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# The Third Circuit Draws a Line in the Sand on New Value in Friedman's

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Seemingly straightforward on its face, certain aspects of the Bankruptcy Code's "new value" defense[1] have proven frustratingly unclear for practitioners around the country. Illustrative of this frustration is the elusive answer to perhaps the simplest question: When does it apply? More specifically, if a creditor is paid post-petition for new value that remained unpaid as of the petition date, can that creditor continue to use that same unpaid new value as a defense under § 547(c)(4) of the Bankruptcy Code? The picture remains muddled nationwide, but in the Third Circuit, at least, the answer is now clear.

### The Lower Court Split

Courts at both the bankruptcy and district court levels across the country have parted ways on how to answer the foregoing question. In one camp, courts have ruled against cutting the preference analysis off at the petition date, thereby allowing post-petition payments (including, notably, payments on administrative expenses under § 503(b)(9) and payments pursuant to critical-vendor orders) to reduce a defendant's new value defense.[2] In the other camp, the prevailing view is that the petition date *does* become the "cutoff" date for assessing new value, such that post-petition payments on pre-petition new value have no bearing on whether a creditor can use that same new value to reduce its liability in a preference action.[3]

### The *Friedman's* Cases

In November 2011, Judge Christopher Sontchi of the U.S. Bankruptcy Court for the District of Delaware issued an opinion that placed Delaware in the latter of the two camps.[4] The facts in *Friedman's* were simple and uncontested: The debtor made payments to the creditor-defendant during the preference period in the amount of $81,997.57 (the "transfer"), after which the creditor provided staffing services to the debtor valued at $100,660.88 (the "new value"). The money owed for these services remained unpaid as of the petition date.

Post-petition, the debtor filed a motion in bankruptcy court seeking authority to pay pre-petition wages, compensation and related benefits. The court granted the motion, pursuant to which the debtor paid $72,412.71 (the "wage order payment") to the creditor. More than a year later, the creditor raised the new value as a defense when the debtor's liquidating trustee sought to avoid the transfer as a preference. The trustee argued that the new value was reduced by the amount of the wage order payment.

Judge Sontchi ruled for the creditor, finding that the Third Circuit Court of Appeals' holding in *In re New York City Shoes Inc.*[5] supported a reading that the petition date should act as the "cut-off" date for calculating new value.[6] That decision was later affirmed on appeal by the U.S. District Court for the District of Delaware, whose ruling the trustee also appealed. As a matter of first impression, on Dec. 24, 2013, the Third Circuit Court of Appeals affirmed the lower courts for several reasons.

The Third Circuit Court of Appeals first held that its prior references on this issue, including *In re New York City Shoes*, were non-binding *dicta* because those cases did not turn on transactions that occurred post-petition.[7] The court next concluded that the plain language of § 547(c)(4)(B) is silent as to when a payment must be made by a debtor to defeat a creditor's new value defense, but the "fact that courts are divided in their interpretations of § 547(c)(4)(B) does not mean ... that the provision is necessarily ambiguous."[8] The court looked at the provision in the context of the Bankruptcy Code as a whole, finding numerous indicators that pointed to the petition date as a cutoff for analysis of new value, such as:

> (1) § 547 is titled "Preferences," suggesting that it concerns transactions occurring pre-petition;[9] (2) the hypothetical liquidation test under § 547(b)(5) must be performed as of the petition date;[10] (3) the statute of limitations for filing a preference action under § 546 begins to run on the petition date;[11] (4) § 547(c)(5)'s "improvement in position" test includes the phrase "as of the date of the filing of the petition";[12] and (5) allowing post-petition payments to affect the preference analysis would be inconsistent unless they also allowed the post-petition extensions of new value to be available as a defense — a position most courts have rejected.[13]

The court then rejected the trustee's arguments that the policies underlying the preference provision and new value defense support consideration of post-petition events. Finding that congressional records indicate that the preference policy is equality of distribution, the court held that "it makes sense that the equality should be measured, and inequalities rectified, as of the petition date."[14] The policies underlying the new value defense are to "encourage trade creditors to continue dealing with troubled businesses [and] treat fairly a creditor who has replenished the estate after having received a preference."

The trustee argued that these policies would be defeated by the creditor "double-dipping" into the same underlying new value by receiving a direct payment for such new value post-petition and indirect credit for the new value as an offset against its preference liability.[15] The court rejected this argument being as misleading, however, finding that regardless of whether a creditor is paid post-petition for pre-petition new value, the creditor still replenished the debtor's estate during the preference period, therefore aiding the debtor in avoiding bankruptcy.[16]

The court also rejected the trustee's arguments that its ruling would result in unequal treatment of creditors, finding that the new value defense was *not* enacted to ensure equitable treatment of creditors, but "to encourage creditors to deal with troubled businesses."[17] Similarly, § 547 was designed to provide equal distribution among *similarly situated* creditors, not so that all creditors will be treated equally.[18]

As a final matter, the court addressed the trustee's argument that *In re Kiwi International Air Lines Inc.*[19] required it to take into account all material post-petition events in determining preference liability.[20] The court found that *Kiwi's* holding (*i.e.,* that pre-petition payments made to a creditor pursuant to an executory contract that is assumed by the debtor post-petition cannot be recovered as preferences, as such payments would necessarily have been made in any event as a § 365 cure payment) demonstrated that there are unique circumstances in which other provisions of the Bankruptcy Code dealing with post-petition transactions directly interact with § 547 and, thus, "can alter the otherwise-straightforward preference analysis."[21] Nevertheless, the issue in the present case was not one of those circumstances. Accordingly, the Third Circuit Court of Appeals affirmed the district court's order.

**Conclusion**

The ability of a creditor to use invoices paid post-petition as new value to offset a preference is likely to remain a hotly contested issue in jurisdictions outside the Third Circuit. Nevertheless, because of the number of preference actions filed in Delaware in particular, *Friedman's* is certainly important and persuasive authority for trade creditors.

1. 11 U.S.C. § 547(c)(4).

2. *See In re Friedman's Inc.*, 2013 WL 6797958, at *5 n.2 (3d Cir. Dec. 24, 2013) (collecting cases).

3. *Id.*

4. *Friedman's Inc. v. Roth Staffing Cos. (In re Friedman's Inc.)*, 2011 WL 5975283 (Bankr. D. Del. Nov. 30, 2011).

5. *In re New York City Shoes Inc.,* 880 F.2d 679 (3d Cir. 1989).

6. *Friedman's*, 2011 WL 5975283, at *4.

7. *Id.*

8. *Id.* at *5.

9. *Id.* at *6.

10. *Id.* at *7.

11. *Id.*

12. *Id.*

13. *Id.* at *8 (collecting cases).

14. *Id.* at *9.

15. *Id.* at *10.

16. *Id.*

17. *Id.* at *12 (quoting *In re Bellanca Aircraft Corp.*, 850 F.2d 1275, 1280 (8th Cir. 1988)).

18. *Id.*

19. *In re Kiwi International Air Lines Inc.,* 344 F.3d 311 (3d Cir. 2003) (holding that preference period payments made to payee pursuant to a contract that is later assumed cannot be recovered as preferences,

as the test set forth in § 547(b)(5) cannot be met).

20. *Friedman's*, 2013 WL 6797958, at *13.

21. *Id.*

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