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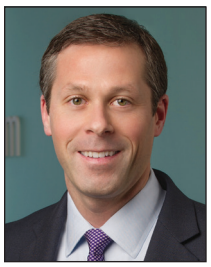
On the Edge

By Jeremy R. Fischer

Double-Dipping in Delaware

Friedman's, Quantum Foods *and Beyond*



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Clients faced with preference suits in any bankruptcy court invariably lament what they view as the inherent unfairness of § 547 of the Bankruptcy Code. They will likely receive only a small dividend on their proofs of claim for unpaid pre-petition invoices, and, to add insult to injury, they are sued for avoidance and recovery of the few payments that they actually received during the preference period. Explaining the policy of "equality of distribution" generally falls on deaf ears in these situations, especially when the clients are summoned to an outside jurisdiction like the District of Delaware to defend the preference suits.

Yet two recent decisions may provide defendants with extraordinary protection from preference liability. The first decision allows defendants to assert undiminished "new value" defenses under § 547(c)(4), even when some or all of that pre-petition new value is paid post-petition under critical-vendor, shipper or wage orders.[1] The second — and related — decision provides that allowed, post-petition administrative expenses could be set off against preference liability and rejects the notion that such a setoff is a "disguised ... post-petition new value defense."[2] Taken together and to their logical conclusion, these decisions may mean that (at least in Delaware) creditors are entitled to "double dip" — to receive payment (or setoff) based on § 503(b)(9) administrative expenses (the first dip), while also asserting undiminished new value defenses based on the very same transactions (the second dip).

In re Friedman's

In *Friedman's*, the debtor paid approximately $82,000 to a creditor during the preference period; the creditor then provided additional services valued at approximately $100,000 and was not paid pre-petition. However, the creditor was paid approximately $72,000 post-petition under a critical-vendor order entered by the U.S. Bankruptcy Court for the District of Delaware.[3]

Subsequently, a liquidating trustee was appointed and sued the creditor for avoidance and recovery of the $82,000 under § 547(b). The creditor asserted a full new-value defense under § 547(c)(4) based on $100,000 of subsequent services that had been rendered.[4] The trustee objected, arguing that the defense must be reduced by the amount of the post-petition payment to prevent the creditor from double-dipping to the detriment of the estate and other creditors. The bankruptcy court ruled that the critical-vendor payments were made post-petition and thus did not diminish the new value defense.[5]

The district court and Third Circuit affirmed. The Third Circuit relied "primarily on the context and policy of the Code, rather than specific language."[6] As a matter of context, the Third Circuit reasoned that § 547

> concerns transactions occurring during the preference period, which is by definition pre-petition.... It would make sense that the calculation of the amount of the preference, and the application of any new value reduced by subsequent transfers, would relate to that period.[7]

As a matter of policy, the panel rejected the trustee's argument that the bankruptcy court's decision undermined one of the basic purposes of

1 *Friedman's Liquidating Trust v. Roth Staffing Cos. LP (In re Friedman's Inc.)*, 738 F.3d 547 (3d Cir. 2013).
2 *Official Comm. of Unsecured Creditors of Quantum Foods LLC v. Tyson Foods Inc. (In re Quantum Foods LLC)*, -- B.R. --, Adv. No. 15-50254 (KJC), 2016 WL 4011727, at *2 (Bankr. D. Del. July 25, 2016).
3 *In re Friedman's*, 738 F.3d at 549-50.
4 Section 547(c)(4) states, "The trustee may not avoid under this section a transfer ... to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor — (A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor[.]"
5 *In re Friedman's*, 738 F.3d at 551.
6 *Id.* at 554.
7 *Id.* at 555.

the new value defense — to "treat fairly a creditor who has replenished the estate after having received a preference" — by allowing the creditor to "unfairly receive double payment, once post-petition, and once indirectly as an offset against its ... preference liability."[8] Instead, the panel noted that "even if a creditor is paid post-petition for new value [that] it provided pre-petition, the creditor still replenished the estate during the preference period, and therefore aided the debtor in avoiding bankruptcy to whatever extent possible."[9] Thus, as a matter of both context and policy, the Third Circuit held that where a payment "is made after the filing of a bankruptcy petition, it does not affect the new value defense."[10] The Third Circuit stated that the courts are "nearly equally divided" on whether a payment must be pre-petition to defeat a new-value defense.[11]

In re Quantum Foods

In *Quantum Foods*, a vendor was paid approximately $13.75 million during the preference period. Following the debtor's bankruptcy filing in Delaware, the vendor continued to provide goods to the estate, and following nonpayment, the vendor was allowed a $2.6 million administrative expense under § 503(b)(1)(A) of the Bankruptcy Code. Thereafter, the creditors' committee appointed in the case filed a suit against the vendor seeking avoidance and recovery of the pre-petition payments; the vendor asserted the right to set off its allowed administrative expense against any potential preference liability.[12]

While "[t]he parties agree[d] that *In re Friedman's* makes [it] clear that 'goods or services provided to the debtor post-petition cannot be used as 'subsequent new value,'" the committee argued that the vendor's "setoff claim [was] really a 'disguised' or 'renamed' post-petition new value defense because, like a new value defense, it has the effect of reducing the total amount of preferential transfers restored to the estate."[13] Conversely, the vendor argued that "its claim is an extrinsic setoff claim, wholly unrelated to the concept of new value defense or to the § 547 preference analysis generally."[14]

The Delaware bankruptcy court framed the question as one of "first impression": "Whether an allowed post-petition administrative-expense claim can be used to set off preference liability."[15] The court answered this question in the affirmative by relying on *In re Friedman's*, stating that "it makes no sense to refer to any claim arising outside of the preference period as a new value defense. 'New value defense' necessarily involves pre-petition activity, so juxtaposition of ... 'post-petition' and ... 'new value defense' is incongruous."[16] While agreeing with the committee that the vendor's setoff would have a similar effect on the amount restored to the estate as the new value defense, the court rejected the committee's analysis that this similarity rendered setoff and new value as being the same thing:

> I am not persuaded by the Committee's argument that Tyson's claim is a disguised new value defense because it has the effect of reducing the amount of preferential transfers returned to the estate. Tyson's setoff claim does not [a]ffect the bottom line of the preference calculation; rather, setting off Tyson's Administrative Claim effects only the amount *paid* to the estate. Tyson's Administrative Claim affects the preference claim externally, not internally. This distinction is not merely semantic but rather evinces the nature of Tyson's claim.[17]

Finally, the bankruptcy court considered whether the administrative expense and preference claims were mutual obligations under both applicable nonbankruptcy law and the Bankruptcy Code. "The judicial consensus is that 'setoff is only available in bankruptcy when the opposing obligations arise on the same side of the ... bankruptcy petition date.'"[18] Because the vendor's administrative expense "is clearly a post-petition obligation of the Debtor," the court determined that the preference claim must also constitute a post-petition obligation in order to satisfy the mutuality requirement.[19] The court held that while "it is axiomatic ... that a preference cause of action concerns only ... pre-petition facts[,]" it is just as obvious that "a preference claim ... necessarily arises *only* post-petition."[20] Thus, the bankruptcy court ultimately held that the vendor was entitled to set off its allowed administrative expense against any potential preference liability without running afoul of *Friedman's*.

Analysis

Standing alone, the holdings of *Friedman's* and *Quantum Foods* are hardly extraordinary. However, when read together and carried to their logical conclusions, the cases appear to support the proposition that a preference defendant is entitled to an undiminished new value defense even where it is also entitled to either payment or setoff based on § 503(b)(9) administrative expenses resulting in whole or in part from the same pre-petition transactions giving rise to the new value.

To be sure, neither case directly addresses § 503(b)(9) issues: The creditor in *Friedman's* was paid for pre-petition services (rather than goods) under the critical-vendor order, and the vendor in *Quantum Foods* held an allowed administrative expense based on providing post-petition (rather than pre-petition) goods to the debtor. Based on these facts, litigants may attempt to distinguish both cases as inapposite. Moreover, from a policy perspective, they may argue that allowing preference defendants the right to claim full new value while also retaining the right to be paid or invoke setoff for a § 503(b)(9) administrative expense based on the *exact same* pre-petition transactions presents a most egregious example of double-dipping at the expense of the estate and its creditors.

8 *Id.* at 558-59 (quoting *N.Y. City Shoes Inc. v. Bentley Int'l Inc. (In re N.Y. City Shoes Inc.)*, 880 F.2d 679, 680-81 (3d Cir. 1989) (internal quotation marks omitted)).
9 *Id.* at 559 (citing *Commissary Ops. Inc. v. Dot Foods Inc. (In re Commissary Ops. Inc.)*, 421 B.R. 873, 878 (Bankr. M.D. Tenn. 2010) ("[T]he possibility that a debtor may pay a creditor's § 503(b)(9) claim post-petition does not negate the value represented by the claim that the creditor provided to the debtor. The deliveries benefit the estate ... regardless of whether the § 503(b)(9) claimants are paid at a later date for those deliveries.")).
10 *Id.* at 549.
11 738 F.3d at 553-54.
12 *In re Quantum Foods*, 2016 WL 4011727, at *1.
13 *Id.* at *2.
14 *Id.*
15 *Id.*
16 *Id.* at *3.
17 *Id.* at *4 (emphasis in original).
18 *Id.* (quoting *Pa. State Employees' Ret. Sys. v. Thomas (In re Thomas)*, 529 B.R. 628, 637 n.2 (Bankr. W.D. Pa. 2015)). The bankruptcy court also noted that § 553 of the Bankruptcy Code only "addresses setoff of pre-petition obligations" and thus is not implicated in the context of post-petition setoffs. *Id.* at *4 n.16.
19 *Id.* at *4.
20 *Id.* at *4-5 (emphasis in original).

However, both the *Friedman's* and *Quantum Foods* courts squarely considered — and rejected — the perceived inequities of double-dipping.[21] In particular, the Third Circuit in *Friedman's* emphasized that a bankruptcy estate benefits from the provision of new value by a vendor, even when that value is later repaid post-petition. A close reading of the decision supports the proposition that, by continuing to do business with a troubled company, a vendor provides independent consideration beyond the mere value of the goods that justifies double-dipping.[22] It is difficult — if not impossible — to imagine how this analysis would be different merely because the new value took the form of goods delivered within 20 days of a bankruptcy filing.

Moreover, while there are few cases that consider double-dipping in the context of § 503(b)(9), the slate is not completely blank.[23] The cases rejecting double-dipping in the § 503(b)(9) context rely on the same policy considerations previously rejected by the Third Circuit, and the *Friedman's* decision cites one such case unfavorably.[24] Conversely, the *Friedman's* decision cites and relies on the analysis of a case allowing § 503(b)(9) double-dipping.[25]

Conclusion

Taken together and to their logical conclusion, the decisions in *Friedman's* and *Quantum Foods* may provide preference defendants the rare opportunity to lawfully double-dip. At least in Delaware, it appears likely that defendants are entitled to either payment of their § 503(b)(9) administrative expense under *Friedman's* or setoff under *Quantum Foods* without affecting their entitlement to an undiminished new value defense based on the exact same transactions. abi

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21 Notably, in considering creditor "equality" and estate "replenishment" arguments about double-dipping, the *Friedman's* panel referenced § 503(b)(9), stating that "the Bankruptcy Code does not give equal treatment to the claims of all creditors, but rather carves out special treatment for creditors or claims of certain kinds. For example, § 503(b)(9) claimants, ostensibly similar to general unsecured creditors, are afforded priority status for administrative expenses." 738 F.3d at 560.

22 *Id.* at 559 ("[The] Appellant's reference to a creditor's 'double dipping' is misleading because it implies that the creditor is receiving payment for goods or services that were never provided, or that the creditor is being paid twice.... [T]he creditor provided services on credit during the preference period. After the debtor's bankruptcy petition was filed, the trustee paid the creditor some of the money owed.... All of the money the creditor received was for goods and services actually provided. The creditor, therefore, was never unjustly enriched.").

23 *Compare TI Acquisition LLC v. S. Polymer Inc. (In re TI Acquisition LLC)*, 429 B.R. 377 (Bankr. N.D. Ga. 2010), and *Circuit City Stores Inc. v. Mitsubishi Digital Elecs. Am. Inc. (In re Circuit City Stores Inc.)*, No. 10-03068-KRH, 2010 WL 4956022 (Bankr. E.D. Va. Dec. 1, 2010) (rejecting § 503(b)(9) double-dipping), *with In re Commissary Ops. Inc.*, 421 B.R. 873 (allowing § 503(b)(9) double-dipping).

24 *In re Friedman's*, 738 F.3d at 559 (citing *In re TI Acquisition* unfavorably).

25 *Id.* (citing and quoting *In re Commissary Ops.* favorably).