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How to Compute "New Value" in Light of Post-Petition Critical Vendor and Section 503(b)(9) Payments

GREGORY G. HESSE AND CAMERON W. KINVIG

Following a decision by the U.S. Court of Appeals for the Third Circuit, post-petition payments made by a debtor to a creditor will not reduce the "subsequent new value" provided by the creditor to the debtor prior to the petition date, at least in that circuit.

In determining their preference liability exposure, creditors typically consider whether they have provided any subsequent "new value" to the debtor after they have received an alleged preferential payment. Debtors and trustees frequently take the position that creditors cannot use as a defense any new value that has been repaid to the creditor post-petition through critical vendor payments or pursuant to Section 503(b)(9) of the Bankruptcy Code. Bankruptcy courts have ruled differently on this issue. Recently, the U.S. Court of Appeals for the Third Circuit became the first circuit court to rule definitively on this issue, in *Friedman's Liquidating Trust v. Roth Staffing Companies LP*.

Now, at least in the Third Circuit, post-petition payments made by a debtor to a creditor will not reduce the "subsequent new value" provided by the creditor to the debtor prior to the petition date.[1]

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FACTUAL BACKGROUND AND PROCEDURAL POSTURE

Friedman's, Inc. ("Friedman's") filed for bankruptcy protection on January 22, 2008 (the "Petition Date"). Within the 90 day preference period (the "Preference Period"), Friedman's made $81,997.57 in payments to Roth Staffing Companies LP ("Roth") for pre-petition services provided by Roth (the "Preferential Transfers"). After the Preferential Transfers were made, but prior to the Petition Date, Roth provided an additional $100,660.88 in services to Friedman's (the "New Value"). Roth was not paid pre-petition by Friedman's on account of the New Value.

Shortly after the Petition Date, Friedman's requested authority from the bankruptcy court to pay pre-petition wages and salaries of its employees and contractors, arguing that if it did not make such payments, employee and consultant departures would follow. The court approved the request, and Friedman's paid $72,412.71 to Roth on account of the New Value (the "Post-Petition Payment").

Friedman's ultimately confirmed a liquidating plan, and a successor in interest — Friedman's Liquidating Trust (the "Trust") — filed suit against Roth, seeking recovery of the Preferential Transfers. In its answer to the Trust's adversary complaint, Roth claimed that because the New Value exceeded the amount of the Preferential Transfers, the Trust could not avoid and recover the Preferential Transfers. The Trust responded that the New Value provided by Roth must be reduced by the amount of the Post-Petition Payment (from $100,660.88 to $28,248.17), and that Roth still had at least $53,749.40 in preference liability after subtracting the reduced New Value from the Preferential Transfers.

In denying summary judgment to the Trust, the bankruptcy court relied on the Third Circuit's opinion in *In re New York City Shoes, Inc.*,[2] and found that the Petition Date operated as a cutoff date for computing "new value," and that because the Post-Petition Payment occurred after the Petition Date, it could not operate to reduce the New Value claimed as a defense by Roth. The U.S. District Court for the District of Delaware affirmed the decision of the bankruptcy court, and cited additional Third Circuit case law as support for its ruling.[3]

DISCUSSION

The Third Circuit began its analysis by reviewing its prior rulings in *New York City Shoes* and *Winstar Communications* to determine whether it was bound by the statements made in each case. After analyzing the facts and circumstances surrounding those cases, the Third Circuit ultimately determined those rulings, which seemed to set the debtor's bankruptcy petition date as the new value cutoff, were dicta, and did not bind its determination of the case at hand.

Statutory Interpretation Shows that the Petition Date Must be Considered as the Cutoff for a New Value Analysis

The Third Circuit then looked to the language of Section 547(b)(4) itself, and determined that it must read that section within the broader context of the Bankruptcy Code and the policies governing its interpretation, rather than attempt to parse the section in a word-by-word analysis. Applying that broad level of review, the Third Circuit found that there were "numerous contextual indicators in the [Bankruptcy] Code that point to the petition date as a cutoff for analysis of the new value defense."[4]

First, the court found that the title of Section 547 itself — "Preferences" — suggests that the section "concerns transactions occurring during the preference period, which is by definition pre-petition," and that "it would make sense that the…application of any new value reduced by subsequent transfers, would relate to that time period."[5]

Second, the court found that the "hypothetical liquidation test"[6] — which must be performed as part of a preference analysis, and uses the bankruptcy petition date as a baseline — is indicative that Friedman's Petition Date was the proper cutoff date for determining the extent of the new value defense.[7]

Third, the court looked to the statute of limitations for filing preference actions in the Friedman's case — which began on the Petition Date — and found "the fact that the statute of limitations for a preference avoidance action under § 547 generally begins on the petition date suggests that the calculation of preference liability should remain constant post-petition."[8]

Fourth, the court looked to the "improvement-in-position" test found in

Section 547(c)(5),[9] and noted that it also used the bankruptcy petition date as a cutoff for liability purposes. The court found such reasoning instructive within the new value context, and stated that the timing elements in Section 547(c)(5) bolstered its reasoning that Friedman's Petition Date was the proper cutoff for new value purposes.[10]

Finally, the court noted that if it allowed "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."[11] However, the court recognized that "the vast majority of courts that have considered this issue have concluded that new value advanced after the petition date should not be considered in a creditor's new value defense."[12]

Policies Underlying Section 547 of the Bankruptcy Code Point to a Petition Date Cutoff for Conducting a New Value Analysis

In responding to the Trust's policy arguments, the court looked to both the Congressional Record, and to U.S. Supreme Court statements regarding the purposes underlying the avoidance powers given a debtor in the Bankruptcy Code. The court found that "the new value defense as part of the preference analysis serves two underlying purposes."[13]

First, "the section is designed 'to encourage trade creditors to continue dealing with troubled businesses."[14] Second, "it is designed to 'treat fairly a creditor who has replenished the estate after having received a preference."[15]

The Trust strenuously argued that a policy allowing Friedman's Petition Date to operate as a cutoff for purposes of a new value analysis would not provide for the "replenishment" of the debtor's estate, and would allow a creditor to receive "double payment" on its claim — once pre-petition, and once post-petition. The court disagreed. Instead, it found that "it is clear that even if a creditor is paid post-petition for new value it provided pre-petition, the creditor still replenished the debtor's estate during the preference period, and therefore aided the debtor in avoiding bankruptcy to whatever extent possible" and that the creditor did not receive a double payment because "all of the money the creditor received was for goods and services actually provided."[16]

In responding to the Trust's argument that the court's reasoning would result in the unequal treatment of creditors, the court noted that "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."[17] The court also noted that its previous ruling in the *Kiwi Air* bankruptcy case was instructive in that it demonstrated "that post-petition events can cast the payment in a different light in order to effectuate the purposes and provisions of the Code," and that "there are unique circumstances in which other provisions of the Bankruptcy Code dealing with post-petition transactions directly interact with § 547 and thus can alter the otherwise straightforward preference analysis."[18]

CONCLUSION

The court in *Roth Staffing* offers significant instruction on how the timing of payments can and should effect the calculation of new value in light of a preference claim. While offering a reasoned and reasonable defense of using a debtor's bankruptcy petition date as a cutoff for preference analysis, the opinion also furthers the policy goals of the Bankruptcy Code by encouraging creditors to provide goods and services to an ailing debtor pre-bankruptcy, and demonstrates that it is incorrect for courts to penalize creditors for acting in good faith.

While blazing a clear path for other circuits to follow, the *Roth Staffing* decision stands alone at the circuit level, and it is likely courts in other circuits will litigate the same issue soon.

NOTES

[1] Appeal taken from the U.S. District Court for the District of Delaware, and filed of record at 738 F.3d at 547.
[2] 880 F.2d 679, 680 (3d Cir. 1989) (stating that a transfer qualified as "new value" if the debtor did not compensate the creditor for the transfer "as of the date that it filed its bankruptcy petition").
[3] *See In re Winstar Comm., Inc.*, 554 F.3d 382, 402 (3d Cir. 2009).
[4] *Roth Staffing*, 738 F.3d at 555.
[5] *Id.*
[6] This test requires a court to compare the payments received by a creditor

during the preference period with the amount the creditor would have received, as of the petition date, if payment had not been made, and the debtor's assets were instead liquidated and distributed to creditors.

[7] *Roth Staffing*, 738 F.3d at 555-56.

[8] *Id.*, at 556.

[9] This test provides a defense from preference liability for creditors that have floating liens on a debtor's inventory and accounts receivables, so long as they do not improve their position during the preference period.

[10] *Roth Staffing*, 738 F.3d at 556.

[11] *Id.*, at 557.

[12] *Id.* (*citing In re Bellanca Aircraft Corp.*, 850 F.2d 1275, 1284-85 (8th Cir. 1988); *In re Rocor Int'l, Inc.*, 352 B.R. 319, 333 (Bankr. W.D. Okla. 2006); *In re George Transfer, Inc.*, 259 B.R. 89, 96 (Bankr. D. Md. 2001); *In re Sharoff Food Serv., Inc.*, 179 B.R. 669, 678 (Bankr. D. Co. 1995); *In re D.J. Mgmt. Grp.,* 161 B.R. 5, 6 (Bankr. W.D.N.Y. 1993); *In re Jolly "N," Inc.*, 122 B.R. 897, 909-10 (Bankr. D.N.J. 1991); *In re Kumar Bavishi & Assoc.*, 906 F.2d 942, 951 n. 9 (3d Cir. 1990)).

[13] *Roth Staffing*, 738 F.3d at 558.

[14] *Id.*.

[15] *Id.* (*quoting In re Almarc Mfg.*, 62 B.R. 684, 688 (Bankr. N.D. Ill. 1986)).

[16] *Id.*, at 559.

[17] *Id.*, at 560.

[18] *Id.*, at 562.