Friedman's Improperly Adds Requirement that New-Value Analysis Closes at Petition Date

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Editor's Note: *For another viewpoint on this case, see the feature on page 30.*

The U.S. Bankruptcy Court for the District of Delaware in *In re Friedman's*[1] allowed a creditor paid in full by the debtor post-petition to receive full subsequent new value credit for the same invoices. Judge **Christopher S. Sontchi** accomplished this feat of judicial gymnastics by relying on *In re New York City Shoes*[2] and reading into 11 U.S.C. § 547(c)(4)(B) a requirement that the determination of whether new value is paid closes at the petition date. *Friedman's* is a significant departure from recent judicial analysis of the new-value defense and should not be followed by other courts.

"Remains Unpaid" vs. "Subsequent Advance"


Joseph L. Steinfeld, Jr.

While some circuits restricted new value credit to invoices that were unpaid at the petition date,[3] more recent decisions permit new value credit to "paid" invoices, *to the extent* that the later transfers paying the invoices were "avoidable."[4] Many courts in "remains unpaid" circuits have now taken pains to distinguish earlier decisions.[5]

In *In re Pillowtex*,[6] Judge **Kevin J. Carey** examined what the Third Circuit in *New York City Shoes* did—and did not—provide as to the subsequent new-value defense. He noted that the dispute in *New York City Shoes* only concerned whether new value had been advanced *subsequent* to a transfer. Whether new value remained unpaid was not before the Third Circuit then or in a later decision.[7] Judge Carey held that the "subsequent-advance" rule (which ignores the petition date) follows the plain language of the statute, advances policy considerations underlying the Bankruptcy Code[8] and takes "into account the subsequent development of decisional law and other scholarship in the twenty years since [*New York City Shoes*] was decided."[9]

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Feature

Post-Petition Payments and Subsequent New-Value Defense

In re Login Bros. Book Co.[10] addressed the availability of the subsequent new-value defense when value given pre-petition is paid post-petition. *Login* explained that the subsequent advance by a creditor of new value in an amount equal to the preference essentially returns a preference to the estate.[11] However, this return of value can itself be diminished if payments are made on the new value, as "there is in effect no return of the preference."[12]

Login correctly noted there is nothing in § 547(c)(4) limiting when an otherwise unavoidable transfer occurs.[13] Finding that the policy behind the exception—to encourage replenishment of the estate—would be defeated if a creditor were allowed to use the exception and receive payment on the new value, the court concluded that any new value credited to the creditor must be reduced by the amount of new value subsequently paid for by the debtor, even if the repayment is post-petition.[14] *Login* is cited with approval by many courts.[15]

Friedman's *Focus on* New York City Shoes

Friedman's ignored recent jurisprudence on post-petition return of new value, as well as the *Pillowtex* decision. Instead, the court relied on *New York City Shoes* and *Winstar* in determining that the petition date closes the new-value analysis.[16] Using *dicta*, the court determined that the inclusion of the phrase "as of the petition date" was a "clear implication" that the Third Circuit intended the petition date to control, despite neither case actually addressing this aspect of the new-value defense.[17] Judge Sontchi then claimed that the preference statute's policy (of not rewarding pre-petition favoritism) is furthered by closing the analysis at the petition date.[18] This policy would still be promoted had the court denied the defendant use of subsequent new value paid post-petition. However, by closing the analysis at the petition date, the court defeated the preference statute's greater policy of promoting equal treatment of pre-petition unsecured creditors.

Under *Friedman's*, some creditors can receive 100 percent payment of their invoices, while receiving a 100 percent reduction in net preference liability based on these same invoices. This "double-dipping" adds insult to the injury of

1 *Friedman's Inc. v. Roth Staffing Cos. LP (In re Friedman's Inc.)*, Case No. 09-10161 (CSS), Adv. No. 09-50364 (CSS), 2011 WL 5975283 (Bankr. D. Del. Nov. 30, 2011) (order denying summary judgment), notice of appeal filed, BAP #11-108 (D. Del. Dec. 12, 2011)).
2 *In re New York City Shoes Inc.*, 880 F.2d 679. (3d Cir. 1989).
3 *See, e.g., In re Kroh Bros. Dev. Co. v. Continental Constr. Eng'rs Inc. (In re Kroh Bros. Dev. Co.)*, 930 F.2d 648 (8th Cir. 1991); *Charisma Inv. Co N.V. v. Airport Sys. Inc. (In re Jet Fla. Sys. Inc.)*, 841 F.2d 1082 (11th Cir. 1988).
4 *See, e.g,. Crichton v. Wheeling Nat'l Bank (In re Meredith Manor Inc.)*, 902 F.2d 257 (4th Cir. 1990); *Laker v. Vallette (Matter of Toyota of Jefferson Inc.)*, 14 F.3d 1088 (5th Cir. 1994).
5 *See In re Jones Truck Lines Inc.*, 130 F.3d 323, 329 (8th Cir. 1997); *TI Acquisition LLC v. S. Polymer Inc. (In re TI Acquisition LLC)*, 429 B.R. 377, 384 (Bankr. N.D. Ga. 2010).
6 *Wahoski v. Am. & Efrid (In re Pillowtex Corp.)*, 416 B.R. 123 (Bankr. D. Del. 2009).
7 *Id.* at 128 (citing *Schubert v. Lucent Tech. Inc. (In re Winstar Comm'n Inc.)*, 554 F.3d 382 (3d Cir. 2009)).
8 *Id.* at 130-31.
9 *Id.* at 129, n. 7 (citing *Toyota of Jefferson* for revised language of final element, but noting language did not conflict with *New York City Shoes*).
10 *Moglia v. Am. Psych. Ass'n (In re Login Bros. Book Co.)*, 294 B.R. 297, 300 (Bankr. N.D. Ill. 2003).
11 *Id.* at 299.
12 *Id.* at 300 (quoting *Erman v. Armco (In re Formed Tubes)*, 45 B.R. 645, 647 (Bankr. E.D. Mich. 1985)).
13 *Id.*
14 *Id.* at 298.
15 *See In re JKJ Chevrolet Inc.*, 412 F.3d 545, 553 (4th Cir. 2005); *Circuit City Stores Inc. v. Mitsubishi Digital Elec. of Am. Inc. (In re Circuit City Stores)*, Adv. No. 10-03068, 2010 WL 4956022, *9 (Bankr. E.D. Va. Dec. 1, 2010).
16 *Friedman's*, 2011 WL 5975283 at *4.
17 *Id.*
18 *Id.*

non-critical creditors by further reducing the pool of funds available for distribution from preference recoveries, often the only source available to pay pre-petition unsecured claims. Denying certain creditors of this windfall will not impact debtors desiring to obtain post-petition services from "critical" vendors. Who among creditors would not take the bargain of having pre-petition invoices paid in return for the mere possibility that they may not get new value credit should an avoidance action be filed two years hence? If concerned, these creditors can seek a waiver of avoidance claims as part of critical-vendor negotiation.[19]

The statutory language contained no temporal limit to when new value is paid by an unavoidable transfer. To create an artificial stopping point reads new language into the statute. The "bright-line" approach advocated by the court ignored that post-petition events are regularly considered when determining the net preference after application of multiple affirmative defenses. If new value is paid for by a transfer that is itself avoidable, this new value cannot receive credit to reduce the net preference liability.[20] Judge Sontchi compounded his erroneous departure from the statute's plain language in *In re Sierra Concrete Design Inc.*[21] In that case, the court again cited the language from *New York City Shoes*, stating that the debtor must not have *fully compensated* the new value as of the petition date. While the court did apply the subsequent advance approach from *Pillowtex*, since Judge Sontchi again cited the entire *New York City Shoes* language as to this element, it appears, at least in his courtroom, the "remains unpaid" approach could nonetheless be enforced in Delaware. *Friedman's* is a decision that begs for reversal, and the authors expect that few, if any, courts will follow its tortured reading of the statute. ■

19 *See, e.g., TI Acquisition*, 429 B.R. at 382.

20 *See In re Paradise Valley Holdings*, 347 B.R. 304 (Bankr. E.D. Tenn. 2006); *In re Terry Mfg. Co.*, 325 B.R. 638 (Bankr. M.D. Ala. 2005); *In re Roberds*, 315 B.R. 443 (Bankr. S.D. Ohio 2004).

21 *Burtch v. Revchem Composites Inc. (In re Sierra Concrete Design Inc.)*, 2012 WL 12734 (Bankr. D. Del. Jan. 4, 2012).