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Trade Creditors Have Their Cake and Eat It Too!

Eleventh Circuit Holds That Subsequent New Value Preference Defense Includes 503(b)(9) Claim Paid Post-Petition



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Trade creditors that deal with financially distressed customers headed toward bankruptcy face not only a risk of nonpayment, but the additional risk that payments received within 90 days of the bankruptcy filing may be clawed back as a preference. However, the U.S. Bankruptcy Code mitigates preference risk by providing several defenses to a preference claim.

One of the more prominent defenses is the subsequent new value defense under Section 547(c)(4) of the Bankruptcy Code. The new value defense reduces a creditor's preference liability dollar-for-dollar by the amount of any *new value* (e.g., goods sold on credit) the creditor had provided to the debtor prepetition after receiving a preference payment.

One issue confronting a creditor that asserts the new value defense is whether the defense includes an administrative expense priority claim under Section 503(b)(9) of the Bankruptcy Code (for goods sold to and received by the debtor in the 20 days before the bankruptcy filing [i.e., a 503(b)(9) claim] that was paid post-petition. Until recently, only a handful of bankruptcy courts had addressed this issue, albeit with conflicting holdings. Now, the U.S. Court of Appeals for the Eleventh Circuit has weighed in. In its recent decision in

Auriga Polymers Inc. v. PMCM2, LLC (Auriga Polymers), the Eleventh Circuit held that a creditor can maximize its new value defense by including the same invoices in both its 503(b)(9) claim paid post-petition and its new value defense. As a result of the Eleventh Circuit decision, trade creditors get to have their cake and eat it too!

A Brief Primer on 503(b)(9) Claims

Section 503(b)(9) grants an administrative expense priority claim for:

"... the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business."

Section 503(b)(9) provides a significant advantage to trade creditors. Claims for goods sold to a debtor prior to its bankruptcy filing are usually treated as general unsecured claims, which usually receive little or no recovery because they are near the bottom of the Bankruptcy Code's claims priority scheme. However, Section 503(b)(9) elevates claims for goods sold to and received by a debtor in the 20 days before the bankruptcy filing to administrative expense priority status. Administrative

claims generally must be paid in full for the debtor to confirm a Chapter 11 plan, and are entitled to full payment prior to any recoveries to lower priority creditors.

Preference Claims and the New Value Defense

According to Section 547(b) of the Bankruptcy Code, a trustee (or debtor in possession) can avoid and recover a transfer as a preference by proving that (a) the debtor transferred its property, such as a payment from its bank account; (b) the transfer was made on account of antecedent or existing indebtedness, such as unpaid invoices for goods sold and delivered; (c) the transfer was made within 90 days of the debtor's bankruptcy filing in the case of a transfer to a non-insider creditor such as a trade creditor; (d) the transfer was made when the debtor was insolvent (which is presumed during the 90-day period); and (e) the transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor.

Section 547(c) of the Bankruptcy Code provides multiple defenses that a creditor may assert to reduce its preference exposure. These defenses are intended to encourage creditors to continue doing business with, and extending credit to, financially distressed companies. One of most frequently asserted defenses is the subsequent new value defense set forth in Section 547(c)(4). According to Section 547(c)(4), a trustee cannot claw back a preference payment where, following the payment, the creditor gave new value to, or for the benefit of, the debtor and (a) such new value was not secured by an otherwise unavoidable security interest and (b) on account of such new value, the debtor did not make an otherwise unavoidable transfer to or for the benefit of the creditor. The new value defense reduces a creditor's preference liability dollar for dollar by the amount of credit extended to a debtor after the creditor's receipt of an alleged preference payment.

The new value defense was at issue in the *Auriga Polymers* case. Specifically, the Eleventh Circuit addressed whether a debtor's post-petition payment of a creditor's allowed 503(b)(9) claim was an "otherwise unavoidable transfer" that

must be excluded from the creditor's new value defense. Prior to *Auriga Polymers*, the Eleventh Circuit had not addressed whether a creditor can assert new value paid post-petition as part of the creditor's new value defense,¹ and no federal Court of Appeals had addressed the issue in the context of 503(b)(9) claims.

The U.S. Court of Appeals for the Third Circuit—in a 2013 decision (*In re Friedman's*)—had previously ruled that a debtor's post-petition payment of a creditor's prepetition wages did not preclude the creditor's inclusion of that same claim in its new value defense. The handful of lower courts that have addressed the issue in the context of 503(b)(9) claims paid post-petition have reached differing holdings. For example, in 2010, a Tennessee bankruptcy court, in *In re Commissary Operations, Inc.*, held that the post-petition payment of a creditor's 503(b)(9) claim did not reduce the creditor's new value defense. However, bankruptcy courts in Georgia and Virginia, in *In re TI Acquisition, LLC* and *In re Circuit City Stores, Inc.*, respectively, have held that a debtor's post-petition payment of a creditor's 503(b)(9) claim precluded the creditor from including the claim as part of the creditor's new value defense.

In *Auriga Polymers*, the Eleventh Circuit held that a creditor/preference defendant can assert its allowed 503(b)(9) claim paid post-petition as part of the creditor/defendant's new value defense. So now, two U.S. Courts of Appeals have adopted a more expansive approach to determining the amount of a creditor's new value defense where the new value was paid post-petition.

Factual Background

Beaulieu Group, LLC, and its affiliates (Debtors), one of the largest carpet manufacturers in North America, filed for Chapter 11 protection on July 16, 2017 (Petition Date). Auriga Polymers Inc. (Auriga) was one of the Debtors' suppliers; Auriga had sold polyester resins and specialty polymers to the Debtors for use in a range of products sold by the Debtors.

During the 90 days prior to the Petition Date (Preference Period), the Debtors had paid more than \$2.2 million to Auriga

for goods Auriga had sold to the Debtors (Prepetition Transfers). During that same period, Auriga had sold over \$3.5 million in goods on credit to the Debtors.

On the Petition Date, the Debtors owed Auriga more than \$4.2 million—at least \$694,502 of which was for goods the Debtors had received within the 20 days before the Petition Date. Auriga filed two claims in the Debtors' bankruptcy cases: (1) a low priority, general unsecured claim in the amount of approximately \$3.6 million, and (2) a 503(b)(9) claim for full payment of the \$694,502 of goods the Debtors had received in the 20 days before the Petition Date.

The Debtors subsequently filed, and the Bankruptcy Court confirmed, a Chapter 11 plan of liquidation under which all of the Debtors' assets—including causes of action, such as preference claims—were transferred to a liquidating trust administered by a liquidating trustee (Trustee). Thereafter, the Trustee filed a complaint against Auriga to avoid and recover the Prepetition Transfers as preferences under section 547(b). The Trustee also disputed Auriga's inclusion of its 503(b)(9) claim paid post-petition as part of its new value defense. Auriga sought a declaratory judgment that the Debtor's post-petition payment of Auriga's 503(b)(9) claim did not prevent Auriga from including the claim in its new value defense.

The parties thereafter entered into a joint stipulation for an interim distribution to Auriga. The parties agreed that all the Prepetition Transfers were avoidable preferences under section 547(b). The Trustee conceded that Auriga had a full new value defense, except with respect to the new value in the amount of \$421,119 included in Auriga's 503(b)(9) claim. The Trustee reserved sufficient funds to pay the \$421,119 balance of Auriga's disputed 503(b)(9) claim pending the Bankruptcy Court's ruling on whether Auriga could recover the 503(b)(9) claim while using that same \$421,119 as new value to reduce its preference liability.

The Bankruptcy Court sided with the Trustee, ruling that Auriga could be paid the \$421,119 under section 503(b)(9) or assert the \$421,119 as part of Auriga's value defense—but not both. The Bankruptcy Court concluded that Trustee's reservation of \$421,119

to satisfy Auriga's section 503(b)(9) claim was an "otherwise unavoidable" transfer² that Auriga could not assert as part of its new value defense.

Auriga appealed the Bankruptcy Court's decision, which appeal went directly to the Eleventh Circuit. The specific question on appeal was as follows:

[W]hether a Liquidation Trustee's post-petition reservation of funds sufficient to pay a defendant's administrative expense claim under § 503(b)(9) amounts to an "otherwise unavoidable transfer" within the meaning of § 547(c)(4) such that it precludes the use of such new value as part of the defendant's affirmative defense of subsequent new value under § 547(c)(4) of the Bankruptcy Code[.]

The Eleventh Circuit's Decision

The Eleventh Circuit reversed the Bankruptcy Court's ruling, holding that the post-petition transfer on account of Auriga's 503(b)(9) claim was not an "otherwise unavoidable transfer" that precluded Auriga from including this claim as part of Auriga's new value defense. The Eleventh Circuit focused on Section 547(c)(4)'s language, concluding that an "otherwise unavoidable" transfer refers solely to prepetition transfers. The Court reasoned that the word, *transfer*, should have the same meaning throughout Section 547(c)(4) since it appeared three times in the statute. The first two instances refer to transfers that qualify as preferences and necessarily must have occurred prepetition. The Eleventh Circuit likewise interpreted the third reference to an "otherwise unavoidable transfer" to be a prepetition transfer.

The Eleventh Circuit also reasoned that Section 547's title—Preferences—suggests that the statute solely deals with transfers during the prepetition preference period. Section 549 of the Bankruptcy Code separately addresses post-petition transfers.

The Eleventh Circuit also noted that a creditor cannot include post-petition extensions of credit to increase its new value defense. It logically follows that a debtor's post-petition payment of new

value does not reduce the creditor's new value defense.

The Eleventh Circuit also reasoned that preference claims and defenses should be determined as of the bankruptcy filing since the statute of limitations for preference claims begins to run on that date. If post-petition payments reduce a creditor's new value defense, the calculation of preference liability would continue to change post-petition depending on when the preference action is ultimately filed.

Finally, the Eleventh Circuit addressed a policy argument the Trustee and the Bankruptcy Court had raised, that a creditor would receive a "double payment" if allowed to use the same invoices as part of the creditor's 503(b)(9) claim paid post-petition and as part of the creditor's new value defense. The Eleventh Circuit rejected this argument. The new value defense merely prevents the disgorgement of amounts paid prepetition, while a 503(b)(9) claim results in the creditor receiving payment of prepetition invoices for goods delivered shortly before the bankruptcy filing that were unpaid as of the filing. The different Bankruptcy Code provisions are the result of Congress' independent policy choices, "all of which are entitled to judicial respect." Section 547(c)(4) has no bearing on a creditor's separate right to payment of invoices that give rise to an administrative claim under section 503(b)(9).³

Conclusion

The *Auriga Polymers* decision is a huge win for trade creditors who continue to do business with a financially distressed customer headed towards a bankruptcy filing. The Eleventh Circuit's holding is binding on federal courts (including bankruptcy courts) in Alabama, Georgia and Florida. Moreover, the decision is sure to have national implications because it is the first U.S. Court of Appeals to hold that a creditor can assert a new value defense under Section 547(c)(4) even if that new value was included in a 503(b)(9) claim paid post-petition.

Now there are two circuit courts, the Third Circuit and Eleventh Circuit, that have refused to restrict a creditor's new value defense where the prepetition new value

was later paid post-petition. While the Third Circuit and Eleventh Circuit decisions specifically related to prepetition wages and a 503(b)(9) claim paid post-petition, respectively, the reasoning of these courts can be applied in other contexts—such as where a creditor's prepetition invoices were paid post-petition pursuant to a critical vendor order. Bottom line, these circuit court decisions allow trade creditors to have their cake and eat it too. ■■■■■

- 1 In 2018, in *In re BFW Liquidation LLC (BFW)*, the Eleventh Circuit joined the Fourth, Fifth, Eighth, and Ninth Circuits in holding that new value that had been paid prepetition could be included as part of a creditor's section 547(c)(4) new value defense.
- 2 In connection with its appeal, Auriga argued that no "transfer" had occurred at all, since the balance of its 503(b)(9) claim had not been paid, but merely reserved by the Trustee. However the Eleventh Circuit concluded that the reservation of funds by the Trustee was a "transfer" for purposes of section 547(c)(4).
- 3 The Eleventh Circuit also rejected an argument by the Trustee that the court was bound to rule in the Trustee's favor by its prior holding in *In re BFW Liquidation, LLC*. The Trustee argued that the *BFW* decision was dispositive because the Eleventh Circuit had held that "[n]othing in the language of § 547(c)(4) indicates that an offset to a creditor's § 547(b) preference liability is available only for new value that remains unpaid." By that same logic, the Trustee argued, nothing in Section 547(c)(4) indicates that the "otherwise unavoidable transfer" had to have occurred prepetition. However, the Eleventh Circuit held that *BFW* was not dispositive because *BFW* dealt with new value paid prepetition, not new value paid post-petition (e.g., in the context of an allowed 503(b)(9) claim).

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