

Eleventh Circuit Strengthens Creditor's Defense to Preference Claim

By Michael L. Cook

A defendant creditor in a preference suit may offset 1) the amount of later “new value” (*i.e.*, additional goods) it sold to the Chapter 11 debtor against 2) the debtor's earlier preferential payment to the creditor, the U.S. Court of Appeals for the Eleventh Circuit recently held. *See, In re BFW Liquidation LLC*, 2018 WL 3850101 (11th Cir. Aug. 14, 2018).

Even when the creditor was paid for the new goods, stressed the court, Bankruptcy Code “§547(c)(4) does not require new value to remain unpaid.” *Id.* at 5. Rejecting the bankruptcy trustee's “policy” argument, the court said its holding “promotes one of the ‘principal policy objectives underlying the [Code's] preference provisions —’ encouraging creditors to continue extending credit to financially troubled debtors.” *Id.* at 10.

STATUTORY PERSPECTIVE

Code §547(b) enables a trustee to avoid “preferential” payments that the debtor made to a creditor within 90 days of the date of bankruptcy. “The trustee may [then] recover the amount of the transfer from the creditor to whom the transfer was made.” *Id.* at 6.

Once the trustee proves the requisite elements of a preferential transfer, the Code provides important exceptions or “safe harbor” defenses to the preference

recipient. Among them is Code §547(c)(4), which insulates the creditor to the extent that, after the debtor's payment, the creditor gave new value to the debtor on an unsecured basis. A creditor who extends further credit in reliance on the debtor's past payments is thus protected. In short, the creditor's preference liability can be effectively reduced to the extent the creditor gave value to the debtor after receiving a preference. The rationale for the statutory exception turns on the replenishment of the debtor's estate to the extent of the new value, minimizing harm to other creditors.

RELEVANCE

The Circuits are split on the extent of the new value defense. Although the Fourth, Fifth, Eighth and Ninth Circuits agree with the Eleventh Circuit's approach in *BFW*, the “Seventh Circuit held, without much discussion, that §547(c)(4) does require new value to remain unpaid.” *Id.* at 6, n.9, citing *In re Prescott*, 805 F.2d 719, 727-28 (7th Cir. 1986), and *In re P.A. Bergner & Co.*, 140 F.3d 1111, 1121 (7th Cir. 1998). The Third Circuit “also stated in a conclusory fashion that §547(c)(4) requires new value to remain unpaid.” *Id.* 2018 WL 385 0101, at 6 n.9, citing *In re N.Y.C. Shoes, Inc.*, 880 F.2d 679, 680 (3d Cir. 1989).

FACTS

The grocery-store chain debtor bought dairy products from the defendant creditor. Within the 90-day period preceding bankruptcy, the debtor had paid the creditor roughly \$564,000 in thirteen separate admittedly preferential payments. *Id.* at 2. During the same time period, however,

after receiving the preferential payments, the creditor delivered roughly \$434,000 worth of new product to the debtor. Because the debtor had paid the creditor for most of the new product, the bankruptcy court only permitted the creditor an offset against its preference liability “to the extent that any new value it extended to the debtor ... remained unpaid” as of the “date of bankruptcy.” *Id.* at 3. Relying on *dicta* in a prior Eleventh Circuit decision, the bankruptcy court stressed that “the new value must remain unpaid.” *Id.* For that reason, it held that the trustee could recover roughly \$434,000 of the \$564,000 paid to the creditor during the preference period. Specifically, the bankruptcy court had “excluded from the amount of new value that [the creditor] could use to offset its preference liability” any “in-voice the debtor had paid” *Id.*

The creditor and the trustee jointly sought a direct appeal to the Eleventh Circuit. The court agreed to hear the appeal. *Id.*

THE ELEVENTH CIRCUIT

The crucial fact in *BFW* was the debtor's payment for the new product it bought from the creditor. According to the trustee, “any new value [the creditor] extended to the debtor during the preference period [had to remain] ‘unpaid’ as of the ... date [of bankruptcy].” *Id.* at 3, citing *In re Jet Florida System, Inc.*, 841 F.2d 1082, 1083 (11th Cir. 1988). But the Eleventh Circuit in *BFW* quickly found that its “statement in *Jet Florida System*” was “dictum” and that it was free to consider anew the central question in the case. *Id.* at 5.

Michael L. Cook is of counsel, at Schulte Roth & Zabel LLP in New York and a member of this newsletter's Board of Editors.

Statutory Language Is Clear

First, the plain language of §547(c) 4 contains nothing even suggesting “that an offset to a creditor’s §547(b) preference liability is available only for new value that remains unpaid.” *Id.* at 6. “The statute only excludes ‘paid’ new value that is paid for with ‘an otherwise unavoidable transfer.’ ... [S]o long as the transfer that pays for the new value is itself avoidable, that transfer is not a barrier to assertion of [the] subsequent-new-value defense.” *Id.* Four other circuits agree. *Id.* citing *In re JKJ Chevrolet, Inc.*, 412 F.3d 545, 551-52 (4th Cir. 2005); *In re Jones Truck Lines, Inc.*, 130 F.3d 323, 329 (8th Cir. 1997); *In re IRFM Inc.*, 52 F.3d 228, 231-33 (9th Cir. 1995); and *In re Toyota of Jefferson, Inc.*, 14 F.3d 1088, 1090-93, 1093 n.2 (5th Cir. 1994).

Supporting Statutory History

The statutory predecessor to §547(c) (4) contained a requirement that new value had to remain “unpaid” to be eligible for setoff against a creditor’s preference liability, said the court. *Id.* at 7. But Congress replaced that language “with new language that omits any such requirement.” *Id.* In fact, a 1970 Commission on the Bankruptcy Laws of the United States “specifically recommended eliminating [the statutory predecessor’s] ‘remaining unpaid’ requirement.” *Id.* at 8. In any event, said the court, “the unambiguous statutory language” enabled it to “reach the same conclusion.” *Id.* at 9.

Supporting Policy Considerations

Rejecting the trustee’s policy arguments, the court stressed that the “principal policy objectives underlying the preference provisions of the ... Code ... encouraged creditors to continue extending credit to financially troubled entities while discouraging a panic-stricken race to the courthouse.” *Id.* at 9, citing *Jet Florida Systems*, 841 F.2d at 1083, and *Union Bank v. Wolas*, 502 U.S. 151, 161 (1991). “If new value must remain unpaid, then vendors who sense that a debtor is in financial difficulty will have an incentive to stop delivering any goods because any payments they would receive, after extension of a short-term period of credit on these deliveries, might be avoided,

and thereby clawed back by the trustee in bankruptcy.

By contrast, if new value need not remain unpaid, then a vendor can continue extending short term credit to the debtor without fear of having all of the payments it receives for its newly delivered goods clawed back by the trustee ...” *Id.* at 9-10. As the court explained, “encouraging creditors to continue extending credit to financially troubled debtors” promotes a principal bankruptcy policy objective. *Id.* at 10. The troubled debtor “would almost always be better off if a vendor continues to supply [it] with goods to sell, and the new-value defense, as interpreted [here], would encourage it to do so.” *Id.* at 11.

Application of Law to Facts

The Eleventh Circuit vacated the bankruptcy court’s judgment, and remanded the case “for a new calculation of” the creditor’s preference liability. *Id.* at 4. The court also gave a concrete hypothetical to explain how the subsequent new value exception worked. If, for example, a creditor received a \$5,000 preferential payment and was later paid for \$4,000 of new value it provided to the debtor, the value of “new goods shipped would wash [the amount] of [the earlier] preferential payments [\$5,000 ... for purposes of avoidability.” *Id.* at 10. The creditor would still be liable for the later \$4,000 payment and for \$1,000 of the original preference, but would avoid a double recovery (\$9,000) by the trustee and fairly limit its exposure to \$5,000. As the court noted, the creditor would be “at risk of losing only a portion of the payments it receives from the debtor.” *Id.*

COMMENT

1. Other uncommitted circuits will probably follow *BFW*. In fact, the Third Circuit also said that its 1989 *N.Y.C. Shoes, Inc.* decision contained *dicta*, not a holding, that new value must remain unpaid as of the date of bankruptcy. *See, In re Friedman’s Inc.*, 738 F.3d 547, 551-52 (3d Cir. 2013).

2. The subsequent new-value exception is not a “net result” rule. The creditor defendant may not net an additional credit extension made *before* it received a preference. *See, In re Fulghum Constr. Corp.*, 706 F.2d 171, 173 (6th Cir. 1983) (“The subsequent advance rule of §547(c)(4), ... forecloses avoidance of the transfer by

the trustee only if the creditor provides additional value *after* the transfer from the debtor to the creditor ...”).

3. The new value given by the creditor is only available as a defense to the prior preference if the debtor’s payment for the new value is itself avoidable and recoverable. *See, In re IRFM, Inc.*, 52 F.3d 228, 232 (9th Cir. 1995) (“... a new value defense is permitted unless the debtor repays the new value by a transfer which is otherwise unavoidable”), quoting §547(c) (4) (new value defense cannot be asserted if debtor paid for new value by “an otherwise unavoidable transfer”) and V. Countryman, “The Concept of a Voidable Preference in Bankruptcy,” 38 *Vand. L. Rev.* 713, 788 (1985) (new value defense available “if these subsequent payments are themselves voidable as preferences (or on any other ground)”).

4. New value extended before bankruptcy and after receipt of a preference may still shield the preference from avoidance even if the new value is paid *after* bankruptcy by court order, *Friedman’s, supra*, 738 F.3d at 549, 557 (“... post-[bankruptcy] payment to a creditor pursuant to [bankruptcy court] wage order ... [does not] reduce ... creditor’s new value defense ... and increase preference liability the same as it would if the payment had been made pre-[bankruptcy].”)



Schulte Roth & Zabel

Schulte Roth & Zabel LLP
919 Third Avenue, New York, NY 10022
212.756.2000 tel | 212.593.5955 fax | www.srz.com
New York | Washington DC | London

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