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Beware of Attempts to Loot § 503(b)(9) Expenses Through Preference Exposure

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Holders of allowed § 503(b)(9) expenses are generally entitled to payment under a confirmed chapter 11 plan and prior to any recovery by lower-priority claims. Often in chapter 11 cases where the case might be teetering on the verge of administrative insolvency, the debtor might attempt to reduce liability to pay § 503(b)(9) expenses, which, in turn, will reduce the amount of administrative expenses that the debtor will need to pay in order to increase the likelihood of a confirmable chapter 11 plan.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) introduced § 503(b)(9), which provides trade creditors with an administrative expense for the value of goods received by the debtor within 20 days before the petition date. However, debtors have found ways to argue that a reduction of the administrative expense is not only permissible under the Bankruptcy Code, but supported by case law. Two ways that the debtor may attempt to reduce § 503(b)(9) expenses is through arguments based on § 502(d) and/or § 547(c), or rather not permitting the use of a new-value defense should there be preference exposure. How is this possible? This article discusses the legal positions typically offered by debtors and explores the case law that has developed so that trade creditors might be prepared to respond to a debtor's attempt to reduce or disallow an otherwise-allowable administrative expense.

Attempts to Use § 502(d) to Disallow § 503(b)(9) Expenses

Section 502(d) of the Bankruptcy Code provides for the temporary disallowance of claims against transferees of avoidable transfers if the transferee does not turn over the transfer.[1] Typically, but not always, the transfer sought to be avoided is an alleged preference because the trade creditor with the § 503(b)(9) claims has a history of dealings with the debtor, who, in turn, made payments within the 90 days prior to the petition date. As a result, the debtor may argue that the § 503(b)(9) expense cannot be paid until the preference liability has been paid, and therefore might delay or withhold payment of the administrative expense.

However, case law is divided on the issue of whether § 502(d) may be used to disallow § 503(b)(9) administrative expenses, with the majority view following the precedent stemming from *In re Ames Department Stores Inc.* In this case, the Second Circuit Court of Appeals held that § 503(b) administrative expenses are not claims subject to the provisions of § 502, but rather are asserted under § 503.[2] However, in *Ames*, the court noted as follows:

> This appeal raises the question of whether section 502(d) of the Bankruptcy Code, which bars allowance of certain claims filed against the debtor's estate by alleged recipients of preferential transfers, also bars allowance to such a claimant of post-petition administrative expense pursuant to section 503(b) of the Bankruptcy Code.[3]

The *Ames* holding was expressly limited to "post-petition" administrative expenses, but a debate remains regarding whether § 502(d) can still

1 4 *Collier on Bankruptcy* ¶ 502.05[1] (citing H.R. Rep. No. 595 (1977)).
2 *In re Ames Dep't Stores Inc.*, 582 F.3d 422 (2d Cir. 2009).
3 *Id.* at 423-24; *see also In re Energy Conversion Devices Inc.*, 486 B.R. 872, 878 (Bankr. E.D. Mich. 2013) (§ 502(d) disallowance does not apply to § 503(b)(9) expenses).

be utilized to temporarily disallow a pre-petition administrative expense under § 503(b)(9). No appellate court has addressed this specific issue, yet a few bankruptcy courts have. To date, the majority of the bankruptcy courts agree that § 502(d) does not apply to administrative expenses under § 503(b)(9).

The majority view expressed in the bankruptcy court decisions appears to recognize a separation between the allowance of administrative expenses generally and the disallowance of claims under § 502(d).[4] First, § 502(d) contains introductory language that is absent from § 503(b). Section 502(d) contains the phrase "[n]onwithstanding subsections (a) and (b) of this section" — reinforcing an argument that only claims subject to § 502(d) are those that are otherwise allowable pursuant to subsections (a) and (b) of § 502. As a result, § 503(b)(9) cannot — and should not — be included. Correspondingly, disallowance or reduction based on § 547(b) preference exposure or other alleged voidable transfers should not be statutorily permissible.

Next, also as a matter of statutory interpretation, § 503(b) provides for the mandatory allowance of the expenses set forth therein, while § 502(d) provides for the disallowance of claims. This contrasting mandatory language can be squared by referencing the introductory sentence of § 502(d), which is absent from § 503(b). The majority of courts faced with the issue keep the treatment of § 503(b)(9) and 502(d) disallowance in the context of § 547(b) preference exposure largely based on the accepted principles of statutory construction.[5] The bankruptcy court in *Energy Conversion* was "persuaded that the correct reasoning and views are those taken by the Second Circuit in the *Ames Dep't Stores* case, regarding § 503(b) administrative expenses in general, and by the courts in the *Plastech Engineered Products* and *Momenta* cases, regarding § 503(b)(9) administrative expenses in particular."[6] However, *Ames* was decided before the BAPCPA amendments to the Bankruptcy Code, and as set forth above, it was limited to *post-petition* administrative expenses, and debtors in many jurisdictions argue that § 502(d) might continue to be utilized to temporarily disallow the pre-petition administrative expense provided by § 503(b)(9).

The minority view and limiting the *Ames* holding is explained in *In re Circuit City Stores*.[7] In this case, the bankruptcy court concluded that administrative expenses under § 503(b)(9) are both administrative expenses and claims, putting temporary disallowance of claims under § 502(d) squarely into play. The rationale in *Circuit City* is based on a reading of Bankruptcy Rule 3002(a) requiring a creditor to file a proof of claim for the claim to be allowed.

The Bankruptcy Code defines a "creditor" in § 101(10)(A) as an "entity that has a claim against the debtor that arose at the time of or before" the commencement of the case. Section 503(b)(9) claims arise before the petition date; therefore, under the *Circuit City* reading, such expenses need to be asserted through the filing of a proof of claim:

> If a "creditor" wishes to be granted an administrative priority under § 503(b)(9), then the creditor must, first, file a proof of claim under § 501, second, have the claim allowed under section 502, and then, third, request administrative expense priority under § 503(a).

This approach is more exacting than the procedure required under § 503(a), which requires an entity to file a "request for payment" in order to receive a payment on account of an administrative expense. The additional hurdles required by holders of § 503(b)(9) expenses under the *Circuit City* analysis give debtors additional reasoning to withhold or disallow payment of the administrative expense until such time as the claim giving rise to the § 502(d) disallowance is resolved.

Using New Value to Offset Expenses

In a similar vein as § 502(d), debtors narrow in on defenses to preference liability in an effort to reduce their § 503(b)(9) liability. By definition, § 503(b)(9) expenses must be made in the ordinary course of business of the debtor to receive administrative treatment. Correspondingly, § 547(b) provides that transfers made by the debtor that might be otherwise avoidable are subject to an ordinary-course-of-business defense, in addition to other defenses.[8] With regard to § 547(c)(4), or the "new value" defense, the analysis is not as simple and, as a result, might lead debtors to seek to discount the § 503(b)(9) expense by limiting the new value available on the preference exposure.

Unsurprisingly, holders of § 503(b)(9) expenses often are subject to potential preference exposure under § 547(b) of the Bankruptcy Code because they had continued to do business with the debtor in the 90 days before the filing of the bankruptcy case. Section 547(c)(4) permits trade vendors to reduce preference exposure by subtracting the value of the goods shipped subsequent to receipt of the preferential transfers but before the petition date from the aggregate preference-demand amount. Similar to § 503(b)(9), the legislative history of § 547(c)(4) suggests that the subsequent new-value defense was enacted to encourage creditors to continue to sell on credit to companies experiencing financial hardship.[9]

In *In re Commissary Operations Inc.*, the bankruptcy court rejected the debtor's argument that the 20-day invoices could not be used as new value because the vendor would receive a double credit for the same invoices.[10] The court noted that holders of § 503(b)(9) expenses are not entitled to liens on the goods subject to the expense and cannot demand the return of such goods (unlike reclamation). Holders of § 503(b)(9) expenses are only entitled to request payment for the value of such goods.[11] Since a debtor can freely use goods subject to a § 503(b)(9) claim after the petition date, the court reasoned that "goods shipped to and received by a debtor in the 20 days prior to bankruptcy are exactly the same money or money's worth as goods shipped free of the seller's strings."[12]

4 *See, e.g., In re Momenta Inc.*, 455 B.R. 353 (Bankr. D.N.H. 2011); *In re Plastech Engineered Prods.*, 394 B.R. 147 (Bankr. E.D. Mich. 2008).
5 *See, e.g., In re Energy Conversion Devices Inc.*, 468 B.R. at 872.
6 *Id.* at 878.
7 426 B.R. 560 (Bankr. E.D. Va. 2010).
8 *See* 11 U.S.C. § 547(c).
9 *Roberds Inc. v. Broyhill Furniture (In re Roberds Inc.)*, 315 B.R. 443, 468 (Bankr. S.D. Ohio 2004).
10 *Commissary Operations Inc. v. Dot Foods Inc. (In re Commissary Operations Inc.)*, 421 B.R. 873 (Bankr. M.D. Tenn. 2010) (holding that 20-day invoices are not disqualified from constituting new value for purposes of § 547(a)(2) and (c)(4)).
11 *Id.* at 877-78.
12 *Id.* (citing *Phoenix Rest. Grp. Inc. v. Proficient Food Co. (In re Phoenix Rest. Grp. Inc.)*, 373 B.R. at 548 (M.D. Tenn. 2007)).

A number of courts have held that goods paid for post-petition under a critical-vendor order can still be used as new value to offset a preference because "the preference window closes at the petition date."[13] Thus, post-petition payment of the invoices that also constitute new value do not impact a vendor's subsequent new-value defense. By analogy, the court in *In re Commissary Operations Inc.* concluded that payment post-petition under § 503(b)(9) should be ignored for purposes of determining a preference exposure.

A number of decisions arising from the *Circuit City* bankruptcies are instructive to better understand the basis for the proponents arguing in favor of disallowance or reduction of § 503(b)(9) expenses in light of preference exposure. The bankruptcy court in *Circuit City*, later in the cases when faced with avoidance action litigation, found that a vendor could not include the goods that were the basis for its § 503(b)(9) claim, which were fully funded by a reserve account, in its preference defense.[14] The staffing vendor in *Friedman's*, defending dealing with new value, was not paid pursuant to § 503(b)(9), but rather pursuant to a first-day wage order, and defenders of the separation of § 503(b)(9) and preference liability argue that *Friedman's* might be extended to § 503(b)(9) expenses.

The minority view appears to be espoused in the notable decision in *Circuit City*, leading the discussion on this issue, to operate as a sufficient wedge to keep the door open for debtors looking to discount otherwise-valid § 503(b)(9) liability to continue to argue that they should be permitted to offset § 503(b)(9) liability based on potential preference exposure. Yet the divide between whether a debtor adopts the majority approach of *Ames* or the minority approach under *Circuit City* appears to be growing in cases that might be nearing administrative insolvency and (1) the trade creditor might not have or want to devote resources to fight for a § 503(b)(9) expense that might otherwise be thought to be not recoverable, and (2) the debtors, typically having the financial backing to press the issue, might not be concerned about maintaining an ongoing relationship with the vendors to ensure that the administrative expense is paid. The vendor might, in its business judgment, be willing to reduce its administrative expense in exchange for a waiver of any preference exposure for economic reasons, as well as to have peace of mind should the case convert or the chapter 5 causes of action vest with a post-confirmation trust inclined to pursue them.

Arguably, creditors consenting to such a reduction to § 503(b)(9) do not assist the overall bankruptcy goal of encouraging trade creditors to continue to work with a debtor as it approaches a bankruptcy filing or in the event of a sale, when an asset-purchaser might require the assistance of the debtor's supply chain. Instead, vendors (if not given assurances of payment of administrative expenses as a result of the bankruptcy filing) might elect to cease to do business with the debtor, which could push it closer to a chapter 7 liquidation. abi

13 *Id.*

14 *See In re Circuit City Stores Inc.*, 2010 WL 4956022, at *20 (Bankr. E.D. Va. Dec. 1, 2010) (holding that preference defense of new value was unavailable under plain meaning of § 547(c)(4)(B) where reserve fund created constitutes "otherwise avoidable transfer"); *see also In re Circuit City Stores Inc.*, 515 B.R. 302, 305 (Bankr. E.D. Va. 2014) (preference defendant cannot use delivery of same goods to both recover under § 503(b)(9) and assert new value under § 547(c)(4)); *but see Friedman's Inc. v. Roth Staffing Cos. LP (In re Friedman's Inc.)*, 738 F.3d 547 (3d Cir. 2013) (affirming decisions allowing creditor paid in full by debtor post-petition as part of first-day orders to receive full subsequent new value on same invoices).

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