas v. PDCM Associates, S.E. (In re PMC Marketing Corp.), 2014 WL 4851990 (1st Cir. BAP Sept. 30, 2014)

In *Wiscovitch-Rentas v. PDCM Associates, S.E.*, the First Circuit Bankruptcy Appellate Panel reversed and remanded a bankruptcy court decision granting summary judgment in favor of defendant on the trustee's action to avoid preferential transfers pursuant to section 547 of the Bankruptcy Code.

The debtor operated a chain of pharmacies that leased stores in shopping centers, including several owned by the defendant. The chapter 7 trustee commenced an action to avoid certain payments made to the defendant as preferences. Defendant filed a motion for summary judgment arguing, among other things, that certain alleged preferential transfers were fully offset by new value provided by the defendant in the form of the debtor's continued use and occupancy of the leased space. The trustee opposed the motion and cross-moved for summary judgment arguing that the new value defense under section 547(c)(4) of the Bankruptcy Code was unavailable to the defendant because all alleged new value was not provided pre-petition and the defendant also received unavoidable post-petition transfers on account of the services provided. The bankruptcy court granted defendant's summary judgment motion and the trustee appealed.

On appeal, the First Circuit Bankruptcy Appellate Panel examined whether the defendant established a new value defense to the preferential transfers. First, the court noted that new value must be provided pre-petition citing statutory language that requires that new value be provided "to the debtor" as opposed to the debtor-in-possession. Next, the court looked at whether the debtor made any "otherwise unavoidable transfers" on account of the new value provided by the defendant. Bankruptcy Code section 547(c)(4) requires that "the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor" on account of the new value. The court concluded that defendant failed to establish the new value defense because it (i) failed

to establish when the new value was provided (i.e. pre or post-petition) and (ii) failed to demonstrate that it did not receive unavoidable post-petition payments related to pre-petition use and occupancy of the leased space. As a result, the court concluded that genuine issues of material fact existed as to availability of the new value defense, reversed the grant of summary judgment and remanded the matter to the bankruptcy court for further proceedings.

COMMENTARY

Practitioners should carefully examine the application of any post-petition payments received by a debtor-in-possession as such payments may have an impact on the viability of the new value defense to avoidance of preferential transfers.

New Value May Be Provided by Third Party Who Benefited From Preferential Transfers

Stoebner v. San Diego Gas & Electric Company (In re LGI Energy Solutions, Inc.), 746 F.3d 350 (8th Cir. 2014)

In *Stoebner v. San Diego Gas & Electric Company*, the Eighth Circuit expanded the application of new value as a defense to preference liability when the new value comes from a non-defendant third party, where the preferential transfers benefited the third party. The Eighth Circuit's decision came on the appeal of two cases, *Stoebner v. San Diego Gas & Electric Company (In re LGI Energy Solutions, Inc.)* Adv. No. 12-3899 and *Stoebner v. Southern California Edison Company (In re LGI Data Solutions Company, LLC)* Adv. No. 12-4011.

In these cases, the debtors provided bill payment services for their clients, including the payment of utility invoices to the utility service provider defendants on account of two restaurants. The defendants sent invoices to the debtors who would subsequently request payment from the restaurants. The restaurants would pay the debtors and the debtors would in turn pay the defendants. During the 90-day preference period the debtors made payments totaling $75,053.85 and $183,512.74 to the defendants. Following receipt of these transfers, the defendants continued providing utility services to the restaurants and the restaurants made additional payments to the debtors in the amount of $297,000.00.

The defendants claimed that the additional payments made by the restaurants constitute new value even though they came from the restaurants, not the defendants. Section 547(c)(4) of the Bankruptcy Code provides that preference exposure is reduced by the amount of new value provided to the debtor after the transfer. However, the trustee argued that such payments cannot constitute new value as Bankruptcy Code section 547(c)(4) limits the new value exception to new value "such creditor" gave to or for the benefit of the debtor.

The Eighth Circuit held that the payments by the restaurants constitute new value, relying in part on *In re Jones Truck Lines*, 130 F.3d 323 (8th Cir. 1997) where the court determined that employees providing labor constituted new value to offset transfers made on account of employee benefit payments. In this case, the court reasoned that because the preference statute allows for recovery from beneficiaries of a transfer, allowing for new value to come from such beneficiaries is consistent with the text of the statute that the new value must come from "such creditor." Thus, the court held that the restaurants' new value could reduce the defendants' preference exposure because the restaurants benefited from the preferential transfers. The court also noted that the trustee's decision to only sue the defendants and not the restaurants "does fundamental violence to 'the prime bankruptcy policy of equality of distribution among creditors.'" The court explained that the restaurants would not get a benefit for the new value provided and would be liable to the defendants for utility services while the estate would be "doubly replenished" by receiving payments from the restaurants and still be able to avoid the transfers made to the defendants.

COMMENTARY

Practitioners should examine all potential sources of new value in assessing potential defenses to preference actions and not focus only on new value provided by the direct creditor/defendant. New value provided by a third party beneficiary of the avoidable transfers may also constitute new value for purposes of section 547(c)(4) of the Bankruptcy Code.

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Short Term Assessment Fee Not Protected by Ordinary Course of Business Defense

Indiana Family and Social Services Administration v. Saint Catherine Hospital of Indiana, LLC (In re Saint Catherine Hospital of Indiana, LLC),
511 B.R. 117 (S.D. Ind. 2014)

Indiana Family and Social Services Administration v. Saint Catherine Hospital of Indiana, LLC addressed the appeal from a bankruptcy court decision which granted summary judgment to Saint Catherine Hospital of Indiana, LLC (Saint Catherine) on its claim for avoidance and recovery of a preferential transfer pursuant to Bankruptcy Code section 547 against Indiana Family and Social Services Administration (FSSA). The district court affirmed the bankruptcy court's decision.

The debtor, Saint Catherine, was a regional health care facility in Charlestown, Indiana. It was classified as a general acute care facility and treated some Medicaid patients. Saint Catherine received reimbursement from state and federal governments in connection with its treatment of Medicaid patients. On April 29, 2011, the Indiana General Assembly adopted a measure designed to increase reimbursement for hospital care of Medicaid patients which would be funded through a Hospital Assessment Fee (HAF) levied on Indiana hospitals. Each hospital's share of the fee was determined by an auditing firm on a pro rata basis. The fee period spanned two years, but the initial assessment was delayed until 2012 while the program awaited necessary federal approval (as a result the assessment for the first year would be levied in 2012 and the assessment for the second year would be levied in 2013). Saint Catherine filed for chapter 11 bankruptcy protection on June 19, 2012. During the preceding 90-day preference period, FSSA withheld Medicaid reimbursements of $615,912.64 (after accounting for certain remissions) on account of the first year's portion of the assessment. Saint Catherine commenced an adversary proceeding against FSSA to recover this amount as a preference under Bankruptcy Code section 547. FSSA contended that the HAF was protected by the ordinary course of business defense to preferences under Bankruptcy Code section 547(c)(2)(A).

In order to determine whether the ordinary course of business defense applied, the court first examined whether the HAF was merely another addition to the parties lengthy running account or a separate and distinct new obligation. The court concluded that the HAF was in the nature of a tax assessment and not part of the parties' prior course of dealing (no one raised and the court did not discuss whether tax payments generally could be avoided). The court then looked at whether the HAF may be nevertheless protected by the ordinary course of business as a new transaction. The court noted that a first time payment may be protected if there is evidence that the debtor and creditor are establishing a new course of dealing. The court observed that a one-time transaction would not be afforded this protection and, similarly, the withholding of funds for the first year of the scheduled two-year assessment would likewise fail to qualify for the ordinary course of business defense. Finally, the court observed that the transfer severely disrupted the debtor's finances and was, therefore, not the type of normal financial relationship that Bankruptcy Code section 547(c)(2)(A) was designed to protect. Thus, the court concluded that the ordinary course of business defense did not apply to shield the HAF assessment withholdings from avoidance as preferential transfers.

COMMENTARY

Governmental withholdings may be subject to avoidance as preferential transfers, particularly, when such assessments were not a regular occurrence in the debtor's business. Practitioners should carefully examine withholdings from a debtor under short term assessments to determine if they may be avoidable under section 547 of the Bankruptcy Code.

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