
Not All Post-Petition Transfers Are Created Equal

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In the precedential opinion *Friedman's Liquidating Trust v. Roth Staffing Companies LP (In re Friedman's)*, Case No. 13-1712 (3rd Cir. Dec. 24, 2013), the U.S. Court of Appeals for the Third Circuit settled the dispute over whether or not an unavoidable post-petition payment made pursuant to a wage order reduces the new-value defense. It does not. In rendering the opinion, the court was confronted with the choice of whether to follow the plain letter of the preference statute or interpret the statute in the context of its surrounding provisions and considering the overriding policies of the Bankruptcy Code. The court opted to rely primarily on the context and policy, rather than the actual words of the statute, and in my humble opinion, reached the correct conclusion. The court also made passing references to the application of the holding to administrative claims under Section 503(b)(9) of the Bankruptcy Code and reclamation claims, which may or may not provide preference defendants with additional protection.

The facts of the case were not disputed and very straightforward. During the preference period, the debtor paid Roth Staffing a total of \$81,997. After these transfers, but before the bankruptcy petition was filed, Roth Staffing provided additional services to the debtor valued at \$100,660. Complete new-value defense, right? Not so fast. After the petition date, the debtor filed a motion with the U.S. Bankruptcy Court for the District of Delaware seeking to pay its employees and independent contractors their pre-petition wages, compensation and related benefits. The court granted the motion and the debtor paid Roth Staffing \$72,412 for pre-petition staffing services. Thereafter, the debtor's liquidating trust commenced a preference action against Roth Staffing seeking to recover the \$81,997 of transfers made during the preference period. Roth Staffing asserted a complete new-value defense on the basis of the \$100,660 worth of services rendered to the debtor after the preference transfers. However, the trust took the position that the post-petition payment pursuant to the wage order reduced the new-value defense to \$28,248, resulting in exposure of \$53,749. Specifically, the trust argued that pursuant to Section 547(c)(4)(B) of the Bankruptcy Code, a preference defendant cannot use new value as a defense if the debtor subsequently pays for such new value with an otherwise unavoidable transfer; in this case, the payment pursuant to the post-petition wage order.

Relying on Third Circuit case law, the bankruptcy court held that the petition date cut off the time when the otherwise unavoidable transfer could be used to reduce the new-value defense. The U.S. District Court for the District of Delaware affirmed. The trust then appealed, claiming that the plain meaning of the preference statute required reduction of new value by the unavoidable post-petition payment, that the holdings of the lower courts allowed Roth Staffing to double-dip because it was using new value that did not replenish the debtor's estate and that prior Third Circuit precedent required the court to consider material post-petition events in the preference analysis.

The Third Circuit began with the analysis of prior precedent to determine whether it was bound by earlier rulings. Finding that any relevant discussions were dicta and in any event, did not directly address the issue before the court, the court moved on to consider the language of the statute. Section 547(c)(4)(B) provides, in relevant part, that "on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor." The trust argued that because the statute is silent regarding whether the otherwise unavoidable transfer must occur pre-petition or post-petition, then it means that all such transfers reduce the new-value defense. However, the court rejected such a focused approach and instead took a step back and considered the context of the statutory provision as well as the policies behind preference actions.

Noting that Section 547 is titled "Preferences" and that by definition, preferences involve pre-petition transfers, the court concluded that by logical extension, any defenses to such transfers should also be considered during this time period. The court also noted that the "hypothetical liquidation test," one of the elements of the prima facie preference action, must be performed as of the petition date. The statute of limitations for preference actions also begins on the petition date. In addition, the "improvement-in-position" test that provides a defense to preference creditors with floating liens specifically cuts off as of the petition date. Finally, the court noted that the use of post-petition transfers to reduce new value would also result in the use of post-petition extensions of new value to increase the defense, a position that has been rejected by a clear majority of courts. Therefore, the court concluded that the context of Section 547(c)(4)(B) supports the conclusions that preference defense analysis ceases on the petition date. In a footnote, the court also recognized that using an unavoidable post-petition transfer to create a pre-petition preference claim sends mixed signals that are at least ill-advised, if not illogical.

The court then went on to consider the policies underlying the preference statute and whether they supported use of the petition date to cut off defenses. The two policies articulated by the Supreme Court are the prevention of a race to the courthouse to dismember a debtor and equal distribution of assets. These policies are both focused on the pre-petition period. Accordingly, the court held that the policies also supported its conclusion. The trust maintained that new value should be reduced because the debtor's estate was not replenished by the post-petition transfer and because Roth Staffing was able to "double-dip" by receiving both payment and new-value credit. The trust also argued that cutting off the defense analysis at the petition date would result in the unequal treatment of creditors. All of these positions were rejected by the court. First, even though the new value occurred pre-petition, the estate still received value from it. Second, there is no "double-dipping" when a creditor is paid for the goods or services it actually provided. Third, the Bankruptcy Code does not require equal treatment for all creditors. Priority and administrative claims, by definition, provide for the favorable treatment of one group of

creditors over another. The Third Circuit therefore concluded that the context of Section 547 (c)(4)(B) and the policies of the preference statute dictate that the new-value analysis end on the petition date.

Interestingly, in a footnote, the court was very clear that it was not addressing whether the assertion of a reclamation claim reduces new value, stating that it is possible that a reclamation claim could be treated differently than other post-petition activities. While the court considered cases involving post-petition payments pursuant to Section 503(b)(9), allowing creditors to assert an administrative claim for goods received by a debtor 20 days before the petition date, to be analogous to the case under consideration, reclamation claims were distinguished as goods provided with the "seller's strings" attached.

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