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# The Impact of Post-petition Events on Preference Liability

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Section 547 of the Bankruptcy Code enables a trustee or debtor-in-possession (DIP) to avoid and recover from creditors certain payments deemed to be "preferences." In general, a preference is (1) any transfer of the debtor's interest in property, (2) to or for the benefit of a creditor, (3) on account of a debt owed by the debtor before the transfer was made, (4) made on or within 90 days (or one year for insiders) before the bankruptcy filing date, (5) that enables the creditor to receive more than the creditor would have received in a liquidation case if the transfer had not been made and the creditor received payment on its debt as provided by the Bankruptcy Code. 11 U.S.C. §547(b). The Bankruptcy Code enables the recovery of these payments on the theory that the paid creditors were "preferred" over unpaid creditors and, therefore, should return the payments so that they may be shared equally with all creditors. *See Kimmelman v. The Port Authority of New York (In re Kiwi Int'l. Air Lines Inc.),* 344 F.3d 311, 316 (3rd Cir. 2003). Several defenses are available to preference claims, including that the creditor provided unpaid "subsequent new value" to the debtor. *See* 11 U.S.C. §547(c).

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Events occurring after a bankruptcy petition is filed must be taken into account when evaluating a preference defendant's liability and defenses. This article focuses on two such events that have been the subject of recent cases, namely (1) whether a debtor's assumption of a contract under which the debtor made the alleged preference payment to the creditor, as §365 of the Bankruptcy Code permits, eliminates the possibility of recovering the payment as a preference; and (2) whether a creditor loses its subsequent new value defense if the bankruptcy court allows the debtor to pay for that new value during the bankruptcy case.

## Assumption of Executory Contracts

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In recent cases, courts have held that assuming a contract under §365 of the Bankruptcy Code bars a preference claim against the other party to that contract. *See Kiwi,* 344 F.3d at 314; *In re Teligent Inc.,* 306 B.R. 752, 756 (Bankr. S.D.N.Y. 2004); *Philips Services Corp. v. Luntz (In re Philip Services (Delaware) Inc.),* 284 B.R. 541, 553 (Bankr. D. Del. 2002), *aff'd.,* 303 B.R. 574 (D. Del. 2003). Under §365, a trustee or DIP is entitled to "assume or reject" executory contracts with third parties. 11 U.S.C. §365(a). In order to assume a contract, the trustee or DIP must cure any default under the contract and compensate the other party for any losses resulting from the default. 11 U.S.C. §365(b)(1)(A) and (B). However, under §547(b)(5) of the Bankruptcy Code, to make out a preference case the trustee or DIP must establish that the alleged preferential transfer yielded the creditor a greater return on its debt than it would have received if the transfer had not taken place and it had received a distribution in a chapter 7 liquidation. *Kiwi,* 344 F.3d at 317. In determining what the creditor would have been paid in a "hypothetical chapter 7," some courts have looked at what *actually happened* in the bankruptcy case with respect to the assumption of contracts. For example, in a recent case, the Third Circuit ruled:

> The trustee's characterization of the defendants' claims as unsecured on the filing date seems to presuppose that a hypothetical chapter 7 trustee would have elected to reject the debtor's agreements with them.... However, the agreements here were not rejected, and they would not necessarily have been rejected in a hypothetical chapter 7 liquidation. Once the debtor assumed the agreements, the defendants...were entitled, pursuant to §365, to full payment of the amounts owed under the agreements.

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*Kiwi,* 344 F.3d at 318-19. Because the creditor would have been entitled to full payment even in a hypothetical chapter 7 case, the court found that a preference claim could not succeed. *Id.; accord, In re Teligent,* 306 B.R. at 756; *In re Philip Services,* 284 B.R. at 553 ("[W]e conclude that once an executory contract is assumed, the trustee or debtor may not maintain a preference action to recover payments made pre-petition pursuant to that contract."); *see, also, In re Superior Toy & Mnfg.,* 78 F.3d 1169, 1174 (7th Cir. 1996) ("Section[s] 547 and 365 are mutually exclusive avenues for a trustee. A trustee may not prevail under both...."); *Alvarado v. Walsh (In re LCO Enter.),* 12 F.3d 938, 940 (9th Cir. 1993) ("The trustee cannot use §547(b) to circumvent the [cure] requirements of §365(b)."). However, some courts in other contexts have refused to incorporate "actual events" into the §547(b)(5) analysis, so the result may differ according to jurisdiction. *See, e.g, Gosch v. Burns (In re Finn),* 86 B.R. 902, 904-05 (Bankr. E.D. Mich. 1988), *aff'd.,* 111 B.R. 123 (E.D. Mich. 1989), *rev'd. on other grounds,* 909 F.2d 903 (6th Cir. 1990).

Consequently, this argument is available potentially to defeat a preference claim if the contract under which the alleged preferential payment was made was assumed in the bankruptcy. In addition, because assumption of an executory contract could limit the ability to bring a subsequent preference action against the other party to the contract, trustees and DIPs should take the potential loss of such an action into account when evaluating the benefits of assuming or rejecting a particular contract.

## Post-petition Payment of Subsequent New Value

Of the several defenses to a preference action, one that is likely to be impacted by a post-petition event is the "subsequent new value" defense. Under §547(c)(4) of the Bankruptcy Code, the trustee or DIP cannot avoid a preferential transfer to the extent that after such transfer, the creditor gave new value in goods or services to or for the benefit of the debtor "on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor." 11 U.S.C. §547(c)(4). In general, courts have interpreted this defense to allow a preference defendant to reduce its preference liability by the dollar value of new goods and services it provided to a debtor after the alleged preference payment as long as the new value remains "unpaid." The courts addressing the issue, however, have split on the issue of when that determination must be made.

The question can be critical because a creditor can often be paid for pre-petition goods or services even after a bankruptcy petition is filed. For example, in some cases a bankruptcy court will authorize a DIP to pay the pre-petition debts of certain "critical vendors" to persuade those vendors to keep supplying the DIP with goods or services it cannot easily obtain elsewhere. In addition, a creditor that supplies goods to a debtor 10 days before the bankruptcy filing might be able to reclaim those goods. *See* 11 U.S.C. §546(c). If the bankruptcy court allows reclamation, the DIP will often offer to pay for such goods rather than allow the creditor to reclaim them. Moreover, the bankruptcy court could permit a creditor to set off a pre-petition amount it owes to the debtor to satisfy a pre-petition debt owed to the creditor by the debtor. If any of these actions effectively pay the creditor for the goods or services for which it later attempts to claim new value credit in response to a preference claim, then it is likely that the trustee or DIP will argue that such payment nullifies the subsequent new value.

The counter-argument posits that new value must only remain unpaid as of the petition date and that any later payment to the creditor does not reduce the creditor's subsequent new value defense. Under §547(c)(4), the subsequent new value defense is not available if the "debtor" makes a payment to the creditor on account of the subsequent new value. As used in the Bankruptcy Code, the word "debtor" generally refers to the pre-bankruptcy petition entity. When the Bankruptcy Code refers to the entity operating in bankruptcy, it refers to the "trustee," "estate" or "debtor-in-possession." For example, §1107(b) of the Bankruptcy Code provides that a professional is not disqualified for employment by a "debtor-in-possession" under §327 just because the professional was employed by "the debtor before the commencement of the case." Several courts have relied on the distinction between the pre-petition "debtor" and the post-petition entity to prohibit creditors who extend unpaid *post-petition* new value to a DIP to use that new value to reduce their preference exposure. *See, e.g., TennOhio Trans. Co. v. Felco Commercial Serv. (In re TennOhio Transportation Co.),* 255 B.R. 307, 310 (Bankr. S.D. Oh. 2000) ("Post-petition advances of new value may not be applied to offset preferential transfers. First, §547(c)(4) specifically requires that the advances be made 'to or for the benefit of the debtor,' and any *post-petition* transfers would not be for the debtor but for the bankruptcy estate."); *Clark v. Frank B. Hall & Co. (In re Sharoff Food Serv., Inc.),* 179 B.R. 669, 678 (Bank. D. Colo. 1995) ("[C]ourts do not apply §547(c)(4) to post-petition transfers. One reason is the reliance upon the specific language 'to or for the benefit of the debtor' as an implication that the subsequent advances of new value are only those given pre-petition, because any post-petition advances are given to the debtor's estate, not the debtor."); *Kellman v. P.S.E.G. (In re Jolly 'N' Inc.),* 122 B.R. 897 (D. N.J. 1991) ("Post-petition advances of new value may not be applied to offset preferential transfers.... Moreover, there is a lack of mutuality for such offsets because post-petition advances are made to the debtor's estate, and not to the debtor.")

The way courts have traditionally articulated the subsequent new-value defense lends further support for this distinction. Numerous courts have stated that subsequent new value reduces preference liability as long as the new value remains unpaid *as of the petition date. See Campbell v. Deans (In re J.R. Deans Co.),* 249 B.R. 121, 138 (Bankr. D. S.C. 2000) ("Finally, the advanced new value must be fully or partially unpaid as of the date of the filing of the petition."); *Brandt v. Sprint Corp. (In re Sonicraft Inc.),* 238 B.R. 409, 414 (Bankr. N.D. Ill. 1999) ("That additional post-preference unsecured credit must be unpaid in whole or in part as of the date of the bankruptcy petition."); *Schwinn Plan Committee v. AFS Cycle & Co. (In re Schwinn Bicycle Co.),* 205 B.R. 557, 568 (Bankr. N.D. Ill. 1997) ("Additionally, the subsequent new value must remain unpaid as of the petition date."); *McLaughlin v. Security Pacific Housing Services,* 183 B.R. 171, 176 (Bankr. W.D. Wis. 1995) ("The exception allows a creditor to set off the amount of post-preference advances that are both unsecured and unpaid on the petition date against any amounts the creditor must return to the trustee under the preference provision."); *Kellman v. P.S.E.G. (In re Jolly 'N' Inc.),* 122 B.R. 897 (D. N.J. 1991) ("Third, the debtor must not have fully compensated the creditor for the 'new value' as of the date that it filed its bankruptcy petition."); *Chaitman v. Paisano Automotive Liquids Inc., (In re Almarc Mnfg. Inc.),* 62 B.R. 684, 686 (Bankr. N.D. Ill. 1986) ("[A]dditional post-preference unsecured credit must be unpaid in whole or in part as of the date of the petition."); *Columbia Packing Co. v. Allied Container Corp. (In re Columbia Packing Co.),* 44 B.R. 613, 613-14 (Bankr. D. Mass. 1984) (Section 547(c)(4) "reduces preference liability to the extent that a recipient of a preference provided new credit to the debtor which remained unpaid and unsecured on the date the petition seeking relief under the Bankruptcy Code was filed.").

Relying on this rationale, at least one court has held that payments made to a creditor by a trustee or DIP after the bankruptcy petition date cannot reduce that creditor's subsequent new value defense:

> The Eleventh Circuit has held that §547(c)(4) requires that the new value remain unpaid as of the petition date, rather than the date the court adjudicates a preference action. *In re Braniff Inc.,* 154 B.R. 773, 784 (Bankr. M.D. Fla. 1993). *See In re Jet Florida System Inc.,* 841 F.2d 1082 (11th Cir. 1988). Plaintiff contends, and the Thurman Estate admits, that Sun Bank received payments for the new advance *through the Thurman Estate.* The transaction records for loan 26, however, indicate that as of the date of the petition, the $10,000 advance remained unpaid. Thus, the

fact that Sun Bank received payment of the new value subsequent to the petition date is irrelevant to this discussion.

*Sun Bank/North Central Florida v. Estate of Thurman (In re Thurman Const. Inc.),* 189 B.R. 1004, 1014 (Bankr. M.D. Fla. 1995) (emphasis added); *see, also, In re Braniff Inc.,* 154 B.R. 773, 784 (Bankr. M.D. Fla. 1993) ("The point that Sunstrand misses in making this argument is that the law requires new value to remain unpaid as of the petition date, not as of the date a bankruptcy court later adjudicates a preference action by the debtor.") (emphasis in original).

In contrast, however, is *Moglia v. American Psychological Ass'n. (In re Login Bros. Book Co.),* 294 B.R. 297 (Bankr. N.D. Ill. 2003). That case held that post-petition repayment by the DIP does operate to reduce a creditor's subsequent new value defense. In reaching this decision, the bankruptcy court stated that it relied on "the plain language and policy behind the statute" to determine "that the timing of a repayment of new value is irrelevant." *Id.* at 300. Arguably, however, the bankruptcy court overlooked the fact that the plain language requiring the "debtor" to make the payment might in fact impose a timing requirement because the debtor and the estate are generally not the same. As a result of this split, this issue must be considered in situations where subsequent new value has been paid for by the debtor after the bankruptcy filing date.

## Conclusion

Events occurring after a bankruptcy petition is filed can impact the viability of preference claims brought by a trustee or DIP. The two events discussed in this article suggest that a trustee or DIP should evaluate the possibility that it may lose the ability to assert a preference claim against a contract party if it assumes a contract. In addition, a preference defendant should be prepared to assert this defensive argument. Furthermore, plaintiffs and defendants in preference actions should understand that the subsequent new value defense is not necessarily eliminated simply because the subsequent new value was paid after the bankruptcy filing. ■

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