By Joseph L. Steinfeld, Jr. and Kara E. Casteel

Critical-Vendor Creditors May Now Double-Dip on New Value

Editor's Note: *For another perspective on this topic, see the feature article on p. 46.*

Joseph L. Steinfeld, Jr.
ASK LLP
St. Paul, Minn.

Kara E. Casteel
ASK LLP
St. Paul, Minn.

Joseph Steinfeld, Jr. is a managing partner and Kara Casteel is an associate at ASK LLP in St. Paul, Minn.

Previously, we provided a counterpoint article that appeared in the March 2012 *ABI Journal*[1] discussing the *Friedman's*[2] decision. In *Friedman's*, the U.S. Bankruptcy Court for the District of Delaware held that Third Circuit precedent compelled a "fixing" of the subsequent new value defense analysis as of the petition date, and accordingly, post-petition payments on pre-petition new value authorized by a critical wage order would not reduce a creditor's new value defense. The court indicated that the statement "as of the date that it filed its bankruptcy petition" from *New York City Shoes*[3] was a "clear implication" that the analysis was fixed as of the petition date.[4]

The article noted that the bankruptcy court's reliance on *New York City Shoes* and *Winstar*[5] was misplaced, as neither case dealt directly with the issue of whether the new value defense under § 547(c)(4)(B)[6] contained a temporal limit as to when the new value could be repaid by an otherwise unavoidable transfer. While the bankruptcy court indicated that the "fixing" of the analysis as of the petition date would further the preference law's goal of not rewarding pre-petition favoritism, the article noted that (1) such policy would still have been promoted had the defendant been denied subsequent new value credit for invoices paid post-petition, and (2) such a stance ignored the preference statute's greater policy of promoting equal treatment of unsecured creditors.[7]

Friedman's was appealed to the Third Circuit. We had hoped that the court would clarify that the bankruptcy court had erroneously followed *dicta* from *New York City Shoes* and *Winstar*. The Third Circuit did so, but nonetheless determined[8] that, at least for critical vendors, unequal treatment of similarly situated creditors is the new norm.

Third Circuit Correctly Determined that the Language Concerning the Petition Date Was *Dicta*

The Third Circuit noted that it was not bound by prior "as-of-the-petition-date" language from *New York City Shoes* and *Winstar*. In *New York City Shoes*, the controlling question was whether the new value had been provided subsequent to a transfer; in *Winstar*, the pertinent issue was whether subsequent new value had been extended on an unsecured basis.[9] The court concluded that it was not bound by extra-statutory language in the previous decisions and could interpret the plain language of the statute by examining both the sentence in question and the context of the law as a whole.[10] Should the plain meaning not be evident from the language of the Bankruptcy Code, courts could then look to the legislative history as a method of interpretation. While the Third Circuit correctly disregarded its prior *dicta*, the court proceeded with a contextual analysis that ignored both the plain text of the statute and the legislative policies behind the statute. In so doing, the court ignored the paramount bankruptcy policy of equality of distribution among creditors, and instead rewarded debtor-chosen creditors to the detriment of other similarly situated creditors.

Court Ignores Statute's Plain Language and Determines that "Context" Compels Closing Analysis as of the Petition Date

The court announced that despite the statute's lack of language specifying a limitation as to when the new value may be repaid, Congress could not have intended for there to be an unlimited time frame for repayment. The court boldly stated that such a determination came not from the language

1 *See* Jeffrey R. Waxman, "Delaware Court Rules Petition Date Fixes Amount of Defendant's Subsequent New Value," XXXI *ABI Journal* 2, 30-31, March 2012, and Joseph L. Steinfeld, Jr. and Kara E. Casteel, "*Friedman's* Improperly Adds Requirement that New-Value Analysis Closes at Petition Date," XXXI *ABI Journal* 2, 42-43, March 2012.
2 *Freidman's Inc. v. Roth Staffing Cos. LP (In re Friedman's Inc.)*, 2011 WL 5975283 (Bankr. D. Del. Nov. 30, 2011).
3 880 F.2d 679 (3d Cir. 1989).
4 *In re Friedman's*, 2011 WL 5975283 at *4.
5 *Schubert v. Lucent Tech. Inc. (In re Winstar Comm'n Inc.)*, 554 F.3d 382 (3d Cir. 2009).
6 Section 547(c)(4) provides as follows:
> (c) The trustee may not avoid under this section a transfer —
> (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor —
> …
> (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.…
7 *See Union Bank v. Wolas*, 502 U.S. 151, 161, (1991) (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-78 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 1978, pp. 6137, 6138) ("The purpose of the preference section is two-fold. First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy…. Second, *and more important*, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.") (emphasis added).
8 *In re Friedman's Inc.*, -- F.3d --, 2013 WL 6797958 (3d Cir. Dec. 24, 2013).
9 *Id.* at *4.
10 *Id.* at *5.

(or lack thereof) in the statute itself, but rather from the "context and policy of the Code."[11]

In its statutory analysis, the court inexplicably determined that an appropriate contextual analysis involved reviewing the title of § 547 rather than the statute's interaction with other Code provisions. Using "pretzel logic,"[12] the court ignored the absence of any temporal limitation in the body of the statute and focused instead on the statute's title, "Preferences," to conclude that Congress intended for the time period for calculating the payment of new value to be limited to the preference period. The court's judicial contortion is further evidenced later in the decision, as the court had to explain how this holding is not at odds with the reasoning in *Kiwi*[13] where the Third Circuit extended the preference analysis to events post-petition.

The court cited several more statutory justifications for closing the analysis at the petition date: Courts have determined that the hypothetical liquidation test should occur on the petition date; the statute of limitations commences on the petition date; extending the analysis past the petition date is inconsistent with § 547(c)(5); and defendants are not allowed to apply post-petition new value to reduce their net preferences.[14] However, the first two of these concerns relate to the plaintiff's burden of establishing its *prima facie* case and the time period in which to bring the same.

In its statute-of-limitations argument, the court stated that if post-petition payments are allowed to decrease new value, the net preference could change based on the filing date of the avoidance action. This concern is misplaced: Section 502(d) specifically disallows claims by creditors[15] to the extent that they retain property of the estate that is recoverable under § 550.[16] Most preference cases are filed on the eve of the statute of limitations, long after critical vendor or wage orders.[17] To the extent that a creditor has filed a timely administrative proof of claim under § 503(b)(9), in most cases the bar date for such claims expires before preference cases are commenced. Regardless of the timing, such a claim would be disallowed under § 502(d) until such time that the avoidance action was resolved.

The court also inexplicably opined that § 547(c)(5)'s inclusion of the language "as of the petition date" is somehow helpful to its position that the subsequent new value analysis closes at the petition date.[18] Section 547(c)(5) provides an affirmative defense to certain creditors with floating liens, provided that the creditor did not improve its position during the preference period. That the court asserted the inclusion of a specific cutoff date in § 547(c)(5), but *not* § 547(c)(4), could be viewed in one of two ways: Either Congress meant for no temporal limitation in § 547(c)(4), as it knew how to create limitations and declined to do so, or the inclusion of a temporal limitation in one section lends support that the analysis of all affirmative defenses should be confined to pre-petition activity.[19]

Ignoring which of these two scenarios was more logical, the court determined that "on balance … the policy of improvement to position prior to the petition date is central to the concept of preference," and therefore, the provision bolstered the court's reasoning. If the provision of new value and the encouragement to continue business with a debtor are also central precepts to the preference policies, it would make sense that any closing date for the new-value analysis also be made explicit in the statute. The inclusion of a cutoff date for one provision but not the other strongly suggests that had Congress wanted to limit the analysis of the new value defense to the petition date, it knew how to do so.

Lastly, the court noted that since defendants may not use unpaid post-petition invoices to offset preferential payments, they should be able to use the new value that was unpaid as of the petition date.[20] However, a creditor that provides post-petition new value to the estate is allowed to file and be paid on an administrative claim. That new value is paid once — and only once. Likewise, if pre-petition new value is paid pursuant to a critical vendor order, the pre-petition new value is paid by the debtor only once. To the extent that the creditor is allowed to take that new value to further reduce its net preference defense, the creditor is allowed to "double-dip" the new value. It is entirely consistent to deny post-petition new value credit to decrease a net preference and deny subsequent new value credit to new value paid post-petition; in each scenario, the creditor receives payment or credit for such new value one time.

Policy Considerations Favor Treating Similarly Situated Creditors Differently

The court also reviewed the congressional records from 1978,[21] which stated that the two goals of the preference section are to discourage creditors from racing to dismember the debtor, and more importantly, to treat creditors equally. Brushing aside the report's specific language that the equal treatment of debtors was the most important policy, the court determined that because the language focuses on the pre-petition period, any measure of equality should likewise be performed on the petition date.[22]

Such reasoning fails to explain how evaluating similarly situated creditors on a specific date, rather than examining the actual treatment of such creditors, furthers the goal of equal treatment of creditors. Indeed, the court minimized the new value analysis that was completed by the *In re Furr Supermarkets*[23] bankruptcy court as merely making a policy argument for reducing new value by post-petition payments, without any contextual support.[24] However, the *Furr Supermarkets* court exhaustively analyzed and calcu-

11 *Id.* at *6.
12 With apologies to Steely Dan for this reference.
13 *In re Kiwi Int'l Airlines Inc.*, 344 F.3d 311 (3d Cir. 2003).
14 *Friedman's*, 2013 WL 6797958 at *7-8.
15 There is a split as to whether § 503(b) administrative claims are disallowed pursuant to § 502(d). *See, e.g., ASM Capital v. Ames Dept. Stores Inc. (In re Ames Dept. Stores Inc.)*, 582 F.3d 422, 424 n.2 (2d Cir. 2009) (holding that § 502(d) does not bar payment of administrative claims, but declining to analyze interaction between §§ 502(d) and 503(b)(9)); *but see In re Circuit City Stores Inc.*, 426 B.R. 560, 571 (Bankr. E.D. Va. 2010) (noting that it was consistent with *Ames* to apply § 502(d) to disallow claims under § 503(b)(9) until claimants had paid into estate preferential transfers).
16 Section 550 provides that "to the extent that a transfer is avoided under section … 547 … the trustee may recover, for the benefit of the estate, the property transferred."
17 *See TWA Inc. v. San Francisco Airports Comm'n (In re TWA Inc. Post-Confirmation Estate)*, 305 B.R. 221 (Bankr. D. Del. 2004) (noting that "preference actions are not filed until late in the case, often on the eve of the § 546 two-year statute of limitations").
18 *Friedman's*, 2013 WL 6797958 at *7.
19 *Id.*
20 *Id.* at *8.
21 *See* fn.7, *supra.*
22 *Friedman's*, 2013 WL 6797958 at *9.
23 *In re Furr Supermarkets Inc.*, 485 B.R. 672 (D.N.M. 2012).
24 *Friedman's*, 2013 WL 6797958 at *8.

continued on page 84

from page 49

lated the net distribution to creditors in a hypothetical bankruptcy under scenarios either denying or allowing creditors the use of new value when such new value had been paid post-petition.[25] The *Furr Supermarkets* court then adopted a view that denied creditors the ability to double-dip by being paid post-petition and reducing their net preference with the new value.[26]

The Third Circuit rejected the *Furr Supermarkets* court's analysis, stating that "[i]f it is a rule in bankruptcy that all creditors must be treated equally, surely the exceptions swallow the rule."[27] As support, the court referenced certain Code provisions that treat shopping center and aircraft leases more favorably. However, critical vendors are *not* accorded priority status via the Bankruptcy Code like some creditors. Instead, debtors are allowed to make first-day motions requesting critical-vendor and wage relief simultaneously when filing a petition, often before all unsecured creditors have notice of the same. These creditors are hand-selected by the debtors for payment, with little requirement that the debtor prove the creditors' necessity.[28]

The Court's Decision Is Inconsistent with *Kiwi International Airlines*

In *Kiwi International Airlines*, the Third Circuit held that to the extent that an executory contract is assumed post-petition pursuant to § 365, a trustee is precluded from bringing an avoidance action to recover payments that are made pursuant to the contract.[29] This earlier decision necessarily took into account post-petition events because no assumption and cure would have occurred on the petition date. The court took pains to distinguish *Kiwi* by stating that *Kiwi* only examined the "unique" set of rights created by § 365 and its interaction with § 547. However, § 365 is not mentioned in § 547; instead, the Third Circuit made a logical examination of post-petition events and their effect on the preference-period transfers. Such examination of critical wage orders should result in an adjustment of preference liability as well.

The Uncertain Future of New Value Credit for § 503(b)(9) Administrative Claims

Although the issue of § 503(b)(9) and reclamation claims was not directly before the court, the court did note that in a case involving a similar issue, the U.S. District Court for the Middle District of Tennessee distinguished post-petition critical-vendor payments from those made on a reclamation claim.[30] The Third Circuit noted that reclamation claims were different than critical-vendor payments because goods shipped subject to reclamation claims are not sold free of the seller's strings. While the court stated that the issue of reclamation and § 503(b)(9) were not in front of it presently, it acknowledged that reclamation claims "could be treated different[ly] from other post-petition activities."[31] Although all post-petition payments should reduce new value, there is at least some hope that reclamation and § 503(b)(9) claimants will not be allowed to double-dip like critical vendor creditors. abi

Editor's Note: *For more on this topic, see* Trade Creditor Remedies Manual: Trade Creditors' Rights under the UCC and the Bankruptcy Code *(ABI, 2011), available for purchase at the ABI Bookstore (bookstore.abi.org).*

25 *Furr Supermarkets*, 485 B.R. at 730-31.
26 *Id.*
27 *Friedman's*, 2013 WL 6797958 at *11.
28 *See In re Kmart Corp.*, 359 F.3d 866, 868 (7th Cir. 2004) (noting that critical vendor order at issue had been issued as debtor had proposed it, without notifying disfavored creditors and without receiving evidence as to necessity of order).
29 344 F.3d at 321.
30 *In re Friedman's Inc.*, 2013 WL 6797958 at *12, n.9 (citing *In re Phoenix Rest. Grp. Inc.*, 317 B.R. 491 (Bankr. M.D. Tenn. 2004)).
31 *Id.*