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Eleventh Circuit Holds Payment of Section 503(b)(9) Administrative Expense Claims Do Not Reduce Subsequent New Value Preference Defense

By Gregory G. Hesse and Brandon Bell*

In this article, the authors analyze a federal circuit court ruling that postpetition payments for the value of goods received by a debtor within 20 days before the petition date, authorized by 11 U.S.C. Section 503(b)(9), do not reduce a creditor's "subsequent new value" preference defense.

In a decision that may encourage continued sales from suppliers to distressed entities, the U.S. Court of Appeals for the Eleventh Circuit in *Auriga Polymers Inc. v. PMCM2, LLC*,[1] joined the U.S. Court of Appeals for the Third Circuit,[2] the only other circuit to directly address the issue, in concluding that postpetition payments for the value of goods received by a debtor within 20 days before the petition date, authorized by 11 U.S.C. Section 503(b)(9), do not reduce a creditor's "subsequent new value" preference defense.

PREFERENCES IN A NUTSHELL

A preference is a cause of action authorized by Section 547(b) of the Bankruptcy Code.[3]

Under Section 547(b), a trustee or debtor-in-possession[4] may avoid any "transfer" of an interest of the debtor in property that:

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[1] *Auriga Polymers Inc. v. PMCM2, LLC*, 40 F.4th 1273, No. 20-14647 (11th Cir. July 17, 2022).

[2] The Third Circuit decision was in *Friedman's Liquidating Trust v. Roth Staffing Cos. (In re Friedman's Inc.)*, 738 F.3d 547 (3d Cir. 2013) (holding only pre-petition "otherwise unavoidable transfers" can offset a creditor's subsequent new value defense).

[3] Title 11 of the U.S. Code, 11 U.S.C. §§ 101–1532.

[4] It is also not uncommon for plan administrators, liquidating trustees, litigation trustees and other similar entities (all of which are typically setup at the end of a bankruptcy to facilitate the wind-down of a given debtor or to try to monetize certain specified assets for certain specified beneficiaries) to pursue preference claims where those claims are properly retained for, and where necessary vested in, such entities.

- Is to or for the benefit of a creditor;
- Is on account of an antecedent debt owed by the debtor before such transfer was made;[5]
- Is made while the debtor was insolvent;[6]
- Is made on or within 90 days before the date of filing the petition;[7] and
- Enables the creditor to receive more than such creditor would have received in a Chapter 7 bankruptcy if the transfer had not been made.[8]

Preference claims make conducting business with a flailing entity a dubious prospect.

Fortunately, Section 547(c) of the Bankruptcy Code offers certain protections for a debtor's unwary counterparties. One such protection is the so-called subsequent "new value" defense embodied in Section 547(c)(4) of the Bankruptcy Code.

THE SUBSEQUENT NEW VALUE DEFENSE

The subsequent new-value defense, embodied in Section 547(c)(4) of the Bankruptcy Code, is intended to protect creditors who provided the debtor with new value after receiving an otherwise avoidable preferential transfer.

A creditor must prove three elements for the subsequent new-value defense:

- That the creditor gave new value after receiving the transfer;
- That the new value was not secured by an otherwise unavoidable security interest; and
- That the debtor did not make an otherwise unavoidable transfer to or for the benefit of the creditor on account of the new value.

If the creditor can satisfy these elements, then the creditor can reduce the preference exposure by the subsequent new value delivered to the debtor.

For a number of years, this, seemingly straightforward defense, suffered from a number of conflicting decisions.

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[5] There are rules set out in Section 547(e) which discuss when a "transfer" is considered made. 11 U.S.C. § 547(e).

[6] Pursuant to Section 547(f), there is a rebuttable presumption that the debtor was insolvent on and during the 90 days before filing for bankruptcy. 11 U.S.C. § 547(f).

[7] That period is extended to one year if the creditor was an "insider" at the time of the transfer.

[8] The idea here is that a fully-secured creditor will not incur any preference liability because it will be paid in full in a Chapter 7.

The majority rule is illustrated by the decision by the U.S. Court of Appeals for the Fifth Circuit in *Matter of Toyota of Jefferson, Inc.*, and is best demonstrated in the context of an example.[9]

In *Toyota of Jefferson*, the bankruptcy trustee disputed the district court's decision limiting the amount of its preference recovery to $90,169.[10] During the preference period:

- The debtor made a $30,830.75 payment on a loan from the creditor;
- The creditor advanced the debtor an additional $82,993.00;
- The debtor repaid the $82,993.00;
- The creditor advanced another $90,169.00; and
- Finally, the debtor repaid the $90,169.00.[11]

The bankruptcy trustee argued that the creditor should not be entitled to reduce its preference exposure with either of the two advances made during the preference period because the debtor had repaid those advances.[12] In other words, the debtor argued that the creditor should not be entitled to reduce its preference exposure, pursuant to Section 547(c)(4), because the subsequent new value provided did not remain unpaid.[13]

The Fifth Circuit rejected this statement, noting that the proper inquiry is not whether the subsequent new value goes unpaid, but whether the repayments were not "otherwise unavoidable."[14] The court then upheld the district court's decision that the creditor's preference exposure was $90,169.00, as no subsequent new value existed to reduce exposure for that payment.[15]

The minority rule stemmed from dicta in the now infamous Third Circuit opinion in *New York City Shoes*.[16] The Third Circuit's decision in *New York City*

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[9] *Matter of Toyota of Jefferson, Inc.*, 14 F.3d 1088 (5th Cir. 1994); *see also Mosier v. Ever-Fresh Food Co. (In re IRFM, Inc.)*, 52 F.3d 228 (9th Cir. 1995) (applying majority approach); *Hall v. Chrysler Credit Corp. (In re JKJ Chevrolet Inc.)*, 412 F.3d 545 (4th Cir. 2005) (same); *Jones Truck Lines, Inc. v. Cent. States, Southeast and Southwest Areas Pension Fund (In re Jones Truck Lines, Inc.)*, 130 F.3d 323 (8th Cir. 1997) (same).

[10] *Id.* at 1090–91.

[11] *Id.* at 1092.

[12] *Id.*

[13] *Id.*

[14] *Id.* at 1093 (the court also notes the "unpaid" requirement as stemming from dicta in decisions such as *New York City Shoes*).

[15] *Id.*

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

Shoes actually turned on the simple issue of when a postdated check was considered transferred.[17] The Third Circuit reversed the lower courts in holding that there was a rebuttable presumption that a postdated check was not transferred on the date of delivery.[18] The Third Circuit went on to conclude that the creditor was not entitled to a subsequent new-value defense because the record failed to rebut the presumption.[19]

Despite that narrow holding, a number of courts seized on dicta from the opinion suggesting that the subsequent new value a creditor provided must remain unpaid. This had the unfortunate effect of creating, essentially, a second new-value analysis. The typical new-value analysis, as illustrated by *Toyota of Jefferson*, keeps a running tally of potential preference payments by the debtor and subsequent new value provided by the creditor, with the preference exposure being the end result of the tally.[20] Plaintiffs seizing on the *New York City Shoes* dicta employed a different new-value analysis which erased, rather than offset, any new value provided by the creditor to the extent it was paid. The chart below depicts the majority and minority analyses using the *Toyota of Jefferson* payments.

***Toyota of Jefferson* Payments**				
Payments	**Preferential Payment (payments made by debtor)**	**Subsequent New Value (loan advances by creditor)**	**Preference Exposure (Majority Approach)**	**Preference Exposure (Minority Approach)**
Payment 1	$30,830.75	N/A	$30,830.75	$30,830.75
New Value 1	N/A	$82,993.00	$0[21]	$0[22]

Cir. 1989); *see also In re Kroh Bros. Dev. Co.*, 930 F.2d 648, 653 (8th Cir. 1991) (creditor who has been paid for the new value may not assert a new value defense); *In the Matter of Prescott*, 805 F.2d 719, 731 (7th Cir. 1986) (same); *In re Jet Florida Sys., Inc.*, 841 F.2d 1082 (11th Cir. 1988) (same).

[17] *New York City Shoes*, 880 F.2d at 679.

[18] *Id.* at 685.

[19] *Id.*

[20] This is not to be confused with the "net" test whereby preference payments during the period are added and all subsequent new value is added and then such subsequent new value is subtracted from the total of the preference payments. Critically, subsequent new value payments can only offset preference payments that occurred before the subsequent new value was provided. In other words, any time the last payment is a preference, that liability can never be offset by a subsequent new value defense.

[21] Here, the preference exposure is fully covered by subsequent new value provided by the creditor.

[22] Here, the preference exposure is fully covered by subsequent new value by the creditor.

Payment 2	$82,993.00	N/A	$82,993.00[23]	$113,823.75[24]
New Value 2	N/A	$90,169.00	$0[25]	$23,654.75[26]
Payment 3	$90,169.00	N/A	$90,169.00[27]	$203,992.75[28]
TOTALS	**$203,992.75**		**$90,169.00**	**$203,992.75**

Decades later, the Third Circuit finally acknowledged the *New York City Shoe's* language as dicta.[29] Uncertainties still persist. For example, under the minority approach, what if the subsequent new value remains unpaid until the debtor files for bankruptcy, but then is paid postpetition? What if, under the majority approach, the subsequent new value was paid postpetition by a transfer that was "otherwise unavoidable?" Enter Section 503(b)(9).

THE IMPACT OF 503(b)(9) ADMINISTRATIVE CLAIMS ON THE SUBSEQUENT NEW-VALUE DEFENSE

Section 503(b)(9) allows a creditor an administrative expense claim for the value of goods received by the debtor in the 20 day period preceding bankruptcy. Because administrative expense claims must be paid in full to confirm a plan of reorganization, they are, in some sense, unavoidable transfers.

Against that backdrop, the question is whether a creditor's subsequent new-value defense is reduced to the extent such creditor receives payment pursuant to Section 503(b)(9) on account of such new value? The Eleventh

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[23] Here, there is no subsequent new value to reduce the preference exposure created by Payment 2.

[24] Under the minority approach, not only is there no subsequent value to reduce the preference exposure created by Payment 2, but Payment 2 also erases the subsequent new value provided by New Value 1. Because there is now no "unpaid" subsequent new value, the preference exposure from Payment 1 returns.

[25] This subsequent new value fully covers the preference exposure from Payment 2.

[26] Under the minority approach, New Value 2 is, at this time, the only "unpaid" subsequent new value, so that subsequent new value reduces the preference exposure from the combined preference payments of Payment 1 and Payment 2.

[27] There is no subsequent new value to offset the final preference payment because the creditor did not provide value after the payment was made. Accordingly, the final preference exposure is the amount of Payment 5.

[28] Under the minority approach, Payment 3 erases New Value 2, meaning there is now no "unpaid" subsequent new value during the entire preference period, so the creditor's preference exposure is the sum of all of the preferential payments made during the period.

[29] *In re Friedman's Inc.*, 738 F.3d at 552.

Circuit, in *Auriga*, held that payment of Section 503(b)(9) administrative expense claims do not reduce a creditor's subsequent new-value defense.[30]

ENTER *AURIGA*

In *Auriga*, the debtor was a major manufacturer and distributor of carpet and hard surface flooring products and the creditor was a vendor who supplied the debtor with certain materials.[31] After filing for bankruptcy, the debtor confirmed a liquidating plan vesting all of its assets, including avoidance actions, in a liquidating trust.[32] In the 90 day period before the debtor filed for bankruptcy, the debtor paid the creditor more than $2.2 million and the debtor received over $3.523 million in goods during that period.[33]

The creditor filed an administrative expense claim pursuant to Section 503(b)(9) for the goods transferred within 20 days of the debtor filing for bankruptcy and received a payment in the amount of $273,382[34] (the difference between the full $694,502 administrative expense claim and the disputed $421,119) during the course of the bankruptcy case.[35] The creditor forthwith filed a general unsecured claim for the remaining unpaid goods delivered more than 20 days prior to the petition date.[36]

The liquidating trustee filed a complaint, seeking to avoid the $2.2 million in pre-petition payments as preferences under Section 547(b).[37] The liquidating trustee and the creditor entered into a stipulation whereby the parties agreed that the $2.2 million in payments were all avoidable preferences, but that all but $421,119 of such payments were protected by the creditor's subsequent new value defense.[38] Because that $421,119 was part of the creditor's Section 503(b)(9) administrative expense claim, the liquidating trustee disputed the creditor's ability to also use it as part of its subsequent new-value defense.[39]

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[30] *Auriga*, *supra* n.1.

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] The amount disputed and the amount paid do not add up to the full $694,502 administrative expense claim. The one-dollar difference is an error from the case, which uses these numbers.

[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.*

Thus, the case was limited to the narrow issue of whether payment of a Section 503(b)(9) administrative expense claim constituted an "otherwise unavoidable transfer" negating a required element of the creditor's subsequent new-value defense.[40]

The bankruptcy court, consistent with its ruling in an earlier adversary brought by the liquidating trustee, held that funds held in reserve to pay Section 503(b)(9) claims are "otherwise unavoidable" transfers for purposes of a Section 547(c)(4) defense, and cannot be used to offset preference liability.[41] The bankruptcy court, in reaching that decision, emphasized the silence of § 547(c)(4) as to whether the "otherwise unavoidable" transfer take place prepetition or postpetition.[42]

The Eleventh Circuit reversed, noting the bankruptcy court's reliance on its previous decision in *In re BFW Liquidation*[43] was misplaced given that the court never said anything about the timing of "otherwise unavoidable" transfers in that case.[44] The court held that postpetition payments made pursuant to Section 503(b)(9) are not "otherwise unavoidable" transfers for purposes of Section 547(c)(4)'s subsequent new-value defense.[45] In reaching this conclusion, the court reasoned that a number of components of Section 547 suggested the relevant transfers must be prepetition, including:

- The statute's title;
- The requirement that new value be given prepetition (suggesting otherwise unavoidable transfers must also occur prepetition);
- That the statute of limitations begins to run on the petition date; and
- That "transfer" should be presumed to have the same meaning

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[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] *In re BFW Liquidation, LLC*, 899 F.3d 1178 (11th Cir. 2008). Additionally, note that in *In re BFW*, the Eleventh Circuit reversed an Alabama bankruptcy court that limited a subsequent new-value defense based on the Alabama bankruptcy court's belief that circuit precedent limited subsequent new-value defenses to that new value that remained "unpaid." The Alabama bankruptcy court believed it was bound by language in the Eleventh Circuit's decision in *In re Jet Florida*. The *In re BFW* court clarified that the suspect language in its *In re Jet Florida* opinion was dicta, and explicitly repudiated any "unpaid" requirement for the subsequent new-value defense. *In re BFW Liquidation, LLC*, 899 F.3d at 1178.

[44] *Auriga*, *supra* n.1.

[45] *Id.*

throughout Section 547(c)(4).[46]

The Eleventh Circuit joins the Third Circuit as the only two circuits to have directly addressed this issue, and both concluded that payment of Section 503(b)(9) administrative expense claims does not preclude goods delivered within 20 days before the petition date from being subsequent new value.

CONCLUSION

While the Eleventh's Circuits decision in *Auriga* and the Third Circuit's decision in *In re Friedman's Inc.* should provide non-debtor suppliers and trade vendors some comfort, remember that the remaining circuits have yet to weigh in on this issue.

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[46] *Id.*