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THIRD CIRCUIT RULES POSTPETITION PAYMENTS DO NOT AFFECT THE NEW VALUE DEFENSE UNDER § 547(C)(4)

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The postpetition payment of prepetition claims commonly occurs in Chapter 11 cases involving operating businesses. In the flurry of first day orders, part of the authority sought is to pay, postpetition, selected prepetition claims deemed critical to the debtor's ability to reorganize, including prepetition wages, compensation and benefits to employees and independent contractors. Issues arise when a postpetition payment is made on a prepetition claim for goods or services that a creditor seeks to use to establish a subsequent new value defense to preference liability under § 547(c)(4) of the Bankruptcy Code.

Generally speaking, under § 547(c)(4), a creditor can reduce preference liability to the extent that, after receiving the transfer at issue, the creditor provides "new value" to the debtor that either remains unpaid or that is paid with a transfer that is itself avoidable.[1] The defense acknowledges that the creditor is, in effect, returning the preference to the

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bankruptcy estate through the provision of new value.[2] However, what happens if the new value remains unpaid as of the petition date, but is then paid postpetition with an unavoidable transfer, such as a court-authorized postpetition payment? Do postpetition payments impact the new value defense, or is the new value defense only limited to prepetition activity? District and bankruptcy courts have come out on both sides of this issue and, until recently, it had not been considered by any circuit court.[3]

In its December, 2013, ruling in *Friedman's Liquidating Trust v. Roth Staffing Companies, LP (In re Friedman's Inc.)*,[4] the United States Court of Appeals for the Third Circuit became the first circuit court to hold that a postpetition payment on account of prepetition new value does not reduce the amount of new value that can be used as a defense to a preference claim under § 547(c)(4). The debtor's petition date is a firm line in the sand for purposes of calculating a new value defense under § 547(c)(4), no matter what payments might be made on account of such new value during the bankruptcy case. In reaching this holding, the Third Circuit analyzed the context of the statute and engaged in a detailed discussion of the general policies underlying the preference statute and clarified the policies and goals of the subsequent new value defense in particular.

I. Background

The facts in *Friedman's* could happen in almost any Chapter 11 case. Prior to the petition date, the debtor paid approximately $80,000 in several payments to a staffing company. The payments were preferential transfers under § 547(b). Following the payments, but before the petition date, the staffing company provided an additional approximately $100,000 in employee services to the debtor. This new value remained unpaid as of the petition date and completely offset the amount of any preference liability of the staffing company. Because the debtor needed the continued services and support of its workforce in its Chapter 11 case, it obtained a first-day "employee wage" order, pursuant to which it paid the staffing company approximately $70,000.

The debtor commenced a preference action seeking to avoid and recover the prepetition transfers to the staffing company, which was subsequently pursued by a liquidating trust as successor in interest to the debtor. Not surprisingly, the staffing company argued that it had no preference liability because of new value which remained unpaid as of the petition date. The liquidating trust countered, however, that the new value had to be reduced by the postpetition payments made to the staffing company, and that only approximately $30,000 in new value was available under § 547(c)(4). The statute itself is silent on this issue and imposes no express temporal limitation on when payments

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on new value must be made to be relevant to new value analysis. The liquidating trust moved for partial summary judgment on this discreet issue.

The bankruptcy court denied summary judgment holding that the entirety of preference analysis in any given case becomes fixed on the petition date and, therefore, postpetition payments have no impact on a subsequent new value defense. The bankruptcy court considered and rejected each of the trust's arguments based on the plain language of the statute. The bankruptcy court believed it was subject to controlling Third Circuit law on the issue—namely, a three-part test for establishing the new value defense articulated by the Third Circuit in *New York City Shoes, Inc. v. Bentley Int'l Inc. (In re New York City Shoes, Inc.)* (hereinafter, "*NYC Shoes*"):[5]

> (1) The creditor must have received a transfer that is otherwise voidable as a preference;
>
> (2) After receiving the transfer, the creditor must have advanced new value on an unsecured basis; and
>
> (3) The debtor must not have fully compensated the creditor for the new value as of the date that it filed its bankruptcy petition.[6]

Calling this test a "holding"[7] of the Third Circuit in *NYC Shoes*, the bankruptcy court explained:

> The last clause clearly supports fixing the entirety of the preference analysis on the Petition Date. . . . The clear implication of the Circuit's inclusion of "*as of the date that it filed its bankruptcy petition*" is that subsequent provision or payment of new value does not affect the preference analysis even if the debtor completely compensates the creditor for its pre-petition claim. This is consistent with the purpose of the preference law—to reduce damaging, prepetition opt out behavior and to level the prebankruptcy playing field for all creditors. Once the bankruptcy is filed the preference law becomes unnecessary. The automatic stay steps in to stop the race to the assets and the supervision of the case by the court, among other things, ensures that similar claims receive similar treatment.[8]

Accordingly, the bankruptcy court denied the liquidating trust's summary judgment motion.

The bankruptcy court's ruling was affirmed on appeal by the United States District Court for the District of Delaware, which held that, although the reference to the petition date in the new value test articulated in *NYC Shoes* was *dicta*, the very same test was repeated a second time by the Third Circuit in *Schubert v. Lucent Technologies Inc.* (*In re Winstar Communications, Inc.)*.[9] The district court felt that it had to "pay a certain deference" to what the Third Circuit said and that it was not "really free to come to a different conclusion than what [the Third Circuit] stated twice."[10] Thus, the district court affirmed the bankruptcy court's decision without any additional analysis.

II. Third Circuit's Analysis

On appeal, the Third Circuit affirmed the district court's order based on the plain language of § 547(c)(4) and the policies underlying preference law in general and the subsequent new value defense in particular. It began, however, with an important discussion of a threshold issue—namely, were its statements concerning the petition date in the new value test articulated in *NYC Shoes* and *Winstar* controlling precedent or *dicta*? Those statements were the exclusive basis for the bankruptcy court's denial of summary judgment and the district court's affirmance of the same. The Third Circuit acknowledged that numerous other courts had adopted and followed this language as if it were a holding by the Third Circuit. Thus, the Third Circuit seized upon the opportunity to clarify the record.

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A. Reference to the Petition Date in *NYC Shoes* and *Winstar* was *Dicta*

The Third Circuit began by restating the basic definition of *dictum*. "If a determination by our Court is not necessary to our ultimate holding, 'it properly is classified as *dictum*.' It is well established that 'we are not bound by our Court's prior *dicta*.' "[11] Since none of the relevant transactions in *NYC Shoes* and *Winstar* occurred postpetition, the "extra-statutory" language concerning the petition date in part three of the new value test was not germane to the court's analysis and therefore unnecessary to the ultimate holdings in those cases.[12] Accordingly, the statements were *dicta* and not binding on either the bankruptcy or district courts.[13]

B. Context and Policy Considerations Guide the Court's Statutory Analysis

The court then focused on the plain language of § 547(c)(4). The statute's silence and the fact that many district and bankruptcy courts were divided over how to interpret the statute on this issue did not make the statute ambiguous. Citing to the Supreme Court's decision in *Kelly v. Robinson*,[14] and various other cases, the court explained that context is "key in determining the meaning of a particular provision and whether or not it is ambiguous."[15] "If, after close examination of the statutory context and underlying policy goals, the plain meaning of a provision is still unclear, we then turn to pre-Code practice and legislative history to find meaning. These tools of construction, however, are tools of last resort."[16]

a. Statute's Silence is Not Determinative

The court rejected the argument that the statute's silence as to temporal limitations is determinative that there is no constraint on using a postpetition payment by the debtor, no matter when it is made, to offset prepetition new value advanced by the creditor. In the court's view, Congress could not have intended a totally open-ended time period within which a debtor could make a payment and defeat a creditor's new value defense.[17] "Rather than focusing, as the parties do, on the presence or absence of individual words and phrases within § 547(c)(4)(B), we take a broader approach to our analysis, examining the provision in the context of the Bankruptcy Code as a whole."[18]

b. Statutory Context

The court found support for its conclusion that the petition date serves as a cutoff date for preference analysis from "numerous contextual indicators" within the Bankruptcy Code. For instance, the court noted the title of § 547—"Preferences"—suggests that the entire focus of the section is on transactions occurring solely within the preference period. Postpetition transfers, on the other hand, are addressed in § 549 of the Bankruptcy Code. The court expressed skepticism that a postpetition transfer authorized under § 549 could have the "pernicious effect" of creating a prepetition preference by reducing a prepetition new value defense.[19] "Would not this at least send mixed signals that are ill-advised, if not illogical?"[20]

The court observed that other preference provisions are silent with respect to temporal limitations, but courts have nonetheless treated the petition date as a cutoff date for those provisions. For instance, § 547(c)(4) itself is silent on another aspect of the new value defense—the ability to use postpetition advances of new value to further reduce preference exposure. The vast majority of courts have held that postpetition new value cannot be used to bolster a new value defense notwithstanding the statute's silence on the matter.[21] Similarly, § 547(b)(5) imposes a requirement that, to be a preference in the first instance, the transfer at issue must result in the creditor receiving a greater recovery than it would have received in a hypothetical Chapter 7 case.

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Courts have held that this "hypothetical liquidation test" should be performed as of the petition date notwithstanding the statute's silence on the matter.[22]

The court also pointed to § 547(c)(5), which uses the petition date as a cutoff date for purposes of calculating the "improvement-in-position" defense for a secured creditor who has a floating lien on inventory and receivables. Although subsection (c)(5) has express language imposing the petition date as the cutoff date for the improvement-in-position test, the court still found that the provision supported its conclusion with respect to the new value defense because it reflects how central the policy of improvement to a creditor's position *prior to the petition date* is to the concept of preferences.[23]

Finally, the court found it significant that the statute of limitations for a preference action begins to run from the petition date under § 546 of the Bankruptcy Code. This suggested to the court "that the calculation of preference liability should remain constant post-petition."[24] Collectively, these "contextual indicators" provided the court support from the Bankruptcy Code that the petition date is a firm line in the sand for purposes of preference analysis, including the determination of a subsequent new value defense under § 547(c)(4).

c. Policy Considerations

The court also relied upon the policies underlying the preference provisions in general and the subsequent new value defense in particular, which further supported its conclusion. Citing to the Supreme Court's opinion in *Union Bank v. Wolas*,[25] as well as an excerpt from a Congressional Committee Report, the court explained that the policies underlying the ability to avoid and recover preferences generally are twofold: (1) to discourage creditors from racing to the courthouse to dismember the debtor in his slide into bankruptcy, and (2) to facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.[26] The Committee Report described the first policy as furthering the second.[27] The court noted that this explanation of preference policy focuses on the prepetition period, causing the court to conclude that "it makes sense that the equality should be measured, and inequalities rectified, as of the petition date."[28]

There are also two policies underlying the subsequent new value defense: (1) to encourage trade creditors to continue dealing with troubled businesses, and (2) to treat fairly a creditor who has replenished the estate after receiving a preference.[29] The court rejected the argument that replenishment of the estate in and of itself is a goal of or policy underlying the new value defense.[30] The court also rejected the argument that if postpetition payments were not considered, the creditor would receive a windfall and be unjustly favored over other creditors.[31] The court explained that even if a creditor is paid postpetition for new value provided prepetition, the creditor "still replenished the debtor's estate during the preference period, and therefore aided the debtor in avoiding bankruptcy to whatever extent possible."[32] Nor can the creditor be viewed as being unjustly enriched through "double-dipping" (i.e., receiving postpetition payment and seeking credit for prepetition unpaid new value) because all of the money transferred was for goods and services actually provided.[33]

Finally, the court rejected the argument that cutting off preference analysis at the petition date results in unequal treatment of creditors. The decision notes many sections of the Bankruptcy Code provide for unequal treatment of certain unsecured claims at the expense of others, as do bankruptcy courts when balancing competing interests, including by entering employee wage orders authorizing the payment of

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prepetition employee claims (as the bankruptcy court did in this case).

> 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. . . . Moreover, we submit that the cases ruling that post-petition payments should be counted so as to achieve "replenishment" and "equality" have lost sight of the real policy objectives as noted above. Nowhere is the goal or rationale of "replenishment" set forth. Nor is "equality" as such to be achieved. Rather, if a creditor has been preferred, he must "disgorge so that all may share equally." In other words, it is all about deterring "the race of diligence," and setting things straight, before bankruptcy.[34]

The court concluded its analysis by stating that the "scheme of the Bankruptcy Code contains numerous post-petition mechanisms for ensuring that similarly situated creditors are treated equally. For this reason, preference analysis need not account for post-petition activity."[35] In this case, the bankruptcy court determined that it was in the best interests of the debtors and their estates to enter the employee wage order that authorized the payment to the staffing company. "We will not undermine the Bankruptcy Court's Order by including such post-petition activity in the preference liability equation. Instead, we will allow the Bankruptcy Code's provisions dealing with post-petition conduct to govern, as we believe Congress intended."[36]

III. Lessons Learned

This case is significant and a positive development for preference defendants within the Third Circuit who now have clarity as to their right to assert a subsequent new value defense without concern over the effects of postpetition payments. The opinion neutralizes any leverage plaintiffs may have previously tried to assert during settlement negotiations based on the existing split among district and bankruptcy courts. Because this case is the initial circuit court decision on the matter, it will no doubt impact settlement discussions and litigation involving this issue outside the Third Circuit as well.

The court's initial discussion of what constitutes *dictum* and its holding that its statements in *NYC Shoes* and *Winstar* concerning the petition date as a cutoff date were, in fact, *dicta* are instructive and a valuable reminder that circuit court decisions are subject to the same analysis of *dicta* no matter how many times a statement appears and regardless of how such statements may have been (mis)characterized, however understandably, by lower courts and counsel.

The opinion is an exercise in statutory construction based on the age-old adage of not to lose sight of the forest for the trees. Context is the key to determining statutory meaning and silence within a statute is not necessarily determinative. Perhaps the most significant aspect of the opinion, however, aside from the primary ruling regarding the new value defense, was the court's discussion of the policies underlying the new value defense. From a practitioner's perspective, the subsequent new value rule is frequently viewed as a no harm no foul defense. A creditor receives a preference but puts it back, thereby replenishing the estate. Through its discussion of the underlying policies, however, the court dispelled the notion that replenishment is key and refocused attention on what it called the true purpose of the defense—deterring the "race of diligence" by creditors and setting things straight before bankruptcy. While replenishment furthers the policy of deterring creditors from the race of diligence, it is not the ultimate goal of the defense. This decision will likely be cited as much for its articulation of the policies and goals of preference law and the new value defense as it will for its ruling that postpetition payments do not impact the new value defense.

Significant remaining issues are how plain-

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tiffs will respond and whether courts outside of the Third Circuit will follow suit. Critics were quick to attack the bankruptcy court's opinion on this issue. Whether they feel the same way about the Third Circuit's ruling remains to be seen.

ENDNOTES:

[1]The actual language of the statute speaks through a double-negative: a transfer is not avoidable as a preference to the extent that, after such transfer, such creditor gave new value (i) *not* secured by an otherwise *unavoidable* security interest, and (ii) on account of which new value the debtor did *not* make an otherwise *unavoidable* transfer.

[2]As discussed below, the defense might be more concerned with whether the creditor returned the preference and less with whether the bankruptcy estate has actually been replenished.

[3]The United States Court of Appeals for the Fourth Circuit has stated in *dicta*, and without any analysis, that postpetition transfers may be considered under § 547(c)(4). Hall v. Chrysler Credit Corp. (In re JKJ Chevrolet Inc.), 412 F.3d 545, 553 n.6 (4th Cir. 2005).

[4]Friedman's Liquidating Trust v. Roth Staffing Cos., LP (In re Friedman's Inc.), 738 F.3d 547 (3d Cir. 2013).

[5]New York City Shoes, Inc. v. Bentley Int'l Inc. (In re New York City Shoes, Inc.), 880 F.2d 679, 680 (3d Cir. 1989).

[6]New York City Shoes, 880 F.2d at 680.

[7]As discussed below, the articulation of the three-part test was affirmed as *dicta* by the Third Circuit on the appeal of this case.

[8]Friedman's Inc. v. Roth Staffing Cos., L.P. (In re Friedman's Inc.), Bankr. No. 09-10161 (CSS), Adv. No., 09-50364 (CSS), 2011 WL 5975283, at *4 (Bankr. D. Del. Nov. 30, 2011) (footnote omitted).

[9]Schubert v. Lucent Techs. Inc. (In re Winstar Comm'ns, Inc.), 554 F.3d 382, 402 (3d Cir. 2009).

[10]Transcript of Bankruptcy Appeal, District Court Civil Action No. 12-306-RGA (Mar. 7, 2013).

[11]Friedman's, 738 F.3d at 552 (internal citations omitted).

[12]Friedman's, 738 F.3d at 552.

[13]Friedman's, 738 F.3d at 552.

[14]Kelly v. Robinson, 479 U.S. 36, 43, 107 S. Ct. 353, 93 L. Ed. 2d 216 (1986).

[15]Friedman's, 738 F.3d at 554.

[16]Friedman's, 738 F.3d at 554.

[17]Friedman's, 738 F.3d at 554.

[18]Friedman's, 738 F.3d at 555.

[19]Friedman's, 738 F.3d at 555 n.5.

[20]Friedman's, 738 F.3d at 555 n.5.

[21]Friedman's, 738 F.3d at 557.

[22]Friedman's, 738 F.3d at 555-56.

[23]Friedman's, 738 F.3d at 556.

[24]Friedman's, 738 F.3d at 556.

[25]Union Bank v. Wolas, 502 U.S. 151, 161, 112 S. Ct. 527, 116 L. Ed. 2d 514 (1991).

[26]Friedman's, 738 F.3d at 557-58.

[27]Friedman's, 738 F.3d at 558.

[28]Friedman's, 738 F.3d at 558.

[29]Friedman's, 738 F.3d at 558 (New York City Shoes, 880 F.2d at 680-81).

[30]Friedman's, 738 F.3d at 558-59 ("Appellant mischaracterizes the objective of § 547(c)(4) in stating that '[t]he most relevant inquiry, and policy consideration . . . is whether the alleged new value replenishes the estate.' As Appellee points out, Appellant conflates the formula for calculating new value with the objective of the new value defense, which is to 'treat fairly a creditor' who provides new value.").

[31]Friedman's, 738 F.3d at 559.

[32]Friedman's, 738 F.3d at 559.

[33]Friedman's, 738 F.3d at 559.

[34]Friedman's, 738 F.3d at 560 (internal citations and footnote omitted).

[35]Friedman's, 738 F.3d at 561.

[36]Friedman's, 738 F.3d at 561.

From the Appellate Courts

RECENT DECISIONS FROM THE APPELLATE COURTS

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SECOND CIRCUIT

Marshall v. Picard (In re Bernard L. Madoff Inv. Sec. LLC), 740 F.3d 81(2d Cir. 2014). 1) Bankruptcy court had authority to enjoin creditors' state law actions against another creditor because alleged claims were derivative of trustee's fraudulent transfer claims that had been resolved through settlement in the bankruptcy court. 2) Creditors' claims were not a matter of private rights reserved for Article III courts because the claims were derivative of claims that belonged to the trustee. Moreover, the creditor who settled with the trustee filed a proof of claim in the case, requiring the bankruptcy court to determine related fraudulent transfer issues.

THIRD CIRCUIT

Friedman's Liquidating Trust v. Roth Staffing Cos. (In re Friedman's Inc.), 738 F.3d 547 (3d Cir. 2013). When an otherwise unavoidable transfer is made after the filing of a bankruptcy petition, it does not affect the new value defense. Debtor's postpetition payments to a staffing agency made pursuant to an order entered after case was filed did not affect preference calculation.

SIXTH CIRCUIT

Grant, Konvalinka & Harrison, P.C. v. Still (In re McKenzie), 737 F.3d 1034 (6th Cir. 2013). Bankruptcy court properly required law firm/creditor to establish validity of security interest for purposes of stay relief. Under § 362(g), creditor was unable to meet the burden of proof on the issue of debtor's equity in the collateral because it failed to establish a valid transfer of collateral. Bankruptcy court properly allowed trustee to use his avoidance powers defensively to defeat the motion for stay relief despite expiration of the statutory limitation on filing avoidance actions.

SEVENTH CIRCUIT

In re Crane, Nos. 13-1277 & 13-1518, 2013 WL 6731850 (7th Cir. Dec. 23, 2013). Trustee could not use strong-arm powers under § 544(a)(3) to avoid recorded mortgages that lacked maturity date and interest rate because under applicable Illinois law such terms are not mandatory to put a good faith purchaser on constructive notice of mortgage.

First Webber Group, Inc. v. Horsfall, 738 F.3d 767 (7th Cir. 2013). Creditor with state court judgment for conversion could not rely on issue preclusion to establish all elements of nondischargeability claim under § 523(a)(6) because judgment did not require a finding of willfulness.

NINTH CIRCUIT

Shapiro v. Henson, 739 F.3d 1198 (9th Cir. 2014). Section 542(a) does not limit turnover actions to claims for property currently in the defendant's possession; trustee may seek turnover from an entity that had possession, custody or control of the property at any time during the bankruptcy case.

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