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Fourth Circuit Declines to Adopt Blanket Rule against Nonconsensual Nondebtor Releases

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A three-judge panel of the Fourth Circuit recently held that although bankruptcy courts may authorize nonconsensual nondebtor releases under appropriate facts and circumstances, bankruptcy courts must make specific factual findings and explain why such findings support the releases.[1]

Bankruptcy Court Proceedings

National Heritage Foundation (NHF), the debtor, is a nonprofit public charity that administers and maintains Donor-Advised Funds. NHF filed for bankruptcy protection in 2009 after a Texas state court entered judgment against it in an amount in excess of $6 million and a subsequent turnover order, which resulted in a freeze on NHF's operating account.[2]


Jason W. Harbour

NHF's proposed reorganization plan included a broad, nonconsensual third-party release, indemnification and exculpation provisions (the "third-party releases").[3] The third-party releases generally applied to the debtor, the committee, members of the committee, officers, directors and professionals. The plan released those parties from claims arising before and through the effective date of the plan, and related to or arising out of the operation of the debtor's business or the chapter 11 case. The released parties made no monetary contribution toward plan distributions, and the plan contained no opt-in or opt-out provisions.[4]


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Certain creditors and the U.S. Trustee[5] objected to the proposed plan,

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1 *Behrmann v. National Heritage Foundation Inc.*, 663 F.3d 704 (4th Cir. 2011) (*Behrmann*).

2 Third Amended and Restated Disclosure Statement in Support of Fourth Amended and Restated Plan of Reorganization of the Debtor, No. 09-10525-SSM, filed Sept. 4, 2009 (D.I. 578), at § 4.2.

3 Fourth Amended and Restated Plan of Reorganization of the Debtor, No. 09-10525-SSM, filed Oct. 13, 2009 (D.I. 665), at §§ 7.19, 7.20 and 7.21.

4 *Id.* at § 7.19.

5 Objections were filed by the U.S. Trustee (D.I. 548), Larry Renick (D.I. 562), Highbourne Foundation, Townsley Foundation, and the Dodie Anderson Foundation (D.I. 584, 585, 648, 649, 650, 651), John Goodson (D.I. 608), and Scott Simpson and Deanna Nord Nogel (D.I. 596).

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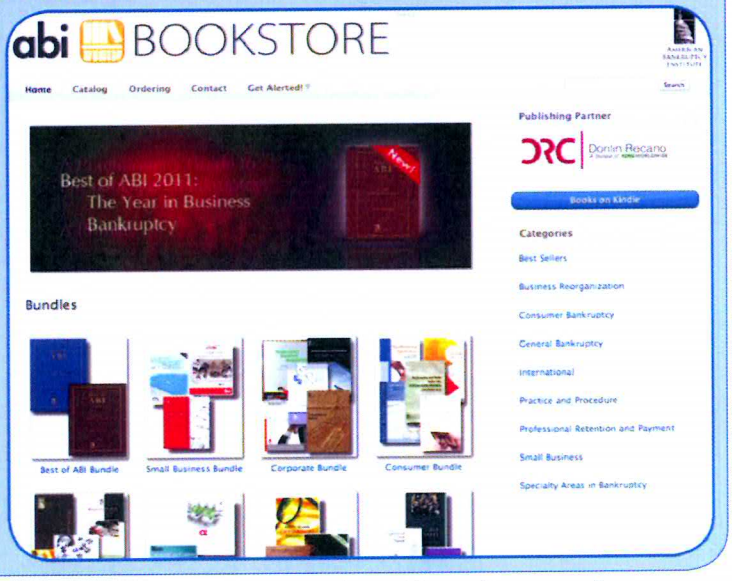

ON THE INSIDE: SUCCESSOR LIABILITY • NEW VALUE • MORTGAGE FORECLOSURE SETTLEMENT • ANNUAL SPRING MEETING PREVIEW AND AGENDA

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Delaware Court Rules Petition Date Fixes Amount of Defendant's Subsequent New Value

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Editor's Note: *For another viewpoint on this case, see the feature on page 42.*

The U.S. Bankruptcy Court for the District of Delaware in *Friedman's Inc. v. Roth Staffing Companies LP (In re Friedman's Inc.)* recently held that a preference defendant may use subsequent new value, even where the debtor paid for such new value after the petition date.[1] Judge **Christopher S. Sontchi**'s decision is consistent with applicable case law and appropriately respects the legal significance of the petition date.


Jeffrey R. Waxman

The facts and issues of the case were "narrow and straightforward": During the preference period, the debtor paid approximately $82,000 to the defendant, and the defendant provided approximately $100,000 of employment services to the debtor, which remained unpaid on the petition date. The debtor was granted a motion for authority to pay certain pre-petition wages, compensation and employee benefits pursuant to 11 U.S.C. §§ 105(a) and 363(b). The debtor thereupon remitted payment of approximately $72,000 to the defendant. About one year later, the debtor commenced the adversary proceeding seeking to avoid the $82,000 of preference period payments. After the defendant asserted the subsequent new value defense, the plaintiff filed a motion for summary judgment claiming that the defendant was not entitled to subsequent new value for services provided pre-petition, but paid after the petition date pursuant to the court order. The court denied the plaintiff's motion, holding that the bankruptcy filing "fixes" the preference analysis as of the petition date and therefore the debtor's post-petition payment on account of the defendant's subsequent new value did not affect the preference analysis.

1 2011 WL 5975283 (Bankr. D. Del. Nov. 30, 2011).

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The court addressed the basic provisions of a preference claim, the subsequent new value defense and the legal basis for granting the wage motion in accordance with the doctrine of necessity before analyzing the parties' plain-meaning arguments, which focused on whether the word "debtor" in 11 U.S.C. § 547(c)(4) referred only to the pre-petition entity or the post-petition entity. The court rejected both parties' "plain-meaning" arguments because it found that both were premised on the fallacious assumption that the debtor and debtor in possession are separate entities. The court found that the "debtor" is a corporate entity existing both pre- and post-petition by considering the following statement: "'Willie Mays is a person that has been elected into the Hall of Fame.' Did Willie Mays come into existence the moment he was elected to the Hall of Fame... Of course not. Did Willie Mays cease to exist upon election into the Hall of Fame... Of course not. Under the rules of English grammar and syntax, the phrase 'that has been elected' in this example is not a temporal restriction. Rather, it is an adjective that sets forth what it is that makes the particular person or thing of interest to the reader. If one is interested in great baseball players it is significant to know that Willie Mays is in the Hall of Fame. If one is interested with bankruptcy it is significant to know whether the company has actually filed bankruptcy."

The court then evaluated the parties' position on the petition date. While acknowledging that the court of appeals did not address the narrow issue before the court, Judge Sontchi found that the Third Circuit's analysis in *New York City Shoes*[2] compelled the conclusion that the "fixed" approach is correct. In *New York City Shoes*, the Third Circuit held that "the subsequent new value defense under section 547(c)(4) has three elements: (1) the creditor must have received a transfer that is otherwise voidable as a preference under section 547(b); (2) after receiving the preferential transfer, the preferred creditor must advance 'new value' to the debtor on an unsecured basis; and (3) the debtor must not have fully compensated the creditor for the 'new value' *as of the date that it filed the bankruptcy petition.*"[3] While many courts outside of the Third Circuit have dropped the language "as of the date that it...filed its bankruptcy petition," the Third Circuit reiterated its holding in *New York City Shoes*.[4]

The court stated that its ruling is "consistent with the purpose of the preference law—to reduce damaging, pre-petition opt-out behavior and to level the prebankruptcy playing field for all creditors. Once the bankruptcy is filed, preference law becomes unnecessary as the automatic stay steps in to stop the race to the assets and the supervision of the case by the court, among other things, ensures that similar claims receive similar treatment."[5] Disparate treatment occurs only with court approval.

Arguably, the Third Circuit's language in *New York City Shoes* and *Winstar* was *dicta*. One can also argue that *Friedman's* is inconsistent[6] with the holding of *Pillowtex*, wherein the District of Delaware held that defendants can assert the subsequent new-value defense through paid or unpaid new value under § 547(c)(4) so long as the payments on account of that new value are not otherwise unavoidable.[7] It cannot be argued that *Friedman's* is inconsistent with the

Feature

2 *New York City Shoes Inc. v. Bentley Int'l Inc.*, 880 F.2d 679 (3d Cir. 1989).

3 2011 WL 5975283 at *4 (quoting *New York City Shoes*) (emphasis in *Friedman's*).

4 2011 WL 5975283 at *4, n. 22 (citing *Schubert v. Lucent Techs Inc. (In re Winstar Comm'n Inc.)*, 554 F.3d 382, 402 (3d Cir. 2009)).

5 2011 WL 5975283 at *4.

6 The two decisions are not inconsistent. *Friedman's* never addressed the broader issue of whether new value had to remain unpaid, but whether such new value had to remain unpaid as of the petition date. A subsequent decision by Judge Sontchi in *Burtch v. Revchem Composites Inc. (In re Sierra Concrete Design Inc.)*, 2012 WL 12734 (Bankr. D. Del. Jan. 4, 2012), which cites the *Friedman's* decision, ruled that the defendant was entitled to assert paid and unpaid subsequent new value.

7 *Wahoski v. Am. & Epfid (In re Pillowtex Corp.)*, 416 B.R. 123 (Bankr. D. Del. 2009).

most basic of bankruptcy tenets: The petition date is a bright line dividing those matters occurring pre-petition from those occurring post-petition,[8] and what happens after the parties' rights have become fixed is legally irrelevant with respect to preference actions.

Further, *Friedman's* does not result in "double-dipping" as critical vendors do not receive two times the benefit. All they receive is the right to full and immediate payment of their claims, usually in exchange for an agreement to continue to provide the post-petition debtor with pre-petition credit terms. Absent the *Friedman's* result, once a debtor's need for a particular vendor has waned, the trustee could seek to recover all of the value of the debtor's post-petition payment by filing an avoidance action against that vendor (who would be precluded from asserting the subsequent new-value defense to the extent such new value was paid in accordance with the court's order). Trade creditors familiar with the implications of accepting a post-petition payment on account of pre-petition claims may be dissuaded from becoming critical vendors at all. Had the court granted the plaintiff's motion, the costs of the *Friedman's* decision may have been borne by future debtors as critical vendors may have elected not to provide debtors with favorable trade terms (or to deal with them post-petition at all) because they might have been just as well served—if not better served—by not becoming critical vendors in the first instance and requiring all debtors agree to the payment terms the vendor required. Those future vendors would still be able to use their subsequent new value as a defense and get a distribution on account of their claims, albeit in the same percentage and at the same time as other unsecured creditors.

Ultimately, the court did not deny the plaintiff's motion for summary judgment based on the policy implications of disallowing the critical vendor's right to assert its subsequent new value. Instead, the court's decision was based on one of bankruptcy's oldest and broadest rules, which remains as correct today as it was when the U.S. Supreme Court ruled in 1924: The petition date separates "the old situation from the new in the debtor's affairs."[9] ■

[8] *See, e.g., Everett v. Judson*, 228 U.S. 474, 479 (1913) ("We think that the purpose of the law was to fix the line of cleavage with reference to the condition of the bankrupt estate as of the time at which the petition is filed"). *See also In the Matter of Wiltse Bros. Corp.*, 361 F.2d 295, 299 (6th Cir. 1966).

[9] *See White v. Stump*, 266 U.S. 310, 313 (1924).