Featured Articles

**Stern v. Marshall: The Constitutional Limits of Bankruptcy Jurisdiction, Redux**
Dhrumil Patel, University of North Carolina School of Law, Chapel Hill, North Carolina

In January of this year, the Supreme Court will consider the scope of bankruptcy jurisdiction in place since Congress amended the Bankruptcy Code in 1984, in response to the Supreme Court's decision in *Northern Pipeline Co. v. Marathon Pipeline Co.*, 458 U.S. 50 (1982) ("Marathon"). The case, *Stern v. Marshall* (Docket No. 10-179), presents the following question: Has Congress authorized, and may it do so constitutionally, a bankruptcy court's adjudication of a compulsory counterclaim by a debtor against a person filing a proof of claim against the estate? The Ninth Circuit held that not all compulsory counterclaims are "core proceedings" arising in or under the Bankruptcy Code. See *In re Marshall*, 600 F.3d 1037 (2010) ("Marshall"). Its holding opens the door for the Supreme Court to determine the constitutionality of Congress' grant of jurisdiction to bankruptcy courts over debtors' counterclaims against creditors filing proofs of claims.

**"Going Concern," "Deathbed" And Other Unfortunate Metaphors In Avoidance Litigation**
David R. Weinstein, Holme Roberts & Owen LLP, Los Angeles, and Danelle G. Kelling, Holme Roberts & Owen LLP, Scottsdale, Arizona

Proving "insolvency" is often a central feature of avoidance litigation. Defined in § 101(32) of the Bankruptcy Code, "insolvency" is a element of both preference and constructively fraudulent transfer actions. Other than with respect to preferential transfers made within 90 days before the order for relief, the trustee (or debtor-in-possession or creditor's committee) must affirmatively prove the debtor's insolvency to establish a preference case and will often do so in a constructively fraudulent transfer action.

**Is It Still New Value? Application of Section 503(b)(9) to the Subsequent New Value Preference Defense**

The issue of whether the holder of an administrative expense under section 503(b)(9) of the Bankruptcy Code can use goods shipped during the 20 days prior to the petition date as subsequent new value to offset an alleged preferential transfer has troubled practitioners since the enactment of section 503(b)(9) as part of the Bankruptcy Abuse Protection and Consumer Protection Act of 2005 (BAPCPA). Although numerous opinions have been published in recent years interpreting nearly every word
of section 503(b)(9), the case law provided little to no guidance on this issue until recently.

More...

**Legislative Update**

Judith Greenstone Miller, Jaffe Rait Heiff & Weiss PC, Southfield, Michigan, and Aisha L. Williams, Gilbert LLP, Washington, D.C.

Since a new Congress has just commenced its work on Capitol Hill, there is no new bankruptcy-related legislation on which to report. Please refer to the ABA Business Committee web page, Legislative News Box, for the October 2010 Legislative Update and other postings of recently proposed and enacted legislation prepared by the Legislation Subcommittee on the ABA Business Bankruptcy Committee.

The Legislative Committee is always looking for volunteers to track, report and write on legislation and legislative developments. If you are interested, please contact either Judith Greenstone Miller, Chair of the Legislation Committee at jmiller@jaffelaw.com or Aisha Williams, Vice-Chair of the Legislation Subcommittee at williamsa@gotofirm.com.

More...

**Spotlight on My Chi To, Recipient of the Kathryn R. Heidt Memorial Award**

At the Fall Meeting of the ABA Section of Business Law Business Bankruptcy Committee in New Orleans, Michael St. Patrick Baxter, Chair of the Committee, awarded the annual Kathryn R. Heidt Memorial Award to New York attorney My Chi To.

More...

**Business Bankruptcy Committee Member Marc L. Barreca Appointed as United States Bankruptcy Judge**

The Business Bankruptcy Committee is pleased to report that one of its members, the Honorable Marc L. Barreca, was appointed as a judge of the U.S. Bankruptcy Court for the Western District of Washington in Seattle. Judge Barreca replaced the Honorable Thomas Glover, who retired from the bench on July 10.

Judge Barreca received his undergraduate degree from the University of Washington, and obtained his law degree from the same school in 1983. He was a partner with the law firm of K&L Gates LLP, where he worked in the Seattle office since 1987. Judge Barreca has been an active member of the Business Bankruptcy Committee, most recently chairing the E-Commerce and Technology-Oriented Bankruptcies Subcommittee. The Business Bankruptcy Committee is extremely proud to have another one its members join the bench.
Watch Recent Business Bankruptcy Committee Webinars

On December 10, 2010, the Business Bankruptcy Committee presented a webinar entitled, "In Pari Delicto: What Are the Recent Cases Saying?" The webinar discussed the current status of this doctrine in bankruptcy litigation. And on April 15, 2010, the Committee presented a webinar on several recent decisions that appear to limit the rights of secured creditors to credit bid in Chapter 11 cases. Below are links to the full webinars and to the slide show presentations.

Business Bankruptcy Committee Webinars...

Materials from the Business Bankruptcy Committee 2010 Fall Meeting

At the Fall Meeting of the ABA Section of Business Law Business Bankruptcy Committee in New Orleans, members of the Committee presented a number of informative and interesting programs. Below is a link to all of the materials provided at these programs. (Access to some of the articles requires your ABA password.)

Fall Meeting Materials...

Attend the 2011 Business Bankruptcy Spring Committee Meeting

The Business Bankruptcy Committee will meet at the ABA Business Law Section Spring Meeting in Boston April 14-16. The Committee members will present prepared a variety of stimulating and cutting-edge programs for bankruptcy and business lawyers. The programs include the Thursday luncheons presented by the Chapter 11 Subcommittee on bank holding company insolvencies and the Secured Creditors Subcommittee on bankruptcy examiners. Below is a link to the brochure of the programs that will be offered at the Spring Meeting. We look forward to seeing you in Boston.

Business Bankruptcy Committee Brochure...

Submit Articles for the Business Bankruptcy Newsletter

The Business Bankruptcy Committee invites you to submit articles for possible publication in future issues. The articles do not need to be long or in-depth, and it is a great way to get involved in the Business Bankruptcy Committee. Articles can survey the law nationally or locally, discuss particular business bankruptcy issues, or examine a specific case. If you are interested in submitting an article, please contact Newsletter
In January of this year, the Supreme Court will consider the scope of bankruptcy jurisdiction in place since Congress amended the Bankruptcy Code in 1984, in response to the Supreme Court’s decision in *Northern Pipeline Co. v. Marathon Pipeline Co.*, 458 U.S. 50 (1982) ("Marathon"). The case, *Stern v. Marshall* (Docket No. 10-179), presents the following question: Has Congress authorized, and may it do so constitutionally, a bankruptcy court’s adjudication of a compulsory counterclaim by a debtor against a person filing a proof of claim against the estate? The Ninth Circuit held that not all compulsory counterclaims are “core proceedings” arising in or under the Bankruptcy Code. See *In re Marshall*, 600 F.3d 1037 (2010) (“Marshall”). Its holding opens the door for the Supreme Court to determine the constitutionality of Congress’ grant of jurisdiction to bankruptcy courts over debtors’ counterclaims against creditors filing proofs of claims.

Section 157(b)(2)(C) of title 28 provides that “counterclaims by the estate against persons filing claims against the estate” are core proceedings. ² Read literally, this section confers jurisdiction over all of a debtor’s counterclaims, both compulsory and permissive. Since its enactment in 1984 following *Marathon*, the section’s broad grant of jurisdiction has been controversial, and courts have construed its language narrowly. At a minimum, following the Supreme Court’s ruling in *Katchen v. Landy*, 382 U.S. 323 (1966), counterclaims based on the trustee’s avoidance powers have been afforded core treatment. *Katchen* determined that because

1 Dhrumil Patel received his J.D. in 2010 from the University of North Carolina School of Law.

2 The distinction between “core” and “non-core” proceedings provides the limit of a bankruptcy court’s jurisdiction to enter final judgment. Under § 157, a bankruptcy court may hear and determine all cases under title 11 and all core proceedings arising under or arising in a case under title 11. A bankruptcy judge may not finally determine a
no claim can be allowed unless and until a creditor has repaid any transfer subject to the avoidance power, resolving the avoidance action is “part and parcel” of the process of allowing or disallowing the creditor’s claim. Until the Ninth Circuit’s ruling in Marshall, for counterclaims not based on a trustee’s avoidance powers, many courts have relied on the distinction between compulsory and permissive counterclaims in Rule 13 of the Federal Rules of Civil Procedure to limit the scope of § 157(b)(2)(C).

In this article, I will first discuss the facts of Marshall and the Ninth Circuit’s holding and then detail the incorporation of the compulsory counterclaim analysis in construing § 157(b)(2)(C). The district court’s broad interpretation of a compulsory counterclaim supports its policy of judicial economy. The application of the “same transaction or occurrence” test in the bankruptcy context, however, is inappropriate given the non-Article III nature of bankruptcy courts. I believe the Ninth Circuit was correct to hold that the “part and parcel” standard in Katchen better hews to the constitutional line motivating Congress in enacting the 1984 Amendments.

Decided in March of last year, Marshall is the first case to hold a debtor’s compulsory counterclaim to a creditor’s filing of a proof of claim to be non-core, and thus outside the bankruptcy court’s jurisdiction. In Marshall, E. Pierce Marshall (“Pierce”), the son of the deceased J. Howard Marshall II (“Howard”), filed a non-dischargeability complaint and proof of claim in Vicky Lynn Marshall’s (“Vicky”) chapter 11 bankruptcy case in California. Vicky (now deceased) was Howard’s widow, and she counterclaimed against Pierce for tortious interference with an inter vivos gift, a state law claim. The bankruptcy court entered a proceeding determined to be non-core. See § 157(c)(1). Instead, the bankruptcy judge makes proposed findings and conclusions that are subject to de novo review by the district court.
“judgment” for Vicky for millions of dollars in compensatory and punitive damages, which Pierce appealed to the district court. Meanwhile, a Texas probate court was administering Howard’s estate, which involved a will contest between Pierce and Vicky. Both participated fully in a five-month jury trial in the Texas probate court. At the conclusion of the trial, the probate court’s findings would have been fatal to Vicky’s state law counterclaim if it had been given preclusive effect by the federal district court in California.

The district court, however, affirmed the bankruptcy court’s “judgment.” On further appeal, the Ninth Circuit ruled that Vicky’s counterclaim in bankruptcy court was not so closely related to Pierce’s claim that it became “part and parcel” of the bankruptcy court’s claims determination and allowance process. That is, although her claim was compulsory, it was not necessary for the bankruptcy court to rule on it before allowing or disallowing Pierce’s proof of claim. Vicky’s counterclaim was therefore non-core, and the bankruptcy court lacked jurisdiction to enter a final judgment on it.

In the context of § 157(b)(2)(C), the issue implicated by granting the bankruptcy court jurisdiction to enter final judgment is this: by filing a proof of claim, does a claimant waive his right to an Article III forum, for all counterclaims against the claimant by the estate? Given the constitutional doubts raised by Marathon, the answer must be no. There must be some notion restricting the reach of the bankruptcy court over all of a debtor’s counterclaims. Prior to the Ninth Circuit’s decision in Marshall, most courts considering this question have concluded that the proper restriction is supplied by the compulsory/permissive distinction in Rule 13(a). But the facts of Marshall raise the question of whether this is the appropriate standard. Indeed, Pierce filed a proof of claim based on allegations of defamation. Vicky’s tortious interference counterclaim was found to be compulsory under the widely used “logical relationship” test. Yet
the Ninth Circuit noted that “there is little overlap of the legal elements” between their two claims. Therefore, the fact finding and evidence required for the claims asserted by Vicky and Pierce would differ widely. In such a case, should the necessary characteristics of an Article III court be so easily given up simply by filing a proof claim?3

It is not surprising that the issues raised by Marshall are controversial. The “logical relationship” test—used to give meaning to the key term “transaction” in Rule 13(a)(1)—is far reaching, and the underlying policy of judicial economy justifies the broad scope of compulsory counterclaims. In Marshall, the Ninth Circuit easily found Vicky’s tortious interference claim to be compulsory, while noting her claim raised broader factual and legal issues. Given that factually and legally distinct claims may nevertheless be compulsory, it is appropriate for the Supreme Court to clarify the full import of § 157(b)(2)(C) and its inclusion of counterclaims as core proceedings.

The Supreme Court’s decision in Stern v. Marshall may effect a significant change in bankruptcy litigation or it may skirt the constitutional issues altogether. Nevertheless, the facts of Marshall present an opportunity to consider § 157 jurisprudence afresh. If the statute is too broad as written, what limiting rules or standards are appropriate? Should the so-called “omnibus” categories of § 157(b)(2)(C) and (O)5 be struck in favor of more narrowly tailored language? Would that come at the expense of the expediency or judicial economy of bankruptcy litigation? These issues present some of the difficulty arising from the non-Article III nature of

---

3 As stated in Collier on Bankruptcy, “the [constitutional] concerns...and the result in Marathon outweigh any argument that unrelated (and even perhaps same transaction) counterclaims are part and parcel of the allowance process.” ¶ 3.02[3][d] (emphasis added).

4 See, e.g., Transamerica Occidental Life Ins. Co. v. Aviation Office of America, Inc., 292 F.3d 384, 389 (3d Cir. 2002) (stating “the concept of a ‘logical relationship’ has been viewed liberally to promote judicial economy”).

5 See Collier, ¶ 3.02[3][d], for this characterization.
bankruptcy courts, and their (potential) resolution awaits the Supreme Court’s decision later this term.
“Going Concern,” “Deathbed” And Other Unfortunate Metaphors In Avoidance Litigation

David R. Weinstein and Danelle G. Kelling

Proving “insolvency” is often a central feature of avoidance litigation. Defined in § 101(32) of the Bankruptcy Code, “insolvency” is a element of both preference and constructively fraudulent transfer actions. Other than with respect to preferential transfers made within 90 days before the order for relief, the trustee (or debtor-in-possession or creditor's committee) must affirmatively prove the debtor's insolvency to establish a preference case and will often do so in a constructively fraudulent transfer action.

Insolvency is a matter for expert analysis. The expert should construct balance sheet-like schedules of assets and liabilities and compare the totals: if liabilities exceed assets, the debtor was “insolvent”. Needless to say, this is much easier said than done. Numerous subtle

---

1 David R. Weinstein, Los Angeles, Holme Roberts & Owen LLP. Danelle G. Kelling, Scottsdale, Holme Roberts & Owen LLP.
2 A debtor’s insolvency is relevant evidence in an actually fraudulent transfer case, but it is not a necessary element of the claim. See, BFP v. Resolution Trust Corp., 511 U.S. 531, 535 (U.S. 1994) (noting that 11 U.S.C. § 548, sets forth the powers of a trustee in bankruptcy to avoid fraudulent transfers. . . It permits avoidance if the trustee can establish (1) that the debtor had an interest in property; (2) that a transfer of that interest occurred within one year of the filing of the bankruptcy petition; (3) that the debtor was insolvent at the time of the transfer or became insolvent as a result thereof; and (4) that the debtor received less than a reasonably equivalent value in exchange for such transfer.) See e.g, In re Vaniman International, Inc., 22 B.R. 166, 185 (Bankr. E.D.N.Y. 1982) (Where a conveyance is made with actual intent to hinder, delay, or defraud creditors, it is not necessary to show that the debtor was insolvent for the conveyance to be voidable as fraudulent.)
3 See Bankruptcy Code § 547(f) which creates a presumption of the debtor’s insolvency during the 90 days preceding the petition.
4 A plaintiff can alternatively (and disjunctively) rely on undercapitalization or an inability to pay debts as sufficient evidence of a debtor’s fiscal distress in a constructively fraudulent transfer action, but “insolvency” is commonly relied on. See e.g, In re McDonald Bros. Constr., Inc., 114 B.R. 989, 997 (Bankr. N.D. Ill. 1990) (noting plaintiff can sustain claim by proving one of three types of fiscal distress). See also, In re Ohio Corrugating Co., 91 B.R. 430, 436 (Bankr. N.D. Ohio 1988) (noting, the “Code specifies three (3) alternative showings which may establish this element. Plaintiff must show that the debtor (1) was insolvent either before or as a result of the transfer; or (2) was undercapitalized; or (3) intended or believed debts would be incurred beyond its ability to pay as such debts matured.”)
5 See Lawson v. Ford Motor Co. (In re Roblin Indus., Inc.), 78 F.3d 30, 38 (2d Cir. 1996) (“whenever possible, a determination of insolvency should be based on reasonable appraisals or expert testimony”)
issues attend the formulation of the “balance sheet”. One prominent issue, for example, is whether to value assets and liabilities the same way. Read carefully, the bankruptcy code suggests not.

Section 101(32) defines “insolvency” as a “financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation [subject to the exclusion of certain property altogether]”. Thus, assets are to be considered at “fair valuation”, but debts do not carry that qualifier, or any qualifier. However, it is fair to ask whether a debt already liquidated, due and unpaid should be counted the same way as a debt that is contingent on something happening, or that might be paid by a co-obligor, especially one with greater resources than the debtor in question. Then again, “debt” is defined broadly to include “liability on a claim”. In turn, a “claim” is broadly defined to include “[a] right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured. . ..” A definition does not get any wider than that, so any right to payment, no matter how qualified or uncertain, is a “claim” for which a debtor owes a debt. So when the insolvency statute says to

422 B.R.783, 858 (Bankr. S.D. Fla. 2009) (“[t]he ‘balance sheet’ test...requires proof that the sum of the debts of a [debtor] is greater than the fair value of that [debtor’s] property”).

Although a true balance sheet is not used because accounting principles do not govern avoidance actions, comparing the referenced lists is often referred to as a “balance sheet test”. See Sierra Steel, Inc. v. Totten Tubes, Inc. (In re Sierra Steel, Inc.), 96 B.R. 275, 277 (BAP 9th Cir. 1989); Lids Corp. v. Marathon Investment Partners, L.P. (In re Lids Corp.), 281 B.R. 535, 540 (Bankr. D. Del. 2002) (“[balance sheet] may be a misnomer because the Balance Sheet Test is based on a fair valuation and not based on Generally Accepted Accounting Principles (‘GAAP’), which are used to prepare a typical balance sheet”) (citation omitted).

The Uniform Fraudulent Transfer Act draws substantially the same distinction. See UFTA § 2(a).

This construct is repeated in subsections (A) and (B) of § 101(32) relative to all entities other than municipalities.

See Lids, supra, 281 B.R. at 545-46 (“[d]ebts are measured at face value because the language, ‘at a fair valuation’ in section 101(32)(A) applies only to the valuation of assets; it does not apply to valuation of debts”) (citations omitted).

See Mellon Bank, N.A. v. MetroCommunications, Inc., 945 F.2d 635, 648 (3rd Cir. 1991) (“[i]n valuing the cost of Metro’s guaranty, the right of contribution from co-guarantors needs to be balanced against the amount of debt for which Metro is liable”).


compare assets at “fair valuation” to “debts”, has it not already accounted for qualifiers and uncertainty surrounding individual “debts”? If so, should not each debt be listed at face amount? This seems to be consistent with the statute but instinctively questionable. The debate continues in the case law.

Sometimes, courts speak casually, perhaps too casually: “The Debtor’s assets and liabilities are tallied at fair valuation to determine whether the corporation’s debts exceed its assets”. Other times, courts seemingly intend to be careful but still send mixed signals. For example, in *Lids*, the court did not reduce the face amount of publicly traded debt because “fair valuation” does not apply to debts in the definition of “insolvency”, but it *did* discount *contingent* liabilities. While facially logical, this is not apparent from the face of the statute, nor is it the only logical conclusion, that debt traded at a discount should not be discounted by the realities of its own market place while debt that may materialize at face value should be discounted because it may not. Another court first found that “fair valuation” does not apply to debts and it would not discount publicly traded debt to the market “even if we must fairly value liabilities”. Neither is valuation of liabilities based on the debtor’s fiscal distress necessarily sensible, since it might, in effect, double-count the burden of the obligation. How to count liabilities on the “balance sheet” is a struggle, indeed.

On the asset side of the ledger, the premise of valuation is at once simpler and more complicated, and there is again a lack of precision in the case law. To begin with, “fair valuation” in the statute is generally equated with other similar formulations of the concept such

---

14 *Mellon Bank, supra*, 945 F.2d at 648; *see also Briden v. Foley*, 776 F.2d 379, 382 (1st Cir. 1985) (“[t]his balance sheet test focuses on the fair market value of the debtor’s assets and liabilities within a reasonable time of the transfers”).
15 *Lids*, 281 B.R. at 546 (“[c]ontingent liabilities must also be included [but] ‘contingent liabilities must be limited to costs arising from foreseeable events that might occur while the debtor remains a going concern’”).
17 *Id.* at 197 n.7.
as “fair value” or “fair market value”.\(^{18}\) For the most part, marginal imprecision in terminology across the spectrum of cases is largely disregarded, at least on this point. The question then becomes how to determine “fair valuation”?

It is common for cases concerning insolvency determinations to begin by saying that the court first determines if the debtor was a “going concern” or “on its deathbed” at the valuation point, which is the date of the transfer in question.\(^{19}\) One could even read at least one case from a circuit court of appeals to suggest that a determination of the “going concern” or “deathbed” dichotomy is a necessary element of the legal analysis.\(^{20}\)

However, whether a debtor was a “going concern” or on its “deathbed” (or subject to any other description of fiscal status) is nowhere in any of the relevant statutes. Indeed, while numerous cases begin their analysis by identifying this dichotomy, virtually none actually perform a comparative analysis that shows how a “going concern” analysis might differ from a “deathbed” analysis.\(^{21}\) Especially puzzling is the fact that few cases even try to define either "going concern" or “deathbed”. While “going concern” is probably a more common accounting term (although even in accounting literature it has surprisingly few articulated parameters), “deathbed” obviously is not and the metaphoric picture of an emaciated skeleton is a gurney adds little to a careful legal analysis.\(^{22}\)

Hence, the careful practitioner will quickly begin to wonder about the meaning and indeed the legal significance of the going concern -- deathbed dichotomy. The uncertainty is

\(^{18}\) See Murphy v. Valencia (In re Duque Rodriguez), 75 B.R. 829, 831 (Bankr. S.D. Fla. 1987) ("'[f]air valuation' for our purposes here is distinguishable from 'fair market value'”).

\(^{19}\) See DAK Industries, supra, 170 F.3d at 1199 (“[t]o succeed in a preference action, a trustee must show, inter alia, that the debtor was insolvent at the time of the contested transaction”).

\(^{20}\) Id. ("[f]irst, the court must determine whether a debtor was a ‘going concern’ or was ‘on its deathbed’").

\(^{21}\) A rare example of a case that seems to do so is the Seventh Circuit’s decision in In re Taxman Clothing Co., Inc., 905 F.2d 166, 168-69 (7th Cir. 1990) (“the only question is whether Permut’s ‘going concern’ valuation ($215,000) is a better estimate of the value of the inventory than the price he paid at the auction in June ($110,000)").

enhanced when one realizes that virtually all courts agree that listing assets “at fair valuation” means that they must be scheduled at amounts they would bring (are predicted to bring) if sold or processed out in a reasonable time and without compulsion on the part of the hypothetical seller (i.e., the debtor).23

That is, almost all courts agree that assets must be valued as if sold, not retained in place by the debtor-owner.24 This makes it especially difficult to contemplate a “going concern value” because the assets in question are specifically not to be considered as if they are retained as part of a going concern.25 Furthermore, while it is fairly easy to think about what “going concern” means relative to a business, so that if one was considering the value of the stock of a corporation or other enterprise ownership it is easy to differentiate between the value of the business as a going concern contrasted with the business being shut down, it is not so easy to think about the “going concern value” of an asset. That is, what is the fair market value of a lathe, a conveyor belt or shelving that is not being sold by an owner-debtor who continues as a “going concern”?26

Further examination of the case law fortunately reveals that the practitioner can develop a reasonably clear answer. The trick is to avoid getting caught up in semantics because research reveals that courts do not really try to determine, or rely upon, the going concern value of assets, despite seeming to say that they are. Rather, since the one nearly universal constant is that assets

23 See e.g., TOUSA, supra, 422 B.R. at 860 (“t]o decide whether a firm is insolvent. . .a court should ask: What would a buyer be willing to pay for the debtor’s entire package of assets and liabilities. . .if the price is positive, the firm is solvent; if negative, insolvent”) (quotations omitted); Lids, supra, 281 B.R. at 541 (“a fair valuation of assets contemplates a conversion of assets into cash during a reasonable period of time”) (quotations omitted).

24 See TWA, supra, 134 F.3d at 194 (“[w]e begin our analysis by recognizing the overwhelming body of authority that makes clear that a fair valuation of assets contemplates a conversion of assets into cash during a reasonable period of time”)

25 See Roblin Indus., supra, 78 F.3d at 37 (“an appraisal based on a sale of [the asset] in place may well have substantially overstated the fair valuation”).

26 See TWA, supra, 134 F.3d at 193 (“[i]n the century that has passed since the enactment of the Bankruptcy Act of 1898, the courts have offered various statements describing how to achieve a fair valuation of assets for a going concern”).
are to be valued as if sold, the dichotomy to be considered by the valuation analyst (and counsel, and the court) is whether the hypothetical sale is to be made by a debtor who continues as a going concern while selling off its assets over a reasonable time, not to exceed the time during which the debtor can sustain itself; or if the debtor’s sale is to be by hypothetical auction, i.e., the proverbial “fire sale” that must be concluded “now” because there is functionally no business within which to house the assets pending orderly marketing.

A comparison of two cases makes the point: two debtors that were described very similarly, were labeled differently. One was a “going concern” and one was not. In Lids,27 for example, the court starts with the predicate that the debtor was a “going concern” throughout the period in question.28 In contrast, in Craftmart,29 the court found the debtor was “on its deathbed”.30 However, when one examines the debtors’ circumstances, they sound similar. Neither had turned a profit, but each maintained normal operations, continued to acquire merchandise and refrained from “going out of business” or fire sales.31 Both courts turned away from GAAP values, looking to determine what could be realized from disposition of the assets. One called this an orderly disposition resulting in fair value and one called this “liquidation”.32

From this considered review, a meaning for the “deathbed” metaphor begins to emerge. That is, if the debtor is actually shut down at the valuation point, or functionally shut down, a fire sale or auction-oriented valuation is warranted, which presumably will result in the lowest value for most things. If not, values should be used that reflect either what the assets are expected to bring in an orderly sale process where neither buyer or seller is compelled to act or, if it is

27 See note 6, supra.
28 281 B.R. at 541.
30 Id. at *4.
31 Lids, 281 B.R. at 538-39; Craftmart, supra at *3.
32 Lids, 281 B.R. at 548; Craftmart, at *4.
higher, what the asset would generate if simply processed out in approximately the same time frame. Collection of good accounts receivable and the sale of the stock-in-trade of a small retailer are two examples where “processing out” the asset is likely to bring more than selling them in bulk, even without compulsion.

**CONCLUSION**

“On its deathbed” is a phrase that has no legal or financial meaning. While it may add to the prosaic value of judicial writing, the phrase should not be given more weight than that to which it is analytically entitled. “Going concern”, on the other hand, has the potential for being credited with independent meaning but doing so adds to the confusion because assets must be valued as if sold, not as if they are retained as part of a going concern.

A valuation dichotomy exists but as this article shows, it is better defined and better deployed in analyzing a case if the dichotomy is recognized to be whether values are assigned as if the assets are sold at a fire sale auction or by means of an orderly sale process where hypothetical buyer and seller have time to negotiate over the highest and best sale price.
Is It Still New Value? Application of Section 503(b)(9) to the Subsequent New Value Preference Defense

PAUL R. HAGE AND PATRICK R. MOHAN

I. Introduction

The issue of whether the holder of an administrative expense under section 503(b)(9) of the Bankruptcy Code can use goods shipped during the 20 days prior to the petition date as subsequent new value to offset an alleged preferential transfer has troubled practitioners since the enactment of section 503(b)(9) as part of the Bankruptcy Abuse Protection and Consumer Protection Act of 2005 (BAPCPA). Although numerous opinions have been published in recent years interpreting nearly every word of section 503(b)(9), the case law provided little to no guidance on this issue until recently.

Bankruptcy courts are now facing this issue with increased frequency and a few courts have finally weighed in. Interestingly, each court interpreted the applicable statutes and reached a somewhat different conclusion. First, although not in the context of a section 503(b)(9) claim, the District Court for the Middle District of Tennessee held in In re Phoenix Restaurant Group, Inc. 1 that a creditor could not use goods subject to a similar reclamation claim as subsequent new value because such goods did not replenish the debtor’s estate. Thereafter, the Bankruptcy Court for the Middle District of Tennessee distinguished section 503(b)(9) claims from the reclamation claim discussed in In re Phoenix Restaurant Group and held that preference defendants could use invoices that would be afforded administrative expense treatment under section 503(b)(9) as subsequent new value to offset a preference in In re Commissary Operations, Inc. 2 Finally, in the most recent opinion on this topic, the Bankruptcy Court for the Northern District of Georgia held in In re TI Acquisition, LLC 3 that fully funded section 503(b)(9) claims are analogous to reclamation claims and, thus, a preference defendant could not use its 20-day invoices as subsequent new value if funds were available to pay such invoices postpetition. In reaching its conclusion, the TI Acquisition court adopted the rationale set forth in Phoenix Restaurant Group.

II. Section 503(b)(9) of the Bankruptcy Code

Section 503(b)(9) of the Bankruptcy Code grants creditors an administrative expense priority for:

the value of any goods received by the debtor within 20 days before the date of commencement of a case under [title 11] in which the goods have been sold to the debtor in the ordinary course of such debtor’s business.4
The addition of this section to the Bankruptcy Code as part of BAPCPA has dramatically changed the Chapter 11 landscape in that it elevated a group of previously general unsecured trade creditors ahead of most other priority claimants. Moreover, because section 503(b)(9) entitles such creditors to an administrative expense, such creditors must typically be paid in full, or accept alternative treatment, in order for the debtor to confirm a plan of reorganization.\(^5\)

In many recent cases where highly leveraged companies liquidate in Chapter 11 after a section 363 sale and unsecured creditors receive only pennies on the dollar, section 503(b)(9) may provide the only means for a trade creditor to recoup a portion of its losses. It appears that this was the purpose of the statute. Although the legislative history to section 503(b)(9) is limited, most commentators agree that the section 503(b)(9) was enacted to provide a degree of protection to creditors who ship goods to the debtor on credit at a time when the debtor was likely insolvent and, moreover, likely knew that it could end up in Chapter 11 in the very near future.

### III. The Subsequent New Value Defense

The subsequent new value defense, as set forth in section 547(c)(4) of the Bankruptcy Code, is one of the most frequently raised defenses to a preference action under section 547(b) of the statute. The subsequent new value defense provides, in essence, that a preferential transfer to or for the benefit of a creditor may not be avoided:

\[ \text{[T]o the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor-} \]

\[
\begin{align*}
(A) & \text{ not secured by an otherwise unavoidable security interest; and} \\
(B) & \text{ on account of such new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor}^6
\end{align*}
\]

The term “new value” is defined generally in section 547(a)(2) of the Bankruptcy Code as “money or money’s worth in goods, services, or new credit… that is neither void nor voidable by the debtor or the trustee.”\(^7\) Much like section 503(b)(9), the legislative history to section 547(c)(4) suggests that the subsequent new value defense was enacted to encourage creditors to replenish the estate by continuing to sell on credit to companies experiencing financial hardship.\(^8\)

For trade creditors, who may ship goods to a debtor on a daily basis, the new value defense (along with the ordinary course of business defense) is perhaps the best protection to the preference demand that inevitably will come once the debtor has filed its Chapter 11 petition. At the risk of grossly oversimplifying the defense, section 547(c)(4) permits creditors to reduce their preference exposure by essentially subtracting the value of the goods shipped subsequent to receipt of the preferential transfers but prior to the petition date from the aggregate preference demand amount.

### IV. Do the Goods Shipped During the 20-Day Period Still Constitute New Value?

Despite the clear mandate of section 547(c)(4), the issue of whether the holder of a section 503(b)(9) claim can still use the value of goods shipped during the 20-day period (typically reflected on an invoice issued by the creditor) as new value is not as simple as it might appear at
first glance. There are very compelling statutory and policy arguments in support of both sides of this issue.

For example, creditors would argue that the 20-day invoices fall squarely within the definition of new value set forth in the statute (which remained unchanged after the enactment of BAPCPA). Moreover, from a policy standpoint, the fact that Congress elected to give such invoices priority in payment over older invoices does not change the fact that the creditor replenished the estate at a time when the debtor was experiencing financial hardship.

On the other end of the spectrum, debtors and trustees argue that permitting a creditor to receive payment on its 20-day invoices as part of a section 503(b)(9) administrative expense and use those same invoices as new value to offset a preference allows such creditor to “double dip” with respect to the 20-day invoices, to the detriment of the estate and other creditors.

As is evidenced by the case law discussed below, a related and equally important issue is whether a creditor is entitled to use paid invoices as new value to offset a preference. The recent trend in the case law is that a creditor can use invoices that were subsequently paid as new value to offset a preference only if the subsequent payment ultimately can be avoided by the estate. Debtors and trustees would argue that a creditor should not be entitled to use its 20-day invoices as new value because the estate cannot avoid any subsequent payment that is made on account of such invoices postpetition (because any postpetition payment would have been made pursuant to a court order or upon confirmation of a plan). Based on the requirement in section 547(c)(4) and the recent case law that new value either: (i) remain unpaid by the debtor, or (ii) be paid by a transfer that can be avoided, debtors and trustees would argue, 20-day invoices that are paid pursuant to an allowed section 503(b)(9) claim simply do not fall within the scope of allowable “paid” new value. As one court noted in a slightly different context:

An unavoidable post-petition transfer on account of new value extended subsequent to a preference should limit the use of § 547(c)(4) by the amount of the unavoidable transfer, as without a reduction in the new value the transferee would be receiving double use of the new value…. There is no requirement within § 547(c)(4) which limits the universe of facts to be considered to those arising pre-petition.

On the other hand, creditors would cite to other courts who have distinguished postpetition payments when conducting a new value analysis, holding that the statutory language does in fact close the window for determining whether a transfer is avoidable, and whether subsequent invoices can be used as new value to offset such a transfer, at the petition date. One such court noted: “The plain language of § 547 closes the preference window at the petition, limiting the § 547(c)(4) defense to new value supplied and payments made before the debtor crosses into bankruptcy.” The rationale for this conclusion is that payments on potential new value invoices that are made postpetition are not made by the debtor (as required by section 547(c)(4)), but rather involve a transaction with the debtor in possession. That being the case, creditors would argue, 20-day invoices that are paid postpetition pursuant to an allowed section 503(b)(9) claim are actually deemed to remain “unpaid” for purposes of calculating the new value defense. Thus, citing the two-part test for new value set forth above, creditors may argue that they are entitled to use 20-day invoices as new value because such invoices were not actually repaid by the debtor (despite the fact that they may have been subsequently paid by the debtor in possession).
a. In re Phoenix Restaurant Group, Inc.

The first published opinion to discuss many of these arguments did not even involve a section 503(b)(9) claim but rather involved a reclamation claim, a similar creditor remedy codified both in the Uniform Commercial Code and in section 546(c) of the Bankruptcy Code. In Phoenix Restaurant Group, a supplier to the debtor asserted a timely reclamation demand in the amount of $540,048.60. Generally speaking, the reclamation statutes permit a supplier to obtain a lien in its favor on goods that it delivered during the 45 days prior to the bankruptcy filing such that it is entitled to either: (i) reclaim the goods, or (ii) obtain an administrative expense for the value of such goods. Ultimately, the goods subject to the reclamation claim in Phoenix Restaurant Group were paid for by the debtor in possession under a critical vendor order.

When the debtor commenced a preference action against the supplier, the supplier asserted the new value defense arguing that it provided new value in the form of shipped inventory, including the reclamation goods, and that such new value remained unpaid as of the petition date. The bankruptcy court held that the postpetition payment of the supplier’s reclamation invoices precluded the supplier from using such invoices as new value to offset the preference.

On appeal, the district court affirmed noting that the purpose of the new value defense was to protect suppliers that “replenish the debtor.” The district court adopted the analysis of the bankruptcy court and held that “the amount of [the supplier’s] reclamation claim could be used to deplete [its] pre-petition ‘new value’ because [it] essentially kept strings on those goods and thus, the goods subject to reclamation did not enhance [the debtor] and did not constitute ‘new value.’”

The district court reasoned:

goods shipped on the eve of bankruptcy that are subject to reclamation are not the same money or money’s worth, as goods shipped free of the seller’s strings. In the same sense that goods subject to a PACA trust do not enhance the debtor because the value of those goods is held in trust for the growers and shippers, goods subject to reclamation do not enhance the debtor to the extent the value of those goods can be reclaimed.

As such, because the supplier had the right to either: (i) reclaim the goods, or (ii) have a reclamation claim with enhanced priority over other creditors, it did not add “new value” to the debtor. Put simply, the reclamation goods did not replenish the estate as the goods were not “shipped free of the seller’s strings.” Any other result, the court determined, would be inequitable because the supplier “could count the same amount in its favor twice, and doing so would clearly place [it] ahead of other creditors, defeating the purpose of §547.”

In conclusion, the court stated:

Whatever benefit [the debtor] obtained by [the supplier’s] shipment of goods to [the debtor] was negated by [the supplier’s] right of reclamation in those same goods. Therefore, [the supplier] did not replenish the debtor in the amount of the reclamation claim, $540,000, and the bankruptcy court properly held that $540,000 did not constitute “new value” for the purpose of [the supplier’s] statutory defense under 547(c)(4).

Because of the obvious similarity between the purposes of, and relief provided under, the reclamation and § 503(b)(9) statutes, a debtor or trustee could point to Phoenix Restaurant Group as support for the proposition that a preference defendant cannot use 20-day invoices as new value if they are subsequently paid by the estate. Such goods simply do not provide the same value to the estate. Alternatively, to prevent “double dipping” on such invoices, the debtor
or trustee could insist that the creditor waive its otherwise allowable section 503(b)(9) claim to the extent it wants to use the underlying invoices as new value to offset a preference.

b. In re Commissary Operations, Inc.

Thereafter, in In re Commissary Operations, Inc., a bankruptcy court in the same judicial district as Phoenix Restaurant Group was faced with the same new value issue in the context of an administrative expense under section 503(b)(9). In that case, the Chapter 11 debtor, a wholesale distributor of food and related items to chain restaurants and restaurant franchisees, commenced bankruptcy proceedings and subsequently determined to wind down its business and liquidate its assets. Over 200 creditors asserted approximately 215 claims for allowance of administrative expenses under section 503(b)(9) of the Bankruptcy Code. The debtor then initiated adversary proceedings seeking to recover alleged preferential transfers from several of the creditors. After commencing the adversary proceedings, the debtor filed a motion for a declaratory judgment with respect to the issue of whether the 20-day invoices could be used as subsequent new value to offset the various preference actions.

The court framed the issue as follows: “whether the goods and invoices making up the pending [§ 503(b)(9)] claims may be included in the [subsequent new value] defense to a preference action.” Citing to Phoenix Restaurant Group, the debtor argued that the 20-day invoices should not be included in the subsequent new value defense because creditors would receive double value for the underlying 20-day invoices. Conversely, the creditors raised no fewer than five arguments for why such invoices should not be excluded from the new value defense analysis, including the following:

i A creditor’s ability to file a claim for a § 503(b)(9) administrative expense is distinguishable from its reclamation rights in that it arises only after the debtor files the bankruptcy petition and does not allow the creditor to seek return of its deliveries or otherwise encumber the delivered goods;

ii Any payment that a creditor may receive on a section 503(b)(9) claim necessarily occurs postpetition and, because postpetition payments are not made by the debtor (but rather the debtor in possession), any payment a creditor may receive or hope to receive cannot deplete that creditor’s new value defense pursuant to the plain language of the statute; and

iii Applying sections 503(b)(9) and 547(c)(4) so as not to limit a creditor’s new value by the amount of its section 503(b)(9) claim furthers the policy of both provisions to encourage creditors to continue to do business with a financially troubled debtor.

The court began its analysis by turning to the statutory language. The court noted that despite the apparent similarity of the statutory provisions, a creditor’s right to assert an administrative expense under section 503(b)(9) “is not linked to or conditioned upon the creditor’s separate, potential right to assert a reclamation claim against the debtor pursuant to 11 U.S.C. § 546(c).” Moreover, the remedies are different because while section 503(b)(9) affords a creditor the opportunity to receive priority in payment for goods delivered within the 20-day period before the bankruptcy filing, “it does not allow a creditor to claim a lien or otherwise repossess those delivered goods.”

The court next attempted to distinguish the district court’s holding in Phoenix Restaurant Group, noting that that court had valued the reclamation right in an amount equal to the value of the goods. As a result, the supplier in that case did not replenish the estate by providing the goods. “The same rationale,” the court found, “does not apply to § 503(b)(9) claims.”
court reasoned that with reclamation claims, the debtor is obligated to segregate and return the goods, depriving the debtor of its ability to use or sell the goods in the ordinary course of business.34 Conversely, even once a section 503(b)(9) claim is asserted, the holder is still not entitled to a lien on the goods subject to the claim and cannot demand the return of such goods.35 Rather, the claimant is only entitled to request priority payment for the value of such goods.36 Because a debtor can freely use goods subject to a section 503(b)(9) claim after the petition date, the Court reasoned, “goods shipped to and received by a debtor in the 20 days prior to bankruptcy are exactly the same ‘money or money’s worth as goods shipped free of the seller’s strings.’”37

Next, referencing a different opinion by the bankruptcy court in the Phoenix Restaurant Group case, the court found that section 503(b)(9) claims are more analogous to prepetition claims which are paid postpetition as part of a critical vendor payment.38 In that opinion, the bankruptcy court had addressed a new value defense asserted by a preference defendant who had received payment in full under a postpetition critical vendor order.39 That court had relied upon the statutory language to rule that “the preference window closed at the petition date.”40 Thus, the critical vendor was entitled to offset its preference exposure by the value of all of its subsequent shipments to the debtor, even if such invoices were ultimately paid postpetition as part of the critical vendor payment.41

Having concluded that 20-day invoices subject to an administrative expense under section 503(b)(9) are more analogous to invoices that are paid pursuant to a critical vendor order than reclamation claims, the court stated:

Obviously, critical vendors, who have been paid in full and do not receive statutory status, should not occupy a more favorable position as preference defendants than § 503(b)(9) claimants, whose administrative claims are expressly contemplated for distribution in the Code and while allowed, have not been paid.42

Thus, the court held, “because goods shipped to and received by a debtor in the 20 days prior to bankruptcy satisfy the definition of ‘new value’ in 11 U.S.C. § 547(a)(2),” and because such invoices remained unpaid at the petition date, a creditor is entitled to use such invoices as new value to offset its preference exposure, if any, especially if such invoices had not actually been paid postpetition.43

Moreover, the court continued, the possibility that the holder of an administrative expense under section 503(b)(9) might subsequently receive payment on such claim postpetition “does not remove those deliveries from the definition of ‘new value’ in 11 U.S.C. § 547(a)(2).”44 Subsequent payment for such deliveries “does not negate the value represented by the claim that the creditor provided to the debtor.”45 Regardless of payment, the court found, the deliveries benefit the bankruptcy estate because the debtor in possession:

realized the mark-up profit on the re-sale of the goods (or use of the goods incorporated into a finished product for sale, for a manufacturing or distributor debtor) and has the ability to fill an order to its customers’ satisfaction. Meeting and fulfilling the expectation of customers achieves the most important goal of a business entity—to maximize its goodwill.46

Finally, the court noted that the similar congressional policies behind the enactment of sections 503(b)(9) and 547(c)(4) supported its conclusion whereas forcing a creditor to choose between
asserting an administrative expense under section 503(b)(9) and preserving its right to assert a subsequent new value defense that includes the 20-day invoices “would work a disservice on Congress’ inherent policy goals” when enacting the respective statutes. Requiring creditors to make such a choice “would chill their willingness to do business with troubled entities” and “deprives sellers of goods of the benefits Congress conferred upon them” when it enacted the statute.

The court also found that its conclusion was supported by the fact that Congress did not amend the subsequent new value defense to provide for a reduction of new value by the amount of any section 503(b)(9) claim when it enacted BAPCPA. There is nothing in the plain language of either statutory provision, the court noted, “that indicates any Congressional intent to offset the intended benefits that 11 U.S.C. §503(b)(9) confers upon sellers through a reduction of available new value in defending a preference action.”

For all these reasons, the court held that 20-day invoices that fall within the scope of section 503(b)(9) are not disqualified from constituting new value for purposes of section 547(a)(2) and (c)(4).

c. In re TI Acquisition, LLC.

Finally, in In re TI Acquisition, LLC, the Bankruptcy Court for the Northern District of Georgia held that a preference defendant could not use its 20-day invoices as subsequent new value to offset a preference if funds were set aside to pay section 503(b)(9) claims in the bankruptcy case.

In that case, the Chapter 11 debtor, a manufacturer of carpeting and textiles, commenced bankruptcy proceedings in the U.S. Bankruptcy Court for the Northern District of Georgia. Prior to the petition date, a creditor provided the debtor with materials used in its manufacturing process. The debtor subsequently commenced an adversary proceeding to recover certain alleged preferential transfers made to the creditor. In calculating the creditor’s preference exposure, the debtor initially credited the creditor for “new value” in the form of shipments potentially subject to a claim under section 503(b)(9). However, the debtor noted that any “new value” credit was subject to a determination of the allowance of the creditor’s section 503(b)(9) claim and, if such claim was allowed, the debtor would not provide the creditor with the “new value” credit and would seek to recover the full amount of the alleged preferential transfer.

After the adversary proceeding was commenced, the court allowed the creditor’s section 503(b)(9) claim, deferring payment until the conclusion of the adversary proceeding. Funds to pay the creditor’s allowed section 503(b)(9) claim were held in reserve.

The court noted that Commissary Operations was the only published decision on point. Nevertheless, the court immediately sought to distinguish that case by noting:

While that court contemplated whether a payment of a § 503(b)(9) claim would affect the available of a § 547(c)(4) new value defense, it does not appear from the reported decision that any payment, or reservation for payment, had been made on any § 503(b)(9) claims at the time the court issued its decision. The Commissary Operations decision, therefore, is informative but is not based on the precise facts before this Court.

Like the Commissary Operations court, the court began its analysis of the interplay between section 547(c)(4) and section 503(b)(9) by comparing section 503(b)(9) claims to two other types of claims allowed under the Bankruptcy Code: (i) reclamation claims, and (ii) claims paid postpetition pursuant to a critical vendor order. Citing to the Phoenix Restaurant Group
decision, the court stated that goods subject to a reclamation demand do not constitute new value because a reclamation creditor keeps “strings” on the goods after shipment. The court noted that in light of the similarity between section 503(b)(9) and reclamation claims, “it is unsurprising that courts look to the treatment of reclamation claims in § 547 actions when considering the treatment of § 503(b)(9) claims.” Thereafter, the court concluded that a creditor’s right to recover goods subject to a reclamation demand is similar to the administrative status given for the value of goods shipped during the 20-day period under section 503(b)(9) of the Bankruptcy Code. The court noted that the Commissary Operations court had sought to distinguish section 503(b)(9) claims from reclamation claims by focusing “on the liens reclamation creditors have on the goods delivered” instead of the enhanced priority afforded to holders of both types of claims. The court disagreed with that court’s approach, finding that although section 503(b)(9) claims may be distinguishable from reclamation claims on the basis that section 503(b)(9) claimants face the risk that an estate may be administratively insolvent (a risk that reclamation creditors do not need to worry about because they can simply take back their goods), the section 503(b)(9) claims in the present case were fully funded through reserves and, thus, were “not any more vulnerable than a reclamation creditor’s [claims].”

The court noted another distinction between section 503(b)(9) claims and reclamation claims, namely that section 503(b)(9) claims do not exist prepetition, whereas reclamation claims are state law claims that exist when a debtor is insolvent, irrespective of whether bankruptcy proceedings have been commenced. Although this distinction may be relevant in some circumstances, the court concluded, such differences were irrelevant in the instant matter because estate funds were set aside to pay the creditor’s allowed section 503(b)(9) claim in full. Thus, as in the case of goods that are reclaimed by a creditor, “it is clear that the estate was not enhanced by the ‘new value’” that was provided. As such, despite the holding in Commissary Operations, the court concluded that section 503(b)(9) claims are more analogous to reclamation claims when such claims have been or will be paid in full.

Next, the court compared section 503(b)(9) claims to critical vendor claims. The Court found only three other cases wherein critical vendor claims were considered in relation to the subsequent new value defense. In two of those cases, the court noted, the courts allowed the assertion of the new value defense when the new value had been paid as a result of a critical vendor order entered early in the life of the Chapter 11 case. In the third case, Commissary Operations, the court noted, that court was concerned that if the allowance of a section 503(b)(9) claim was viewed as a bar to the assertion of the new value defense, then critical vendors, whose claims were given priority status via court orders, would be given better treatment than section 503(b)(9) claimants, whose claims are statutorily favored.

The court found that payment pursuant to a critical vendor order differs markedly from the statutory payment accorded to section 503(b)(9) claims. Citing to Phoenix Restaurant Group, the court noted that “critical vendor” orders afford the debtor-in-possession “a great deal of latitude in negotiating the terms and conditions of ‘critical vendor’ status while conditioning the designation as a ‘critical vendor’ on the creditor’s agreement to provide post-petition credit to the debtor-in-possession.” In particular, one of the conditions of critical vendor treatment that can be negotiated is how to address a critical vendor’s potential preference liability. In short, whereas critical vendor treatment allows the debtor-in-possession room to negotiate, section 503(b)(9) affords no such room. Further, payments to section 503(b)(9) claimants are mandatory under the Bankruptcy Code whereas critical vendor motions are subject to approval
of a bankruptcy court. Thus, the court found, “[i]t is appropriate to distinguish between payments pursuant to § 503(b)(9) and payment pursuant to critical vendor orders.”

As additional support for its conclusion that section 503(b)(9) claims are more analogous to reclamation claims than they are to critical vendor claims, the court raised the paid vs. unpaid new value issue discussed above. The court noted that there are two prevailing approaches with respect to the new value defense, the “remains unpaid” approach (wherein a creditor can only use unpaid new value) and the “subsequent advance” approach (allowing both paid and unpaid new value so long as the payment on the new value itself was an avoidable transfer). The court noted that the subsequent advance approach, unlike the remains unpaid approach, “essentially follows the text of the [Bankruptcy Code].” Although other courts have described the Eleventh Circuit as supporting the remains unpaid approach, the court noted that it was “unclear whether the Eleventh Circuit officially has adopted the remains unpaid approach.”

Regardless, the court determined that based on the nature of the section 503(b)(9) claims and the reserve account intended to fund such claims, either approach would lead to a reduction in the creditor’s new value approach. Under the remains unpaid approach, the court found that “postpetition payment of [the creditor’s] § 503(b)(9) claim would deplete [the creditor’s] new value defense.” Likewise, the creditor’s new value defense would be reduced under the subsequent advance approach because fully funded section 503(b)(9) claims, like reclamation claims, do not replenish the estate since the debtor is denied the uninhibited use of the new value.

Finally, like the Commissary Operations court, the court considered the policies behind the subsequent new value defense and how best to achieve those policies when dealing with section 503(b)(9) claims. The court noted that there are two primary policy considerations behind the subsequent new value defense. “The first objective is to encourage creditors to continue extending credit to financially troubled entities while discouraging a panic-stricken race to the courthouse.” The second objective, the court found, “is to promote equality of treatment among creditors.” The new value exception, the court explained, “fosters these objectives because it limits the defense to the extent by which the bankruptcy estate has been enhanced by the creditor’s actions.”

With respect to the first objective of the new value defense, the court agreed that the availability of the new value defense encourages continued commerce with distressed entities. However, prepetition creditors are rarely aware of whether a company to which it ships goods will commence a bankruptcy proceeding within 20 days of shipping. Therefore, a creditor cannot know that it may be able to assert a section 503(b)(9) claim. That being the case, the court noted, the incentive to do business with distressed entities is not influenced by the possibility of creditors losing the availability of the new value defense as a result of a section 503(b)(9) claim. Further, as in the present case, when creditors are paid in full or funds are reserved for payment in full for section 503(b)(9) claims, section 503(b)(9) itself functions as a means of encouraging continued business with a debtor. In short, denying a creditor the right to use its 20-day invoices as new value, the court held, is not inconsistent with the first policy consideration because creditors are encouraged to continue extending credit to a financially troubled entity by the requirement in the Bankruptcy Code that it will receive an administrative expense for its 20-day invoices.

Turning to the second policy consideration, the court concluded that providing a creditor with full payment of its section 503(b)(9) claim and allowing the estate to recover preference payments in full is the best way to promote the equal treatment of creditors because it gives the
section 503(b)(9) claimant full value for its claim, “but only does so one time.” Conversely, the court found:

Allowing BOTH new value credit and payment of the § 503(b)(9) claim elevates the claim of that creditor and results in double payment to that creditor. The estate then must pay the allowed administrative claim and would be unable to recover a preference payment that would otherwise be available for distribution to other creditors.

Thus, the court held, much like the treatment accorded to reclamation claimants, “a creditor that delivered goods to the debtor prepetition is not entitled to the new value defense under § 547(c)(4) when that creditor has been paid in full by a § 503(b)(9) claim.” Interestingly, in so concluding, the court noted: “If the estate were administratively insolvent, there may be no basis to hold that the claim was paid and the decision of the Court might be different.” Because the funds were reserved to pay the creditor’s section 503(b)(9) claim, however, the court found that it would be inequitable and contrary to the statute to allow the new value defense to be used for the 20-day shipments.

V. Conclusion

Until other courts weigh in on these issues, it will remain unclear whether, and to what extent, a preference defendant can use goods subject to an allowed section 503(b)(9) claim as subsequent new value to offset a preference. Clearly there is much to debate. In any event, it is important that practitioners who represent both debtors and creditors alike are familiar with the issues and opinions discussed above. Creditors will want the bankruptcy court to adopt the Commissary Operations approach, thereby allowing them to obtain an allowed section 503(b)(9) claim without having to worry about whether they are increasing their future preference exposure in doing so. Conversely, debtors and trustees will likely use TI Acquisition as leverage to increase the preference recovery to the estate, especially in cases where funds can be set aside to pay allowed section 503(b)(9) claims in full.

NOTES
1. In re Phoenix Restaurant Group, Inc., 373 B.R. 541 (M.D. Tenn. 2007).
5. See 11 U.S.C.A. § 1129(a)(9) which mandates that the court shall confirm a plan of reorganization only if “the plan provides that—
   (A) with respect to a claim of a kind specified in section 507(a)(1) or 507(a)(2) of this title, on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to the allowed amount of such claim”
6. 11 U.S.C.A. § 547(c)(4)
12. Bellanca Aircraft, 850 F.2d at 1284.
15. Phoenix Restaurant Group, 373 B.R. at 545.
17. Phoenix Restaurant Group, 373 B.R. at 547.
18. Phoenix Restaurant Group, 373 B.R. at 547.
22. Phoenix Restaurant Group, 373 B.R. at 548.
23. Phoenix Restaurant Group, 373 B.R. at 549.
30. Commissary Operations, 421 B.R. at 877 (citing In re Ames Dept. Stores, Inc., 582 F.3d 422, 424 n.2, 52 Bankr. Ct. Dec. (CRR) 23, Bankr. L. Rep. (CCH) P 81582 (2d Cir. 2009), cert. denied, 130 S. Ct. 1527, 176 L. Ed. 2d 151 (2010) (Congress “amended section 546(c)(2) to provide that ‘[i]f a seller of goods failed to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9)’

34. Commissary Operations, 421 B.R. at 878.
42. Commissary Operations, 421 B.R. at 878.
44. Commissary Operations, 421 B.R. at 878.
47. Commissary Operations, 421 B.R. at 879.
53. TI Acquisition, 2010 WL 1993848.
54. TI Acquisition, 2010 WL 1993848.
55. TI Acquisition, 2010 WL 1993848.
56. TI Acquisition, 2010 WL 1993848.
57. TI Acquisition, 2010 WL 1993848.
58. TI Acquisition, 2010 WL 1993848.
59. TI Acquisition, 2010 WL 1993848.
61. TI Acquisition, 2010 WL 1993848 at *3.
62. TI Acquisition, 2010 WL 1993848 at *3.
Spotlight on My Chi To  
Recipient of the  
Kathryn R. Heidt Memorial Award

At the Fall Meeting of the ABA Section of Business Law Business Bankruptcy Committee in New Orleans, Michael St. Patrick Baxter, Chair of the Committee, awarded the annual Kathryn R. Heidt Memorial Award to New York attorney My Chi To.

My Chi To is a partner at Debevoise & Plimpton LLP and a member of the firm’s Bankruptcy & Restructuring Group. She has experience representing debtors, creditors and investors in complex restructurings, bankruptcies and acquisitions of troubled companies. Ms. To advises a wide range of clients in connection with second-lien, mezzanine and real estate financings and restructurings.


Ms. To is a Fellow of the American College of Investment Counsel, and a member of the Association of the Bar of the City of New York. She is active in the ABA Business Bankruptcy Committee, where she is Vice-Chair of the Sub-Committee on Partnerships and Limited Liability Entities in Bankruptcy. She is a Board member of the Asian American Law Fund of New York, Inc.
Ms. To joined the firm in 1998 and became a partner in 2005. She received her LL.L. and LL.B. from the University of Ottawa in 1994 and 1995, respectively. From 1995 to 1996, Ms. To served as a Law Clerk to the Honorable Claire L’Heureux-Dubé, Supreme Court of Canada. In 1998, she received an M.Phil. in Politics from the University of Oxford, where she was a Rhodes Scholar. Ms. To is bilingual in French and English.

When receiving the award, Ms. To noted that Kate Heidt “deeply touched many people,” and it was obvious that she was “really loved on a personal level and respected on a business level.” Ms. To stated Kate Heidt “exemplified what it means to be a good person,” and she will strive to emulate Ms. Heidt.

**Background of the Award**

Kate died unexpectedly in May of 2005 at the age of 51. At the time of her death, she was the chair of the ABA Section of Business Law’s Business Bankruptcy Committee. This memorial award honors Kate’s memory. Kate was a tenured member of the faculty at the University of Pittsburgh School of Law. She was an accomplished author, scholar, teacher, lawyer, and administrator. In addition to her leadership roles at the ABA, she served in leadership capacities at the American Association of Law School’s Section on Creditors’ and Debtors’ Rights. She was a counselor in the truest sense of the word -- a wonderful mother, a friend to many, a dedicated mentor to students and young lawyers, and a trusted voice of wisdom. She left us too soon. This Award is designed to serve as a lasting tribute to all she was and all for which she stood and to recognize the importance of bankruptcy education and scholarship to the ABA Business Bankruptcy Committee and the bankruptcy profession.

In order to be eligible to receive the Kathryn R. Heidt Memorial Award, individuals must meet the following criteria:

- Be an attorney or law student;
- Be a member of the ABA;
- Be under age 40;
- Either have published a recent article on a bankruptcy related topic in an ABA sponsored publication or have produced a significant report, study, or other work product in conjunction with service on the ABA Business Bankruptcy Committee, a subcommittee of the ABA Business Bankruptcy Committee, or task force of the ABA Business Bankruptcy Committee;
- Have demonstrated leadership potential within the ABA or the larger legal community; and
- Have displayed generosity of spirit.