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Timing is everything: One circuit says the new value window closes as of the petition date

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SEPTEMBER 23, 2022

Introduction

Section 547 of Chapter 11 of Title 11,[1] (the Bankruptcy Code) empowers certain parties to claw back "preference payments" made by a debtor to a creditor within 90 days of a bankruptcy filing.

However, the new value that a creditor provides to the debtor after receiving a preference payment oftentimes may offset its preference liability on a dollar-for-dollar basis.[2] While the concept may seem straightforward, the "new value" cannot be counted where the debtor later makes an "otherwise unavoidable transfer"[3] to the creditor on account of, or, in other words, that satisfies, the new value received.[4]

Section 503(b)(9) of the Bankruptcy Code also focuses on the timing of a creditor's provision of value, in the form of goods, to a debtor. Under this provision, certain creditors are entitled to an administrative priority claim for "the value of any goods received by the debtor within 20 days before the date of commencement of a case."[5]

Not surprisingly, courts have reached inconsistent conclusions as to whether § 503(b)(9) invoices paid or reserved for post-petition can also be counted as part of a creditor's new value defense.

Recently, in *Auriga Polymers Inc. v. PMCM2, LLC*,[6] the 11th Circuit Court of Appeals (the Court) reversed a bankruptcy court's decision on direct appeal, which had held amounts reserved for post-petition payments of § 503(b)(9) claims cannot also be included as part of a creditor's new value defense because the funds being held in reserve for eventual payment were "otherwise unavoidable transfers."

In reversing the bankruptcy court's decision, the Court relied primarily on the analysis in *Friedman's Liquidating Trust v. Roth Staffing Cos. (In re Friedman's Inc.)*,[7] a 3rd Circuit Court of Appeals decision that previously had held that post-petition payments received by a creditor after a bankruptcy filing pursuant to a court-approved wage order could also be counted as part of a creditor's new value defense.

Thus, the Court held that the new value window closes on the petition date (i.e., courts should not consider payments made post-petition) and creditors can rely upon § 503(b)(9) invoices as part of their new value defenses to reduce preference liability.

Statutory framework

A. Preference claims

Under § 547(b) of the Bankruptcy Code, certain parties can "avoid" a transfer if the relevant *prima facie* preference elements are satisfied. Essentially, this cancels the transaction and compels the creditor to return or "disgorge" a debtor's payments or transfers of property so that such payments or property can be reallocated pro rata to all unsecured creditors.

For transfers avoided under this provision, 11 U.S.C. § 550(a) empowers the trustee to then "recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property."

The new value that a creditor provides to the debtor after receiving a preference payment oftentimes may offset its preference liability on a dollar-for-dollar basis.

Section 547(c) provides creditors with nine defenses to a preference claim, which were promulgated to encourage creditors to continue doing business with financially distressed companies and to give them a chance at avoiding a bankruptcy filing. The "new value defense," which is codified in § 547(c)(4), is one of those defenses, and states, in pertinent part:

The trustee may not avoid under this section a transfer ... 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 [that was both:] (A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make ***an otherwise unavoidable transfer*** to or for the benefit of such creditor.

Simply put, this means that a creditor that provides new value to the debtor after receiving a preferential transfer can use that new value to offset a portion of its preference liability.

B. Section 503(b)(9)

Section 503(b)(9) of the Bankruptcy Code grants certain creditors administrative expense priority for "the value of any goods received by the debtor within 20 days before the date of commencement of a case under [Title 11] in which the goods have been sold to the debtor in the ordinary course of such debtor's business."

Unlike the oftentimes miniscule recoveries creditors receive on account of their unsecured claims, § 503(b)(9) confers administrative claim priority to creditors that deliver goods within the 20-day window, which may result in full payment of such claims.

Procedural background and facts

Beaulieu Group, LLC, along with certain affiliates and subsidiaries (collectively, Beaulieu), was a vertically integrated family of companies in the carpet industry. Beaulieu filed for Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the Northern District of Georgia (the Bankruptcy Court) on July 16, 2017 (the Petition Date).

The Court held that a post-petition court-authorized transfer ... made on account of a § 503(b)(9) claim is not an "otherwise unavoidable transfer" within the meaning of § 547(c)(4) and, thus, does not reduce a creditor's new value defense.

Following the effective date of Beaulieu's plan of liquidation, Beaulieu's liquidating trust, administered by PMCM 2, LLC (the Trustee), filed a preference action against one of Beaulieu's suppliers, Auriga Polymers (Auriga). The Trustee sought to avoid and recover $2.2 million in payments (the Pre-Petition Transfers) made to Auriga during the 90-day period before the Petition Date, from March 18, 2017 to June 16, 2017 (the Preference Period) under §§ 547(b) and 550 of the Bankruptcy Code.

Also, during the Preference Period, Auriga delivered Beaulieu over $3.523 million of goods (the Goods). At least $694,502 of those Goods were delivered in the ordinary course of business within twenty days of the Petition Date, and thus satisfied the requirements of § 503(b)(9). The Trustee agreed to reserve $694,502 to cover Auriga's § 503(b)(9) claim as there was a dispute over the actual amount of the claim.

Auriga also asserted a new value defense under § 547(c)(4) in the amount of $421,119, which overlapped with a portion of Auriga's § 503(b)(9) administrative expense claim.[8] Thus, the question before the Bankruptcy Court was "whether post-petition transfers made under a 11 U.S.C. § 503(b)(9) request could also be relied upon to reduce the creditor's new value defense."

Specifically, the Bankruptcy Court had to address whether the funds the Trustee held in reserve to pay Auriga's § 503(b)(9) claim constituted an "otherwise unavoidable transfer" that could be used to offset Auriga's preference liability.

The Bankruptcy Court sided with the Trustee, holding that the funds being held in escrow by the Trustee for payment of Auriga's § 503(b)(9) claim were "otherwise unavoidable transfers," so the "new value" defense would not also be available for the § 503(b)(9) portion of Auriga's unpaid invoices.

Following the Bankruptcy Court's decision, Auriga appealed to the district court, which stayed the case to allow for an immediate appeal to the Court.

The court's decision

The Court reversed the Bankruptcy Court's decision. The Court first rejected the Trustee's argument that the 11th Circuit's prior decision in *Kaye v. Blue Bell Creameries, Inc. (In re BFW Liquidation, LLC)*,[9] which considered whether the pre-petition payment of new value invoices constituted "otherwise unavoidable" transfers, supported its position. The Court distinguished the *In re BFW Liquidation* decision based on the fact that Auriga's § 503(b)(9) claim escrow reserve was funded post-petition for the benefit of the Trust.[10]

The Court then considered the *Friedman's* decision, which to date had been the only circuit court decision to address the "otherwise unavoidable" concept in the post-petition context. The *Friedman's* decision held that court-approved post-petition invoice payments made pursuant to a wage order were "not otherwise avoidable" payments because the new value window closes as of the petition date.

While the *Friedman's* court did not explicitly address the § 503(b)(9) issue,[11] the Court determined that the *Friedman's* court's reasoning was just as applicable in the § 503(b)(9) context.[12]

The Court buttressed its holding by noting that the Bankruptcy Code is silent as to whether *post*-petition payments should impact the subsequent new value defense.

Acknowledging that the construction of § 547(c)(4) did not include an express temporal limitation, the Court reasoned that the meaning of the term "transfer" should be consistent throughout the provision, and since the other references to the term transfer in the provision are all clearly pre-petition, Congress did not intend for post-petition payments to affect a creditor's defenses.

In addition, the Court observed that the title of Section 547, "Preferences," also intimated that the "transfers" described in the section were only intended to be pre-petition transfers, as all such transfers need to occur pre-petition. This is further supported by the fact that creditors that deliver goods *post-petition* cannot include those deliveries in their new value defenses, so courts should also not consider post-petition payments.

Moreover, the Court addressed how the statute of limitations for the filing of avoidance actions in a voluntary bankruptcy case begins to run on the petition date.

Accordingly, if post-petition transfers could defeat a new value defense, "the calculation of preference liability could change

depending on when the preference avoidance action was filed," encouraging plaintiffs to wait and see if all or a portion of a creditor's claims are paid post-petition as such payments would arguably reduce the available new value defense.

Finally, Congress intentionally favored creditors who ship goods within 20 days before a bankruptcy filing (as set forth in § 503(b)(9)), and the Court did not want to disturb this policy.

Given the foregoing, the Court held that a post-petition court-authorized transfer, in this case, a reserve for future payment, made on account of a § 503(b)(9) claim is not an "otherwise unavoidable transfer" within the meaning of § 547(c)(4) and, thus, does not reduce a creditor's new value defense.

Conclusion

The *Auriga* decision is a very positive development for trade creditors who supply goods within the 20-day § 503(b)(9) window and continue doing business with financially distressed companies up until the days and weeks before the petition date.

However, it is important to keep in mind that the Court's decision is only a first step. Since the Court is the first circuit court to address this issue, as the 3rd Circuit in *Friedman's* carved out the post-petition payment of § 503(b)(9) claims from its holding, only time will tell how other circuit courts, or even potentially the Supreme Court, will resolve this issue.

Notwithstanding, this holding should provide creditors some additional protection against the prospect of preference exposure, at least for bankruptcy cases filed in states covered by the 11th Circuit (Alabama, Florida, and Georgia).

Notes

[1] United States Code §§ 101 *et seq*.

[2] *Id*. § 547(c)(4).

[3] The convoluted nature of the phrase "otherwise unavoidable," and the ambiguity surrounding Congress's intent in drafting § 547(c)(4), has long been a source of uncertainty for courts when considering the new value defense, especially in the context of pre-petition paid new value. For example, transfers made unavoidable under one of the other § 547(c) defenses could be said to be "otherwise unavoidable" for purposes of" § 547(c)(4)(B), although that is not entirely clear from the statutory text.

[4] *Id*. § 547(c)(4)(b).

[5] *See* § 503(b)(9).

[6] 2022 U.S. App. LEXIS 19761 (11th Cir. July 18, 2022).

[7] 738 F.3d 547 (3d Cir. 2013).

[8] Auriga's $694,502 § 503(b)(9) claim included $421,119 in new value provided by Auriga to Beaulieu. The Trustee disputed that Auriga could also use that same $421,119 as part of its § 547(c)(4) new value defense. The parties agreed, however, that Auriga had an allowed § 503(b)(9) claim for $273,382 (the difference between the total § 503(b)(9) claim of $694,502 and the disputed portion of $421,119). Thus, the Trustee made an interim distribution of $273,382 to Auriga and the Trustee established a reserve in the amount of $421,119, which would be sufficient to pay the full amount of Auriga's § 503(b)(9) claim as asserted.

[9] 899 F.3d 1178 (11th Cir. 2018).

[10] The Court focused on how all of the transfers at issue in *In re BFW Liquidation* were made pre-petition. Thus, the decision's reasoning and holding was not instructive as to whether *post*-petition transfers could be used to offset a creditor's new value defense. Moreover, because the use of the phrase "otherwise unavoidable transfer" in the context of § 547(c)(4)(B) specifically relates to pre-petition conduct, and does not address post-petition conduct, it would have been superfluous for the *In re BFW Liquidation* court to refer to these transfers as "otherwise unavoidable transfers *made pre-petition*."

[11] *See In re Friedman's Inc.*, 738 F.3d 547, 554 n.2 (3d Cir. 2013) ("The Wage Order in the instant case was filed pursuant to §§ 105(a) and 363(b) of the Bankruptcy Code, provisions often invoked in Critical Vendor Orders. Given the similarity of the Wage Order to a Critical Vendor Order, the issue presented in these cases is analogous.

Also analogous are cases in which post-petition payments were made pursuant to § 503(b)(9), which allows for administrative expense priority for the value of goods received by a debtor 20 days before filing for bankruptcy.")

[12] *See In re Friedman's*, 738 F.3d at 555.

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This article was first published on Westlaw Today on September 23, 2022.