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11th Circ. Ruling Boosts Defense Against Clawback Suits

By **Thad Wilson and Jonathan Jordan** (August 5, 2022, 3:36 PM EDT)

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In July, the U.S. Court of Appeals for the Eleventh Circuit reversed a bankruptcy court's decision holding that a subsequent new value defense to avoidable preference liability must be reduced by payments the creditor-defendant receives during the course of a bankruptcy case.

In doing so, the Eleventh Circuit joined the U.S. Court of Appeals for the Third Circuit in ruling that payments received by a creditor after a bankruptcy filing for prebankruptcy shipments of goods do not diminish the creditor's new value defense.

By excluding post-petition payments from the new value analysis, the Eleventh Circuit decision better insulates creditors from avoidable preference exposure.

Anatomy of a Preference Lawsuit

The case — Auriga Polymers Inc. v. PMCM2 LLC as Liquidating Trustee for the Beaulieu Liquidating Trust — arose from the bankruptcy of Beaulieu Group LLC, one of North America's largest carpet manufacturers.

Before the bankruptcy filing, Auriga sold polymer resins and specialty polymers to the debtor for use in making textile products. As carpet prices fell due to slackening consumer demand, Beaulieu faced a liquidity crisis and filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of Georgia in July 2017.

The bankruptcy court approved a plan of liquidation that transferred Beaulieu's assets, including claims for avoidable preferential payments, to a liquidating trust.

The liquidating trustee then filed a lawsuit against Auriga, seeking to recover $2.2 million in payments made to Auriga during the 90 days before the bankruptcy filing.

The Bankruptcy Code permits a debtor — or in this case, a liquidating trustee — to sue a creditor, and under certain conditions, to avoid and recover payments made by the debtor in the 90 days before a bankruptcy filing. But it also gives creditors a defense for new value — goods, services or money — provided to a debtor after the creditor receives payments from the debtor during that 90-day period.

There is, however, a catch. The new value that reduces a creditor's liability must either remain unpaid, or if paid, must be paid with an otherwise unavoidable payment.

This is commonly referred to as the subsequent new value defense. The triple negative construction of Section 547(c)(4) has given courts and practitioners trouble ever since it was drafted.

Auriga and the trustee agreed the subsequent new value defense protected all but the debtor's last payment, totaling just over $421,000. Auriga argued that its liability for the $421,000 payment should be reduced by the nearly $695,000 value of its polymer shipment made after receiving the $421,000 payment, leaving Auriga with zero liability.

The trustee argued the new value defense did not apply. It noted that shortly after the bankruptcy filing, Auriga asked to be paid for the $695,000 shipment as a priority claim under Section 503(b)(9) of the Bankruptcy Code, which gives priority payment to shipments of goods made to a debtor in the last 20 days before its bankruptcy filing.

Since Auriga was entitled to full priority payment of that $695,000 under Section 503(b)(9), the trustee argued, Auriga should not be entitled to "double dip" and use that same new value to shield it from preference liability.

After all, it argued, Section 547(c)(4) of the Bankruptcy Code requires the new value to remain unpaid — or if paid, to be paid with a payment that is not an otherwise unavoidable transfer. According to the trustee, the Section 503(b)(9) claim payment was an otherwise unavoidable transfer, so the $695,000 could not reduce the clawback of the $421,000 prebankruptcy payment.

Noting that the statute does not prescribe a time limit on the otherwise unavoidable transfer proviso, the bankruptcy court agreed with the trustee. Auriga appealed to the U.S. District Court for the Northern District of Georgia, which certified the case for direct appeal to the Eleventh Circuit.

Finding Meaning in a Silent Statute

The Eleventh Circuit sided with Auriga and held that a creditor's receipt of payment under Section 503(b)(9) after a bankruptcy filing does not reduce the amount of the creditor's new value the creditor provided the debtor before the filing.

Writing for the court, U.S. Circuit Judge Barbara Lagoa noted that the Bankruptcy Code is silent on what to do about post-bankruptcy payments for purposes of the subsequent new value defense. The Eleventh Circuit disagreed with the bankruptcy court on the significance of that silence.

Reviewing the statute in context, the Eleventh Circuit opined that the Bankruptcy Code was designed to limit defenses relating to prebankruptcy payments; post-bankruptcy payments do not affect a creditor's defenses. The court reached this decision after concluding that:

- The term "transfers" in Section 547(b) of the Bankruptcy Code refers to transfers made before a bankruptcy filing, and the use of the word "transfers" in Section 547(c)(4) — the subsequent new value defense — should be interpreted consistently, so that otherwise unavoidable transfers mean only transfers made before a bankruptcy filing;

- The title of the statute, "preferences," implies that its focus is the 90-day preference period before bankruptcy — and there is a different section, Section 549, that addresses post-bankruptcy transfers;
- If new value extended after a bankruptcy filing does not help a creditor, as a number of courts have concluded, then to be consistent, payments received after a bankruptcy filing should similarly not hurt a creditor;
- The statute of limitations, which begins to run on the bankruptcy filing date, implies a creditor's liability should be fixed on that date — not affected by post-bankruptcy events; and
- Congress intentionally favored creditors who ship goods within 20 days before a bankruptcy filing — as set forth in Section 503(b)(9) — and the Eleventh Circuit did not wish to disturb this policy.

Despite the Eleventh Circuit's holding and reasoning in Auriga, there is no settled consensus among the circuits. While lower courts in and outside the Eleventh Circuit have addressed the issue, the Eleventh Circuit found the case to be one of first impression for its docket.

It adopted the rule — though not all the reasoning — of the Third Circuit's 2013 opinion in Friedman's Liquidating Trust v. Roth Staffing Companies LP, which held that only prepetition payments reduce a creditor's subsequent new value defense.

The Eleventh Circuit also noted that dicta in the 2005 U.S. Court of Appeals for the Fourth Circuit case Hall v. Ford Motor Credit Company — "some of the challenged transfers occurred after JKJ CP filed for bankruptcy and these transfers may in fact be 'otherwise unavoidable'" — implying that post-petition transfers may reduce the new value defense.

Payments pursuant to Section 503(b)(9) are not the only context in which otherwise unavoidable payments have been discussed in the context of the subsequent new value defense.

In Friedman's, for instance, the Third Circuit ultimately held that post-petition payments made under a court-approved wage order do not reduce the amount of a creditor's subsequent new value defense.

In Phoenix Restaurant Group Inc. v. Proficient Food Co. in 2007, the U.S. District Court for the Middle District of Tennessee rejected a supplier's attempt to rely on new value that was later paid post-petition under a critical vendor order.

The trend in the Third and Eleventh Circuits appears to be moving away from strict textual analysis and policy considerations focusing on equal treatment of creditors — the raison d'être for avoiding preferential payments — toward a bright-line divide between the pre- and post-petition worlds.

Prior to the petition date, debtors may be pressured to pay for new value by unfair creditor measures, so defining the term "transfers" under Section 547(c)(4) to include prepetition payments mitigates the evil Section 547 was designed to curb.

On the other hand, post-petition payments are not subject to the same creditor pressures. They are made under the aegis of the automatic stay and must be approved by the bankruptcy court pursuant to one or more provisions of the Bankruptcy Code.

Indeed, Section 503(b)(9) payments have specific congressional imprimatur. Thus, the danger of unfair creditor pressure to repay new value is greatly diminished after a bankruptcy case is filed.

Buttressing a Defense for Creditors

Trade creditors who supply companies in financial distress will welcome Auriga as a reinforcement of protections U.S. Congress enacted in Section 547(c) and Section 503(b)(9).

A demarcation between prepetition and post-petition payments will not only create more certainty once a case is filed, but it will provide trade creditors with the ability to manage their exposure by providing goods in the last 20 days prior to a bankruptcy filing, knowing that post-bankruptcy payments under Section 503(b)(9) will not disturb their viability and amount of their defense.

With the right facts and venue, creditors that continue to supply goods to companies up to the moment of a bankruptcy filing may find themselves better protected from preference liability in clawback suits — a result debtors should also welcome because of the potentially increased availability of necessary trade credit when it is needed the most.

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