

Effect of Post-Petition Payments on 'New Value' Defense

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The U.S. Court of Appeals for the Third Circuit's recent decision in *Friedman's Liquidating Trust v. Roth Staffing Companies LP (In re Friedman's)*, No. 13-1712 (3d Cir. Dec. 24, 2013), provides bankruptcy practitioners with long-awaited guidance on the effect that the post-petition payment of prepetition claims has on the calculation of the "new value" defense for purposes of determining preference liability.

The issue in *Friedman's* arose in the context of an adversary proceeding commenced by Friedman's Liquidating Trust against Roth Staffing Companies LP to recover certain allegedly preferential transfers made to Roth. Section 547(b)(4)(A) permits, under certain circumstances, a trustee or debtor to avoid as preferential payments made by the debtor within the 90 days preceding the commencement of the bankruptcy case. If a trustee avoids a transfer, it may, with certain exceptions, recover the value of the transferred property from the transferee.

One of the most statutory defenses to an alleged preference is the new-value defense, which permits a creditor to reduce its preference exposure by the value of any goods or services provided to a debtor on an unsecured basis after the allegedly preferential transfers were made. There exists, however, unsettled law as to whether subsequent new value must remain unpaid in order to offset preference liability. The Third Circuit explored this issue in *Friedman's* in the context of where prepetition new value was satisfied post-petition by payments made pursuant to a first-day order of the bankruptcy court.

In *Friedman's*, the liquidating trustee filed a preference complaint seeking the recovery of transfers that were paid to Roth in the 90-day period preceding the commencement of the bankruptcy case. In response, Roth asserted a new-value defense on account of employee staffing services that were provided subsequent to the allegedly preferential transfers. While Roth had not been paid for these additional services as of the petition date, approximately \$72,000 of the \$100,660 owed was paid post-petition pursuant to a first-day order authorizing the debtor to pay its employees and independent contractors outstanding prepetition wages, compensation and related benefits. The bankruptcy court routinely enters this type of relief pursuant to its authority to enter orders that are necessary to carry out the provisions of the U.S. Bankruptcy Code and to authorize transactions deemed necessary to preserve the value of the debtor's estate. In this instance, the debtor represented that the payment of the prepetition amounts was necessary to maintain morale and avoid employee departures. The issue addressed in *Friedman's* was whether the post-petition payments made to Roth under the wage order should be applied to reduce the amount of new value available to offset Roth's preference liability, or whether only prepetition payments should be considered for purposes of calculating the new value available to a preference defendant.

The Third Circuit ultimately affirmed the decisions of the underlying courts, holding that the post-petition payments made pursuant to the wage order did not reduce the new value available to Roth in defending the preference complaint. The Third Circuit, however, rejected the position that its decisions in *New York City Shoes v. Bentley*

International (In re New York City Shoes), 880 F.2d 679 (3d Cir. 1989), and *Schubert v. Lucent Technologies (In re Winstar Communications)*, 554 F.3d 382 (3d Cir. 2009), were controlling on the issue of whether post-petition payments should be excluded from consideration in relation to preference actions. The court noted that the pertinent language from such decisions, which is often cited for the position that subsequent new value must remain unpaid as of the petition date, was nothing more than dicta. Instead, the Third Circuit based its conclusion on what it referred to as the context and policy of the Bankruptcy Code. In the statutory context, the Third Circuit noted that the petition date is used as a reference point in several other statutory provisions pertinent to preference actions. Further, the court viewed two of the underlying policies of the preference provision as being (1) equality of treatment of similarly situated creditors, and (2) preventing the dismemberment of the debtor. With those policy goals in mind, the court emphasized that equality should be measured and inequalities rectified as of the petition date. The Third Circuit further noted that the bankruptcy court has the ability to weigh competing policy interests in authorizing debtors to take certain actions, including paying prepetition wages and invoices to preserve the value of the debtor's estate. As such, the court noted that the bankruptcy court's authority would be undermined if such payments were to subject a creditor to greater preference liability.

The Third Circuit's decision in *Friedman's* has several notable effects for bankruptcy practitioners. First, *Friedman's* makes clear that court-authorized post-petition payments—whether through a wage order, critical vendor order or payment of a claim under Section 503(b)(9) of the Bankruptcy Code—do not reduce the amount of new value that a defendant may assert to offset preference liability. This clear direction from the Third Circuit provides creditors with assurance that they will not risk reducing a potential defense in a future preference action by accepting payment of outstanding invoices and agreeing to continue doing business with a debtor post-petition. Second, the court's recognition of the often-cited language from *New York Shoes* and *Winstar* as dicta potentially weakens the position that subsequently advanced new value must remain unpaid as of the petition date in order to offset preference liability, as in *Wahoski v. American & Efird (In re Pillowtex)*, 416 B.R. 123, 129 (Bankr. D. Del. 2009).

Finally, *Friedman's* supports the position that the bankruptcy court has the power to authorize a debtor's payment of certain prepetition claims pursuant to Sections 105 and 363 of the Bankruptcy Code. Indeed, the Third Circuit goes so far as to state that critical vendors can be given preferred treatment under these sections of the Bankruptcy Code. While critical vendor and similar orders are regularly entered by the bankruptcy court, the Third Circuit has not previously opined on the propriety of such orders.

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