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When the Third Circuit Speaks, Trade Creditors Should Listen: Takeaways on Subsequent New Value from *In re Friedman's*

The Subsequent New Value Defense

The "subsequent new value" defense of Section 547(c)(4) of the Bankruptcy Code is a mouthful: Pre-bankruptcy payments (or, as they are referred to in bankruptcy terms, "transfers") to a creditor from a debtor cannot be avoided as a preference by a bankruptcy trustee "to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor...on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor." Whew! For those of you scoring at home, that is a *triple* negative: The trustee *cannot* avoid a transfer if the creditor gave new value on account of which the debtor *did not* make an *unavoidable* transfer.

The subsequent new value defense is a powerful tool to fend off preference actions. Why? Because unlike the ordinary course of business defense, it is an objective, numbers-based analysis. Usually, a bankruptcy trustee cannot dispute this defense. Settlement negotiations with the trustee typically begin with the trustee accepting that he cannot avoid any transfer that is protected by new value. It is therefore critically important for trade creditors to understand this defense.

In particular, creditors, regardless of where they are located, should pay attention to any court opinions in the Third Circuit Court of Appeals on preference issues. Why? Because the Third Circuit includes the District of Delaware, and as readers are probably painfully aware from personal experience, many of the largest Chapter 11 bankruptcies are filed in Delaware. And large Chapter 11 bankruptcy filings are often followed by hundreds (sometimes thousands) of bankruptcy preference actions.

Subsequent New Value, a Simple Example

Here is a simple example to warm you up: Seller Co. is paid $50,000 by Buyer Co. on January 1st. On January 10th, Seller Co. delivers $30,000 in product to Buyer Co. on 30-day terms. Buyer Co. files bankruptcy on February 1st without paying Seller Co. When Buyer Co.'s bankruptcy trustee tries to avoid the $50,000 payment as a preferential transfer, Seller Co.'s maximum exposure for a preference is $20,000. Why? Because

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after Seller Co. was paid the $50,000, the $30,000 in product Seller Co. delivered will be treated as "subsequent new value."

But Things Are Rarely That Simple

What if, unlike the example above, there are many deliveries and payments during the 90 days? Can a creditor claim new value for product that the debtor paid for during the 90-day preference period? What if, after the bankruptcy filing, the creditor is treated as a "critical vendor" and as a result receives payment for pre-petition invoices? What if some of the unpaid product was delivered during the 20 days before bankruptcy and the creditor is entitled to an administrative expense under Section 503(b)(9)?

The starting point for this analysis is whether a creditor is entitled to credit for "paid" new value. Consider the table on page 2.

For this example, assume that the buyer files bankruptcy on April 1, 2010. Seller is paid $1,000 on January 10th (transaction #1), delivers $1,000 in product on January 20th (transaction #2), is paid for the January 20th delivery on January 30th (transaction #3), and so on. Courts take two different approaches to this. The first approach, known as the "subsequent advance" approach, allows the creditor to use the subsequent new value defense for product that was paid for during the preference period. The second approach, known as the "remains unpaid" approach, requires that the new value remain unpaid. You can see the differences in the creditor's exposure in these examples. For the "subsequent advance" approach,

Transaction	Dated	Payment	New Value Given	Exposure: Subsequent Advance Method	Exposure: "Must Remain Unpaid" Method
1	1/10/2010	$1,000		$1,000	$1,000
2	1/20/2010		$1,000	$0	$0
3	1/30/2010	$1,000		$1,000	$2,000
4	2/10/2010		$1,000	$0	$1,000
5	2/20/2010	$1,000		$1,000	$3,000
6	3/10/2010		$1,000	$0	$2,000

the creditor has $0 exposure. For the remains unpaid approach, the creditor would be on the hook for $2,000.

Where does the Third Circuit, and in particular, Delaware come out on this issue? This is not a simple answer. In 1989, the Third Circuit Court of Appeals issued a decision in the New York City Shoes bankruptcy case, and in a single sentence in that decision offhandedly remarked that new value must remain unpaid. Those two simple words—"remain unpaid"—have caused a lot of problems for creditors in the last 25 years, with many courts interpreting that opinion to mean that a creditor cannot assert the subsequent new value defense for invoices paid during the preference period. Other courts have disagreed because the creditor-defendant in *New York City Shoes* was not paid at all for any of the new value that it provided. Therefore, these other courts have characterized the *New York City Shoes* requirement of "remains unpaid" as "*dictum*." What is "*dictum*?" In the legal context, it means anything that a court says in an opinion that is not necessary for its decision. While bankruptcy courts are required to follow precedent, they are not required to follow a holding that is dictum.

> After *Pillowtex*, most bankruptcy trustees in Delaware generally assumed that any bankruptcy judge in Delaware would apply the "subsequent advance" approach, notwithstanding the *New York City Shoes* "remains unpaid" language.

More recently, in what is generally considered the most complete discussion of this defense, Judge Kevin J. Carey of the Delaware Bankruptcy Court issued a written opinion in the Pillowtex bankruptcy case. The court held that the remains unpaid language in *New York City Shoes* is dictum. Accordingly, in Judge Carey's view, Delaware bankruptcy courts are not required to follow the remains unpaid approach. Rather, Judge Carey adopted the "subsequent advance" approach.

The *Pillowtex* holding was a significant win for trade creditors. After *Pillowtex*, most bankruptcy trustees in Delaware generally assumed that any bankruptcy judge in Delaware would apply the "subsequent advance" approach, notwithstanding the *New York City Shoes* "remains unpaid" language.

However, the *Pillowtex* opinion did not address the issue of new value that is paid *post-petition* pursuant to Section 503(b)(9) of the Bankruptcy Code or under a critical vendor order. While 503(b)(9) goods remain unpaid on the petition date, such claims must be paid in full later in a Chapter 11 bankruptcy case. Is payment on such claims post-petition an unavoidable transfer, thereby disqualifying the creditor from the subsequent new value defense? Until recently, there was no clear answer to this question in the Third Circuit, or any other circuit court for that matter.

In re Friedman's, Inc.

Enter the December 2013 opinion of the Third Circuit Court of Appeals in *In re Friedman's Inc.* In the 90 days prior to the petition date, the debtor made payments to the creditor, an employee-staffing company, totaling $81,997.57. After receipt of the transfers, but prior to the petition date, the creditor provided staffing services to the debtor valued at $100,660.88. These invoices were not paid prior to bankruptcy.

After bankruptcy, the debtor filed a motion seeking authority to pay its employees and independent contractors. This type of motion is similar to the critical vendor motions discussed above. The bankruptcy court granted the motion and the debtor paid the staffing company's pre-bankruptcy invoices.

Over a year later, the trustee of the debtor's bankruptcy estate filed a preference action seeking to recover the $81,997.57. The creditor argued that the transfers were not avoidable because it provided new value to the debtor in the form of staffing services subsequent to the payment. In other words, the creditor thought it had a complete new value defense. The trustee argued that the creditor's new value must be reduced by the amount that the debtor had paid to the creditor pursuant to the wage order. Any other approach, the trustee argued, would result in the creditor receiving double-credit for the same services (i.e., the creditor would be "double-dipping" by using such invoices as new value to reduce its preference exposure *and* it would be receiving payment in full pursuant to the wage order).

What happened? The Third Circuit disagreed with the trustee, and found for the creditor. Focusing on the statutory language and the policies behind the subsequent new value defense, the court held that the creditor's payment under the wage order did not reduce the new value defense. The preference analysis, the court reasoned, closes at the petition date. This was a complete win for the creditor.

Conclusion: Takeaways from *In re Friedman's, Inc.*

Any time a circuit court speaks on preference issues, creditors should listen. This is particularly true in the Third Circuit, where the court's ruling could have implications in Delaware, a traditional hotbed of preference litigation. Here are some of the important takeaways.

This provides creditors with some comfort: They can now accept critical vendor status on the front end without fear of increasing their preference exposure on the back end.

The Remains Unpaid Approach Could Be Dead in the Third Circuit:

The *Friedman's* court did not expressly endorse the subsequent advance approach used by the Delaware bankruptcy court in *Pillowtex*. That was to be expected, because in the case before the *Friedman's* court, the subsequent new value was not paid during the preference period (rather, it was paid post-petition). Nevertheless, the *Friedman's* court did the next best thing from a creditor's perspective: It confirmed that the "remains unpaid" language in the *New York City Shoes* opinion was dictum. Prior to *Friedman's*, some courts and commentators had characterized the Third Circuit as a remains unpaid jurisdiction. After *Friedman's*, those days are probably over.

Creditors Should Rest Easier in Accepting Critical Vendor Status

A creditor designated as a critical vendor will receive payment on pre-bankruptcy invoices. Getting paid is always a good thing, right? Maybe not. Bankruptcy trustees usually argue that critical vendor status (and the associated payment of pre-bankruptcy invoices) negates the subsequent new value defense. Trustees would argue that this is improper double dipping.

However, after *Friedman's*, this common argument from bankruptcy trustees is probably a loser in courts in the Third Circuit. Under *Friedman's*, courts should ignore any post-petition events in determining the creditor's subsequent new value defense. This provides creditors with some comfort: They can now accept critical vendor status on the front end without fear of increasing their preference exposure on the back end.

Friedman's Goes a Long Way Toward Resolving the 503(b)(9)/New Value Issue

Prior to *Friedman's*, some courts held that a creditor cannot assert the subsequent new value defense for Section 503(b)(9) goods (again, under the theory that this is impermissible double-dipping). Other courts have come to the opposite conclusion. The *Friedman's* Court noted the split in authority, and is the first circuit-court-level appellate court to even mention the issue.

Although *Friedman's* did not involve 503(b)(9) goods, its reasoning probably applies in the 503(b)(9) context. An aggressive bankruptcy trustee may argue that the discussion of Section 503(b)(9) was dictum and, thus, is not binding. Nevertheless, a creditor can make a compelling argument that the reasoning of *Friedman's* would be just as applicable to Section 503(b)(9). Accordingly, *Friedman's* is persuasive authority for how that court would likely rule on the subsequent new value issue in the context of Section 503(b)(9). There is still no circuit court directly addressing this issue, but the tide may be turning in creditors' favor.

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