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Protecting What You Have, Pursuing What You're Owed: Eleventh Circuit Rules That Distributions on Section 503(b)(9) Claims Do

Not Reduce the New Value Defense to Preferences

By **James S. Carr[1] and Dana P. Kane[2], Kelly Drye & Warren LLP**

There can be no doubt that the current economic landscape is challenging and forces businesses to make difficult choices. The trade creditor's unenviable task during these times is to maintain valuable business relationships in the hopes of sustaining profitability, which often requires the continued extension of credit terms to customers despite the heightened risk of those customers being unable to satisfy their debts.

When your customer's financial distress reaches the point of filing for bankruptcy, you know from the outset that collection of outstanding receivables will be significantly reduced, if not eliminated entirely. In any event, you diligently file your proof of claim, dutifully monitor the progress of the case and hope for a minimal distribution. Then, your already bad situation is exacerbated when you receive a demand letter that asks for return of payments that your company was able to collect from the debtor before it filed for bankruptcy. At that point, your job shifts from maximizing your company's recovery to protecting what it already has been paid. Fortunately, the Eleventh Circuit Court of Appeals' recent decision in *Auriga Polymers Inc. v. PMCM 2, LLC*[3] allows you to accomplish both goals.

Background: The Intersection of Preferences, New Value and 503(b)(9) Claims

Being sued for a preference is a bitter pill to swallow. From your perspective, you got paid by the customer on account of trade debt that the customer legitimately incurred and owed. However, in furtherance of two fundamental objectives woven throughout the Bankruptcy Code – preventing a race to the courthouse to dismantle a financially troubled debtor and promoting the equality of distributions among similarly situated creditors[4] – section 547 of the Bankruptcy Code allows a trustee to avoid payments made by a debtor (1) to or for the benefit of a creditor; (2) on account of an antecedent debt; (3) while the debtor was insolvent; (4) during the 90-day period before the petition date[5]; and (5) that enables the creditor to receive more than it would in a hypothetical Chapter 7 case.[6] The Bankruptcy Code also recognizes some affirmative defenses to the avoidance of allegedly preferential transfers, certain of which are designed to promote the equally important policy of encouraging creditors to continue conducting business, on terms, with a financially troubled counterparty. Prominent among the affirmative defenses is the "subsequent new value" defense embodied in section 547(c)(4). By allowing creditors to offset their potential liability, the new value defense rewards those creditors that received an avoidable 90-day payment from the debtor, but thereafter, replenished the debtor's estate by shipping new product to the debtor.

Specifically, section 547(c)(4) provides that a creditor's exposure on preferential transfers can be reduced where, subsequent to one or more of those transfers, the creditor provided unsecured new value "on account of which new value the debtor did not make an otherwise unavoidable transfer to . . . such creditor."[7] Despite its plain language, the application of section 547(c)(4) is not very straightforward in practice and has sparked significant litigation over the years. Of particular importance to the vendor community, one of the divisive issues has been the question of whether a creditor's asserted new value defense can be used if the creditor receives payment of its section 503(b)(9) administrative claim.[8] Until recently, only three courts had issued published decisions addressing this precise question.[9]

Bankruptcy courts in the Northern District of Georgia and the Eastern District of Virginia have aligned with plaintiffs on this issue, ruling that creditors cannot count as "new value" goods supplied on credit terms that are also included in a 503(b)(9) claim. Otherwise, plaintiffs argue that the result is an impermissible "double dip" allowing the creditor to recover twice on the same extension of value.[10] They also assert that, more generally,

allowing creditors to use so-called "section 503(b)(9) new value" undermines the policy reasons for the existence of the new value defense: to encourage continuity of business on credit terms with a financially troubled entity, thus replenishing the estate with product. That objective is not achieved where the amount by which the estate was enhanced leaves the estate in the form of a distribution on a 503(b)(9) claim.**[11]** In short, a payment to satisfy a section 503(b)(9) claim is an "otherwise unavoidable transfer" that causes the section 547(c)(4) defense to fail.**[12]**

Conversely, the bankruptcy court in the Middle District of Tennessee sided with the defendant in holding that an allowed section 503(b)(9) claim did not reduce the availability of the new value defense.**[13]** The court reasoned that the objectives of sections 503(b)(9) and 547(c)(4) are consistent with one another, not opposed, since both Bankruptcy Code provisions foster a creditor's willingness to conduct business with a financially troubled entity.**[14]** Moreover, requiring a creditor to choose between getting a distribution on its section 503(b)(9) claim or maximizing its new value defense strips away the benefits Congress conferred on suppliers of goods in enacting section 503(b)(9).**[15]**

The only appellate court to come close to resolving these diametrically opposed results is the Third Circuit Court of Appeals in *In re Friedman's, Inc*.**[16]** There, the Third Circuit held that post-petition payments on pre-petition invoices, paid pursuant to a "first day" order, did not reduce the amount available for the new value defense.**[17]** Importantly, the *Friedman's* court held that where an "otherwise unavoidable transfer" is made post-petition, the new value defense is unaffected.**[18]** Consequently, the *Friedman's* decision has been widely viewed as a harbinger of how the Third Circuit would rule if presented with the narrower issue surrounding section 503(b)(9) claims and the applicability of the new value defense. The Third Circuit, however, expressly limited its ruling to post-petition payments under a critical vendor order, and the court suggested the result could be different for distributions on allowed section 503(b)(9) claims.**[19]**

While the divergence of trial court opinions on the 503(b)(9)/547(c)(4) issue has led to uncertainty for both plaintiffs and defendants, plaintiffs have enjoyed two advantages that translate into significant leverage in settlement discussions. First, when it comes to litigable issues, plaintiffs typically are better positioned to absorb the litigation costs since they have economies of scale on their side. Creditors bear the full financial burden of proving their defenses while plaintiffs can spread litigation costs over many cases, sometimes numbering in the thousands. Exacerbating this disparity, plaintiffs' counsel routinely pursue avoidance actions on a contingency fee basis, which is rarely (if ever) true of defense counsel. Perhaps more importantly, creditors have the burden of proof under 547(c)(4) since it is an affirmative defense, raising the cost of litigating the section 503(b)(9) issue.

The Eleventh Circuit Weighs In: The Beaulieu Decision

Where the Third Circuit stopped short, the Eleventh Circuit took that last step and issued a decision that will help defendants that have a new value defense and a 503(b)(9) claim.**[20]** In what will surely be regarded as a landmark ruling in avoidance litigation, *Beaulieu* stands for the proposition that in the Eleventh Circuit "otherwise unavoidable transfers" made post-petition in the context of payment on a 503(b)(9) administrative claim do not impact a creditor's new value defense under section 547(c)(4). Creditors can receive full payment on their allowed 503(b)(9) claims without sacrificing a valuable defense to potential preference liability.

Once one of the largest carpet manufacturers in North America, Beaulieu Group LLC and its affiliates filed Chapter 11 bankruptcy petitions in July 2017.**[21]** A Chapter 11 plan of liquidation was confirmed in May 2018, resulting in the formation of a post-confirmation liquidating trust and the appointment of a liquidating trustee to administer the debtors' assets and liabilities in accordance with the terms of the plan. Among the assets transferred to the trust on the plan's effective date were avoidance actions under Chapter 5 of the Bankruptcy Code. The trustee filed nearly 200 adversary proceedings seeking the return of alleged preferential and/or constructively fraudulent transfers.

One of the many defendants was Auriga Polymers, Inc., a supplier of polyester resins and specialty polymers to the debtors.**[22]** According to its proofs of claim, Auriga was owed

over $4.2 million dollars as of the commencement of the bankruptcy case, of which $3.52 million was asserted as a general unsecured claim and $694,502 was asserted as a section 503(b)(9) administrative claim.**[23]** During the 90-day preference period, Auriga received more than $2.2 million in transfers that the trustee initially sought to avoid under section 547(b).**[24]** The demand in the complaint, however, eventually was reduced to $421,119, comprising part of Auriga's section 503(b)(9) claim, for which the trustee would not agree to provide new value credit.**[25]** With its answer, Auriga filed a counterclaim for a declaratory judgment that it could both recover on its section 503(b)(9) claim and use the same underlying shipments in its calculation of new value under section 547(c)(4). Pending a resolution of the issue, the trustee made a partial distribution of $273,382 on Auriga's section 503(b)(9) claim and held $421,119 in a disputed claims reserve.**[26]** When the bankruptcy court ruled against Auriga on summary judgment, Auriga's appeal made a brief stop at the district court, which granted both parties' joint request to certify the appeal and the novel question of law directly to the Eleventh Circuit:

[W]hether a Liquidation Trustee's post-petition reservation of funds sufficient to pay in full a defendant's administrative expense claim under § 503(b)(9) amounts to an "otherwise unavoidable transfer" within the meaning of § 547(c)(4) such that it precludes the use of such new value as part of the defendant's affirmative defense of subsequent new value under § 547(c)(4) of the Bankruptcy Code.**[27]**

Before beginning its analysis, the Eleventh Circuit noted the scarcity of reported case law on the issue before it. Few courts have addressed the narrower question of whether a recovery on a section 503(b)(9) claim negatively impacts a creditor's new value defense, and when the search was broadened to encompass whether any post-petition payments are "otherwise unavoidable transfers" within the meaning of section 547(c)(4)(B), only the Third Circuit's decision in *In re Friedman's* provides guidance at the circuit court of appeals level. The Eleventh Circuit considered the meaning of the phrase "otherwise unavoidable transfers" in section 547(c)(4) within the wider context of the Bankruptcy Code. In so doing, the Eleventh Circuit articulated four reasons why that phrase should be interpreted to mean that only pre-petition transfers can limit the new value defense:

- The word "transfer" is used three times in section 547(c)(4), and that word should be presumed to have the same meaning throughout that provision of the Bankruptcy Code. The first two uses of the term refer to the transfers that constitute preferences under 547(b); these necessarily are pre-petition transfers. Thus, the third use of the word – that disqualifies new value on account of which the debtor made "an otherwise unavoidable transfer" – should also be read to refer to preferential pre-petition transfers.**[28]**
- The entirety of section 547(b) is entitled "Preferences," and is concerned with transactions occurring during a preference period that is defined to be pre-petition. Whether a transfer is preferential, and the calculation of the preference amount (including the amount by which exposure is reduced by new value), should be confined to the same time period.**[29]**
- It is well-settled that post-petition goods supplied post-petition cannot be used toward a creditor's new value preference defense. By the same logic, post-petition payments should not affect a creditor's defense.**[30]**
- The statute of limitations under section 546(a) of the Bankruptcy Code applicable to preference actions starts running on the petition date. If post-petition payments impact a new value defense, then the net preference exposure can change depending on when a lawsuit is filed, which is a nonsensical result.**[31]**

While the bulk of the *Beaulieu* opinion deals with statutory language and contextual arguments that appeal mostly to scholars, the final few paragraphs are important for businesses. The Eleventh Circuit disagreed outright with the notion that allowing creditors to recover in full on a 503(b)(9) claim without a reduction to a new value defense is a "double dip." Unpaid invoices comprising a section 503(b)(9) claim are only satisfied once, not twice, for the goods supplied to the debtor once distributions on administrative claims are made pursuant to a plan.**[32]** The second "dip" is not a double payment, the Eleventh

Circuit reasoned, but rather a determination that creditors need not disgorge pre-petition payments that they received on other shipments. Most importantly, the *Beaulieu* court recognized that a vendor's right to be paid on a section 503(b)(9) claim without undermining the vendor's ability to offset preference exposure for the same value is not inconsistent with the Bankruptcy Code's overarching policy objectives. Equality of distribution is not the goal – it is equality of distribution among similarly situated creditors. To the extent that Congress provide vendors who supply product to debtors during the 20-day period preceding the petition date an enhanced recovery, it is a policy choice that should be honored.**[33]**

Conclusion

While the *Beaulieu* decision is binding on courts within the Eleventh Circuit (Georgia, Florida and Alabama), this decision, which is well reasoned, should have a persuasive effect on courts in other jurisdictions. Irrespective of the jurisdiction in which preference actions are pending, however, defendants have much more leverage in settlement negotiations to pursue what they are owed under 503(b)(9) without reducing the impact of the new value defense.

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Credit Research Foundation

As originally published in
Perspective by CRF 3Q2022

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