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Feature

By Jeffrey R. Waxman

# Petition Date Fixes Amount of Defendant's Subsequent New Value

**Editor's Note:** *For another perspective on this topic, see the feature article on p. 48 of this issue by Joseph L. Steinfeld, Jr. and Kara E. Casteel.*

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The *ABI Journal* published a pair of articles in the March 2012 issue[1] addressing the U.S. Bankruptcy Court for the District of Delaware's decision in *Friedman's Liquidating Trust v. Roth Staffing Companies LP (In re Friedman's Inc.)*.[2] This article provides an update following the recent decision of the Court of Appeals for the Third Circuit[3] affirming the decisions of the bankruptcy and district courts.

The facts of the case are undisputed. During the preference period, the debtor paid the defendant approximately $82,000, and the defendant provided approximately $100,000 of employment services to the debtor, which remained unpaid as of the petition date. The bankruptcy court granted the debtor's motion for authority to pay certain pre-petition wages, compensation and employee benefits pursuant to 11 U.S.C. §§ 105(a) and 363(b).[4] Pursuant to the wage order, the debtor subsequently remitted approximately $72,000 to the defendant. Approximately one year later, the debtor's liquidating trust commenced an adversary proceeding 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 that were provided pre-petition, but paid after the petition date pursuant to the court's order. The bankruptcy court denied the plaintiff's motion, holding that the filing of the bankruptcy "fixes" the preference analysis as of the petition date; therefore, the debtor's post-petition payment on account of the defendant's subsequent new value did not affect the preference analysis. After the district court affirmed the bankruptcy court, the plaintiff appealed. On appeal, the plaintiff raised three issues: (1) the bankruptcy and district courts erred by relying on *dicta* from Third Circuit's *New York City Shoes*[5] and *Winstar*[6] decisions; (2) by allowing the defendant to use the new value defense for services that were paid post-petition, the defendant was impermissibly allowed to "double dip" without replenishing the debtor's estate; and (3) the bankruptcy and district court decisions were inconsistent with the Third Circuit's decision in *Kiwi Air*.[7]

## *New York City Shoes* and *Winstar*

The plaintiff asserted that the lower courts incorrectly relied on the third prong of the *New York City Shoes* and *Winstar* test for the subsequent new value defense, and therefore, as a threshold matter, the Third Circuit needed to determine whether it was bound by its precedent. *New York City Shoes* is often cited for establishing the following three requirements for subsequent new value defense: (1) the creditor must have received a transfer that is otherwise voidable as a preference under § 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 its bankruptcy petition*.[8]

1 *See* Jeffrey R. Waxman, "Delaware Court Rules Petition Date Fixes Amount of Defendant's Subsequent New Value," XXXI *ABI Journal* 2, 30-31, March 2012, and Joseph L. Steinfeld, Jr. and Kara E. Casteel, "*Friedman's* Improperly Adds Requirement that New-Value Analysis Closes at Petition Date," XXXI *ABI Journal* 2, 42-43, March 2012.
2 2011 WL 5975283 (Bankr. D. Del. Nov. 30, 2011).
3 *In re Friedman's Inc.*, -- F.3d --, 2013 WL 6797958 (3d Cir. Dec. 24, 2013).
4 This type of motion is frequently referred to as a "critical wage motion," and an order granting such relief is known as a "critical wage order."
5 *In re New York City Shoes Inc.*, 880 F.2d 679 (3d Cir. 1989).
6 *In re Winstar Communications Inc.*, 554 F.3d 382 (3d Cir. 2009).
7 *In re Kiwi Int'l Air Inc.*, 344 F.3d 311 (3d Cir. 2003).
8 *New York City Shoes*, 880 F.2d at 680 (emphasis added).

Since *New York City Shoes*, a number of courts have addressed whether the third requirement was binding or whether it was *dicta*. Twenty years later, the Third Circuit had another opportunity to address the requirements for the subsequent new value defense in the *Winstar* case, and the court referred to the three-part test of *New York City Shoes* as a "holding."[9]

In *Friedman's*, the court of appeals reviewed *New York City Shoes* and *Winstar* and found that its prior statements of the law "may well have been *dicta*." The court, therefore, found that neither the bankruptcy court nor district court was bound by those prior opinions. The court then turned to the plaintiff's substantive arguments, addressing the relevant statutory language.

The court's finding that the third prong of the *New York City Shoes* and *Winstar* test is *dicta* should not be surprising given the underlying facts of both of those cases, but the Third Circuit's decision should finally put an end to a lengthy debate about the new value defense that has raised difficulties for practitioners and courts during the last 20 years.[10]

## Statutory Analysis

The court's analysis of the statute began with the axiomatic statement that where the statutory language is plain, the court's sole function is to enforce it according to its terms. The court found that § 547(c)(4)(B)[11] "is silent as to when a payment must be made by a debtor to defeat a creditor's new value defense," and district and bankruptcy courts are nearly equally divided on the issue of whether such payments must have been made before the petition date.[12] Despite the split on the issue, the court found that just because "courts are divided in their interpretations of § 547(c)(4)(B) does not mean, however, that the provision is necessarily ambiguous."[13] Context, the court stated, is "key in determining the meaning of a particular provision and whether or not it is ambiguous."[14]

Before stating its interpretation, the court rejected the parties' statutory interpretations as formalistic. First, the court rejected the defendant's argument that the word "transfer" as used in § 547(c)(4)(B) refers to § 547(b), which provides that in order for a transfer to be avoidable, it must have occurred within the 90 days preceding the petition date. The court also rejected that the second use of the word "transfer" must mean that it is also modified by the 90-day phrase. The court found that although the word "transfer" is clearly modified in a way referring back to the 90-day period, referring to the "otherwise unavoidable transfer" issue is not and the addition of the word "unavoidable" did not give the court any basis to think that such a temporal limitation should apply.[15] The court also rejected the defendant's argument that the use of the word "debtor" rather than "estate" or "debtor in possession" indicated that the provision only refers to pre-petition activity.[16] Rather than focusing on the individual words and phrases within § 547(c)(4)(B), the court took a "broader approach to [its] analysis, examining the provision in the context of the Bankruptcy Code as a whole."[17]

The Court found five contextual indicators to support concluding that the petition date is the cutoff for analysis of the new value defense. First, the title of § 547, "Preferences," suggests that it is concerned with transactions occurring during the preference period; accordingly, the court found that it makes sense that the calculation of the preference, including the new value defense, would relate to that time period. Second, the hypothetical liquidation test of § 547(b)(5) must be performed as of the petition date, so that is the date for the cutoff of determining new value. Third, the statute of limitations set forth in § 546 runs from the petition date. Had Congress intended to allow post-petition transactions to affect the impact on the estate, it likely would have crafted a different statute of limitations. Fourth, extending the preference period would have been inconsistent with the improvement-in-position test in § 547(c)(5). Lastly, the court found that were it to allow post-petition payments to affect the preference analysis, "it would seem logical also to consider post-petition extensions of new value to be available as a defense," which other courts have considered but have declined to allow.[18] Accordingly, the court concluded that "the context of the Code supports the conclusion that post-petition payments by a debtor do not affect a creditor's new value defense."

Despite having found the statutory language unambiguous, the court addressed the plaintiff's policy arguments, which included the congressional record. The court stated that the new value defense serves two underlying purposes: It was designed "to encourage trade creditors to continue dealing with troubled businesses [and] to treat fairly a creditor who has replenished the estate after having received a preference."[19] Accordingly, the court rejected the argument that permitting a creditor that was paid post-petition to also get credit for the new value provided during the preference period would be permitting the defendant to receive a double benefit.[20] Even if a creditor is eventually paid post-petition for the new value that it provided pre-petition, it still provided services to the debtor's estate during the preference period, which therefore aided the debtor in avoiding bankruptcy to whatever extent possible.

The court also found the argument of "double-dipping" misleading because it implies that the creditor received payment for goods or services that were never provided, or that the creditor is being paid twice. The court found that the creditor provided services on credit during the preference period, and the trustee paid the creditor pursuant to the wage order after the debtor filed its petition. All of the money that the creditor received was for goods and services that it actually provided, and the creditor was therefore never unjustly

9 *Winstar*, 554 F.3d at 402.

10 *See, e.g., Wahoski v. Am. & Efrid Inc. (In re Pillowtex Corp.)*, 416 B.R. 123, 130-31 (Bankr. D. Del. 2009). *See also* Carl N. Kunz III and Thomas M. Horan, "New Value Must Remain Unpaid? It's Time to Resole *New York City Shoes*," *ABI Journal*, Vol. XXV, No. 9, p. 36, November 2006.

11 11 U.S.C. § 547(c)(4) provides, in relevant part:

> (c) The trustee may not avoid under this section a transfer —
>
> (4) 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 —
>
> (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.

12 *Friedman's*, 2013 WL 6797958 at *5. The Third Circuit cited nine cases — five supporting that new value must remain unpaid as of petition date, and four in support of the proposition that the timing of a repayment of new value is irrelevant.

13 *Friedman's*, 2013 WL 6797958 at *5.

14 *Id.*

15 *Id.* at *6.

16 *Id.* (citing 11 U.S.C. §§ 329 and 521).

17 *Id.*

18 *Id.* at *8.

19 *Id.* at *10 (quoting *New York City Shoes*, 880 F.2d at 680-81) (internal quotes omitted).

20 This argument had been accepted by other lower courts, including *In re T.I. Acquisition LLC*, 429 B.R. 377, 385 (Bankr. N.D. Ga. 2010); *In re Login Bros. Book Co.*, 294 B.R. 297, 301 (N.D. Ill. 2003); and *In re MMR Holding Corp.*, 203 B.R. 605, 609 (Bankr. M.D. La. 1996).

enriched.[21] The court also rejected the plaintiff's argument that cutting off preference analysis at the petition date results in unequal treatment of creditors:

> If it is a rule in bankruptcy that all creditors must be treated equally, surely the exceptions swallow the rule. It could be said that some creditors are treated more equally than others. There are special provisions for aircraft leases and shopping center leases, and some claims are given priority over others.... Inequality per se is not to be avoided; indeed, reasoned and justified inequality sometimes prevails, usually based on what is in the best interest of the estate.[22]

The court rejected the notion that the goals of bankruptcy are "replenishment" or "equality;" rather, bankruptcy and avoidance actions are "all about deterring 'the race of diligence,' and setting things straight, before bankruptcy."[23] To that end, the Bankruptcy Code contains numerous post-petition mechanisms to ensure that similarly situated creditors are treated equally, but preference analysis does not need to account for post-petition activity. Bankruptcy courts often consider and weigh competing policy objectives in authorizing post-petition payments, such as the wage order. Were the court to permit the liquidating trustee to avoid transfers based on the post-petition order, the court "would be giving with one hand and taking away with the other [as] the intended goal of the [wage] Order — to ensure 'continued service, satisfaction and loyalty of [the debtor's] numerous employees' — would not be served if the Debtor sought and obtained permission to pay wages to [the defendant] one week but then sued [the defendant] for a preference the next."[24] The court of appeals refused to undermine the bankruptcy court by including such post-petition activity in the preference-liability equation; therefore, the Bankruptcy Code's provisions related to post-petition conduct are allowed to govern.

In their article featured in this issue, Steinfeld and Casteel incorrectly assert that the Third Circuit's ruling ignored the plain language of the statute and criticize the Third Circuit's contextual analysis as "pretzel logic." To the contrary, the Third Circuit's analysis was consistent with its holistic reading of the Bankruptcy Code in other decisions, including most notably the *en banc* decision of the court in *Cybergenics*,[25] and the Third Circuit appropriately reviewed other relevant Code provisions from which the court correctly concluded that the petition date is the temporal limitation at which preference analysis is set. Each of those other provisions leads to the inexorable conclusion that the petition date is the date upon which the preference analysis is fixed.

Steinfeld's and Casteel's analysis is flawed because it depends, in part, on the general assumption that preference actions are often brought late in a bankruptcy case. Such reliance upon the timing of preference actions "in most cases" is irrelevant to the court's statutory analysis, which is applicable in all cases. Ironically, Steinfeld and Casteel ignore the fact that, if there were no temporal limitation, creditors who continued to do business with the debtor would be able to assert a new value defense for all of the goods and services provided after the petition date (and taking the analysis a step further, might assert a new value defense even for goods and services provided to the debtor even after the preference action was commenced). In such a case, § 502(d) is not implicated, as the majority of courts that have addressed the issue have held that § 502(d) does not disallow or otherwise affect administrative expenses.[26]

**_Friedman's_ addressed a significant issue with respect to whether new value paid post-petition constitutes new value for purposes of § 547(c)(4). Looking forward, the more important issue is whether pre-petition new value that is entitled to an administrative priority under § 503(b)(9) is similarly entitled to receive credit for having provided subsequent new value.**

Ultimately, the court's analysis in *Friedman's* was correct, but more importantly, the court reached the correct result. When debtors file chapter 11 petitions, they are seeking to reorganize or liquidate on a going-concern basis. It is in that chapter 11 context that debtors seek (and receive) approval of critical-vendor or critical-wage motions. If trustees or liquidation trusts were permitted to bring suit against those same critical vendors or employees later and those vendors and employees were not permitted to assert their new value defense, it is unlikely that critical vendors and employees in future cases would agree to provide goods and services to the chapter 11 debtor on favorable terms. The effect of such an event would be that many chapter 11 debtors would not be able to reorganize or realize the greatest value as a going-concern business. This is significant because the value of a reorganized debtor or sale on a going-concern basis has a much greater effect on distributions to creditors than allowing a finite universe of critical-vendor defendants to assert the new value defense for pre-petition goods or services provided and for which they were paid post-petition.

## Kiwi Air

Finally, the court of appeals addressed the plaintiff's argument based on the applicability of the Third Circuit's *Kiwi Air* decision. In *Kiwi Air*, the court held that the debtor's post-petition assumption of an executory contract under § 365 and a stipulated order pursuant to § 1110 required the trustee to cure certain defaults. Therefore, the assumption of

21 2013 WL 6797958 at *10 (quoting *New York City Shoes*, 880 F.2d at 680-81) (internal quotes omitted)).
22 *Id.* at *11 (citing *In re Primary Health Sys. Inc.*, 274 B.R. 709, 709 (Bankr. D. Del. 2002)).
23 *Id.* at *11.
24 *Id.* at *12.
25 As noted in *Cybergenics v. Chinery*, 330 F.3d 548, 559 (3d Cir. 2003), the Supreme Court previously stated that "[s]tatutory construction ... is a holistic endeavor," (quoting *United Savings Assn. of Tex. v. Timbers of Inwood Forest Associates Ltd.*, 484 U.S. 365, 371, 108 S. Ct. 626, 98 L. Ed. 2d 740 (1988)). *See also Kelly v. Robinson*, 479 U.S. 36, 43, 107 S. Ct. 353, 93 L. Ed. 2d 216 (1986) ("[W]e must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy.").
26 *See, e.g., ASM Capital v. Ames Dept. Stores Inc. (In re Ames Dept. Stores Inc.)*, 582 F.3d 422, 424 (3d Cir. 2009); *In re Plastech Engineered Products Inc.*, 394 B.R. 147 (Bankr. E.D. Mich. 2008); *In re Durango Georgia Paper Co.*, 297 B.R. 326, 331 (Bankr. S.D. Ga. 2003); *In re Lids Corp.*, 260 B.R. 680 (Bankr. D. Del. 2001); *In re CM Holdings Inc.*, 264 B.R. 141 (Bankr. D. Del. 2000).

the underlying agreement precluded a trustee from bringing a preference action to recover pre-petition payments made pursuant to the contract.

The *Friedman's* court stated that "if anything, *Kiwi Air* teaches that post-petition events can cast the payment in a different light in order to effectuate the purposes and provisions of the Code, [which] translates into a directive that we should not undermine the purpose of the Wage Order. This is best accomplished by precluding post-petition payments made pursuant to the Wage Order from consideration in preference-liability analysis." Therefore, the court held that the debtor's post-petition payment pursuant to the wage order did not affect the defendant's preference liability.

## Implications of *Friedman's*

To be certain, *Friedman's* addressed a significant issue with respect to whether new value paid post-petition constitutes new value for purposes of § 547(c)(4). Looking forward, the more important issue is whether pre-petition new value that is entitled to an administrative priority under § 503(b)(9) is similarly entitled to receive credit for having provided subsequent new value. While that issue was not before the court, and the Third Circuit expressly sidestepped the issue of whether a reclamation claim should reduce the new value defense,[27] the court's extensive statutory and policy analysis strongly suggests that there is no distinction between new value that is subsequently paid as part of a wage or critical vendor order, and new value that is subsequently paid pursuant to another court order (*e.g.*, a § 503(b)(9) administrative expense paid pursuant to a confirmation order or an order of distribution in a chapter 7 case). abi

**Editor's Note:** *For more on this topic, see* Trade Creditor Remedies Manual: Trade Creditors' Rights under the UCC and the Bankruptcy Code *(ABI, 2011), available for purchase at the ABI Bookstore (bookstore.abi.org).*

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27 *Id.* at *12, n.9. While addressing the decision of *In re Phoenix Rest. Grp. Inc.*, 317 B.R. 491 (Bankr. M.D. Tenn. 2004), the court of appeals specifically stated that "we need not resolve the question of whether assertion of a reclamation claim should reduce a new value defense, as we are only considering the effect of payments made pursuant to a Wage Order (akin to a Critical Vendor Order). We acknowledge, however, that reclamation claims could be treated differently from other post-petition activities under the rule [that] we are establishing the purpose of the Order." The court did not, however, elaborate on how a reclamation claim might be treated differently from other post-petition activities, and in fact, by stating that reclamation claims "could be" different, the court really sidestepped the issue in its entirety, leaving that argument for another day.