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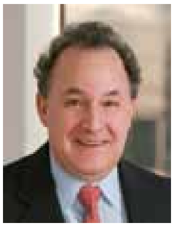

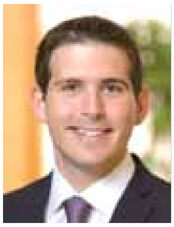

A New Preference Defense?

A trade creditor faces many risks when its customer files for bankruptcy. Nonpayment of the creditor's claim is one such risk. Adding insult to injury, a creditor also faces preference risk for the return of all payments the creditor received from the debtor within 90 days of the bankruptcy filing.

A debtor, trustee, or other party with standing can recover a preference claim by satisfying all of the requirements of Section 547(b) of the Bankruptcy Code. They include the following: (a) the debtor transferred its property, such as by tendering a payment, to or for the benefit of a creditor (Section 547(b)(1)); (b) the transfer was made on account of existing or antecedent indebtedness the debtor owed the creditor (Section 547(b)(2)); (c) the debtor made the transfer when it was insolvent, based on a balance sheet definition of liabilities exceeding assets, the proof of which is aided by a presumption of insolvency during the 90-day period prior to the bankruptcy filing (Section 547(b)(3)); (d) the transfer was made within 90 days prior to the bankruptcy filing, in the case of a transfer to a non-insider, such as a trade creditor, or within one year prior to the bankruptcy filing, in the case of a transfer to an insider, such as the debtor's officers, directors, controlling shareholders and affiliates (Section 547(b)(4)); and (e) the creditor received more from the transfer than it would have received in a Chapter 7 liquidation of the debtor, which requirement is satisfied if unsecured creditors in the bankruptcy case are not recovering 100% of their claims.

> Two frequently invoked defenses to preference claims are the "ordinary course of business" and the "new value" defenses.

Creditors typically rely upon several defenses to reduce or eliminate their preference liability. Two frequently invoked defenses to preference claims are the "ordinary course of business" and the "new value" defenses. The "ordinary course of business" defense requires a creditor to prove that (a) the alleged preference paid a debt that was incurred in the ordinary course of the debtor's and creditor's businesses and (b) the payment was either made in the ordinary course of the debtor's and creditor's business affairs or according to ordinary business terms that exist within an applicable industry. The "new value" defense reduces a creditor's preference liability to the extent the creditor provided new goods or services to the debtor after receiving the alleged preference payment.

Recently, in the *Quantum Foods* case, the U.S. Bankruptcy Court for the District of Delaware (one of the busiest and most influential bankruptcy courts in the United States), approved, for apparently the first time, a creditor's use of a new preference defense. The creditor successfully argued that it could setoff its allowed administrative expense claim, for goods it had provided on credit terms to the debtor after the bankruptcy filing, to reduce any potential preference liability on a dollar-for-dollar basis.

Overview of a Trade Creditor's Setoff Rights

Setoff rights are significant state and federal law rights that a creditor can use to reduce its exposure on its claim against a financially distressed customer. Setoff rights often exist where the trade creditor and the debtor sell goods or provide services to each other. A creditor asserting its setoff rights nets out the creditor's claim owed by the debtor against the creditor's obligations to the debtor. For example, if ABC owes XYZ $1,000 and XYZ also owes ABC $700, then XYZ can net out, or setoff, the amounts owed so that ABC only pays XYZ the net amount of $300. XYZ's setoff rights are easily understandable and efficient—they excuse ABC from having to pay XYZ $1,000 and then requiring XYZ to immediately pay $700 back to ABC. In bankruptcy cases, a creditor is granted setoff rights because it would be clearly unfair to force the creditor to pay the full amount of its indebtedness to a financially distressed debtor when the creditor faces the real risk of the debtor's delayed payment of only a fraction of, or nonpayment of, the creditor's offsetting claim.

The Bankruptcy Code does not create independent setoff rights. Instead, Section 553 of the Bankruptcy Code preserves a creditor's setoff rights that already exist under applicable federal or state law. However, the Bankruptcy Code limits a creditor's setoff rights. For instance, the automatic stay that arises under Section 362 of the Bankruptcy Code applies to a creditor's attempt to exercise its setoff rights following a debtor's bankruptcy filing. A creditor must first obtain the bankruptcy court's approval of relief from the automatic stay to enable the creditor to exercise its setoff rights against a debtor. Section 553 of the Bankruptcy Code also limits a creditor's exercise of setoff rights that arose within 90 days of the bankruptcy filing or resulted in an improvement in the creditor's position during the 90-day period.

The Quantum Foods Case

On Feb. 18, 2014 (the "petition date"), Quantum Foods and several of its affiliates (the "Debtors") filed Chapter 11 petitions in the U.S. Bankruptcy Court for the District of Delaware. Approximately two months after the bankruptcy filing, Tyson Fresh Meats, Inc. and Tyson Foods, Inc. (together, "Tyson") sold meat products to the Debtors for which the Debtors failed to pay. The bankruptcy court granted Tyson an allowed administrative expense claim in the amount of $2,603,841.09.

On March 25, 2015, the Official Committee of Unsecured Creditors (the "Committee") appointed in the bankruptcy case sued Tyson to avoid and recover, as preferences, several payments totaling nearly $14 million by the Debtors to Tyson within 90 days of the bankruptcy filing. Tyson denied that the transfers were avoidable preferences. Tyson also asserted a counterclaim for the setoff of its allowed administrative expense claim in the amount of $2,603,841.09 against any recovery the bankruptcy court might ultimately award to the Committee in its preference action against Tyson.

> Setoff is only valid in bankruptcy if the debtor's and the creditor's opposing obligations are mutual and both arose either before or after the petition date.

The Committee argued that Tyson was not entitled to offset its administrative expense claim against Tyson's preference liability. The Committee contended that Tyson's setoff claim was really a "disguised" attempt to improperly include post-petition new value as part of Tyson's new value defense, an argument which most courts have rejected. The Committee relied on a 2013 decision of the U.S. Court of Appeals for the Third Circuit, in the *Friedman*'s case, which is binding on the Delaware bankruptcy court. The Third Circuit held that a creditor's unpaid administrative expense claim for goods and/or services the creditor provided to the debtor post-petition cannot be included in determining the creditor's new value defense, since the petition date is the cutoff date for computing new value.

Tyson countered that it was asserting its setoff rights, based on its allowed administrative expense claim, as a counterclaim to reduce its preference liability. The new value defense had nothing to do with Tyson's assertion of its setoff rights.

The bankruptcy court held that Tyson had properly invoked its setoff rights, based on its allowed administrative expense claim for meat products it had provided to the Debtors after the bankruptcy filing, to reduce its preference liability. The court did not consider Tyson's setoff claim a backhanded attempt to assert Tyson's unpaid administrative expense claim as part of its new value defense.

The court then reviewed the validity of Tyson's setoff counterclaim. The court explained that setoff is only valid in bankruptcy if the debtor's and the creditor's opposing obligations are mutual and both arose either before or after the petition date. Thus, setoff applies to mutual, post-petition obligations. Tyson's administrative expense claim was clearly a post-petition obligation of the Debtors. Therefore, Tyson could use its administrative expense claim to setoff its preference liability only if the Committee's preference claim also arose post-petition. The court concluded that a preference claim arises post-petition because preference claims exist, and can be asserted, only after a debtor files a bankruptcy case. It did not matter that the Committee's preference claim was based on the Debtors' payments to Tyson prior to the bankruptcy filing.

The bankruptcy court also rejected the Committee's invocation of Section 502(d) of the Bankruptcy Code to bar Tyson from setting off its administrative expense claim to reduce its preference liability. Section 502(d) requires the court to disallow a creditor's pre-petition claim until the creditor has returned all preferential transfers it had received from the debtor. However, Section 502(d) makes no reference to administrative expense claims. Extending Section 502(d) to administrative expense claims would also be harmful to a debtor's ability to reorganize because trade creditors would be discouraged from extending post-petition credit to a debtor if the debtor could raise a preference claim as a defense to payment of creditors' administrative expense claims. Interestingly, other courts do not share this view and have held that a debtor can invoke Section 502(d) to disallow all claims, including administrative expense claims, based on a creditor's potential preference liability.

For all of the above reasons, the bankruptcy court denied the Committee's motion for dismissal of Tyson's counterclaim. Tyson was, therefore, free to setoff its allowed administrative expense claim to reduce its preference liability.

However, in an earlier 1984 decision, the U.S. Bankruptcy Court for the Middle District of Georgia, in the *Georgia Steel, Inc.* case, held that a creditor could not setoff its allowed administrative expense claim to reduce its preference liability. The *Georgia Steel* court relied on the predecessor to Section 502(d) in the Bankruptcy Act, this country's bankruptcy statute prior to the Bankruptcy Code, to disallow all of a creditor's claims, including its administrative expense claims, until the creditor had repaid all preferential transfers. This competing view provides courts with a justification for refusing to allow a creditor's assertion of setoff rights on account of its administrative expense claim to reduce potential preference exposure.

The court concluded that a preference claim arises post-petition because preference claims exist, and can be asserted, only after a debtor files a bankruptcy case.

Conclusion

Creditors facing preference risk can continue to raise several defenses, such as the new value and ordinary course of business defenses, to reduce or eliminate preference liability. Thanks to the *Quantum Foods* decision, creditors now have an additional arrow in their quivers, and could seek to offset their administrative expense claims to reduce their preference exposure. Yes, great news for the trade; however, in light of the contrary holding of the *Georgia Steel* court and the scarcity of court decisions addressing this issue, other bankruptcy courts will hopefully follow the *Quantum Foods* holding to build support for this new preference defense.

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