

ALERTS

Eleventh Circuit Strengthens Creditor's Defense to Preference Claim

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A defendant creditor in a preference suit may offset (a) the amount of later “new value” (i.e., additional goods) it gave the Chapter 11 debtor against (b) the debtor’s earlier preferential payment to the creditor, held the U.S. Court of Appeals for the Eleventh Circuit on Aug. 14, 2018. *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 (“Code”) “§ 547(c)(4) does not require new value to remain unpaid.” *Id.*, at *5. Rejecting the bankruptcy trustee’s “policy” argument, its holding, said the court, “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 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 "invoice the debtor had paid" *Id.*

The creditor and the trustee jointly sought a direct appeal to the Eleventh Circuit. The court granted their petition for permission to appeal. *Id.*

The Eleventh Circuit

The crucial fact in *BFW* was the debtor's payment for the new value it received 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.

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. "... [T]he 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 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, but would avoid a double recovery by the trustee and fairly limit its exposure. 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

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. *In re Friedman’s Inc.*, 738 F.3d 547, 551-52 (3d Cir. 2013).

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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