**Does a Critical Vendor Lose Its New Value Defense to a Preference Action?**

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If the vendor has a pre-petition claim and is selected as a critical vendor, does that vendor lose its new value defense for the invoices paid under the critical vendor order? B&B recently encountered the issue while defending a vendor in the Delaware bankruptcy court. Judge Sontchi decided the issue this week and the result is a big win for creditors.

**The Bankruptcy Preference Law**

The Bankruptcy Code vests the trustee with far reaching powers to avoid transfers and transactions prior to a bankruptcy filing. The power to avoid preferential transfers is out of the trustee's most potent weapons, and the Bankruptcy Code defines a preferential transfer expansively to include nearly every transfer by an insolvent debtor during the preference period. Vendors are discouraged from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. A debtor is deterred from preferring a vendor by the requirement that any vendor that receives a greater payment than similarly situated vendors disgorge the preference so that like vendors receive an equal distribution of the debtor's assets.

Not all transfers made within the preference period may be recaptured. One of the most effective and commonly used preference defenses used by a vendor is the subsequent new value or subsequent advance rule, which excludes from recapture those payments to a vendor who subsequently extends goods or services (or credit for those goods or services) to the debtor.

**Beating the Preference Lawsuit: The Subsequent New Value Defense**

The subsequent advance rule has its most frequent application where a vendor provides goods or services on open account and the debtor pays the vendor at various points during the preference period. Congress intended to protect the open account vendor with the subsequent

new value rule. Under this analysis, a single transfer during the preference period is not analyzed in isolation from the overall course of business between the vendor and debtor, as the basis for maintaining the open account is the debtor's entire financial picture and not the debtor's most recent payment.

The objectives of the subsequent new value rule are: (1) to encourage a vendor to continue to extend credit to financially troubled debtor, possibly helping the debtor avoid bankruptcy; (2) to promote equality among vendors; and (3) to reward vendors who actually enhance the estate during the preference period. Without the exception, a vendor who continues to extend credit to the debtor would merely be increasing its bankruptcy loss and in effect be punished for continuing to work with the debtor.

**Application of the Subsequent New Value Defense**

As a hypothetical, on January 1 the debtor gives an unsecured vendor a check for $10,000 for goods supplied. On January 5, the vendor provides the debtor an additional $10,000 in goods on open account (no purchase money security interest is taken in the goods). On February 1 the debtor files bankruptcy. The January 1 payment, made within 90 days before the bankruptcy filing, may be recaptured as a preference assuming that the criteria for the preference law were met. However, because the subsequent advance of goods by the vendor replenished the bankruptcy estate, the subsequent new value rule permits the vendor to reduce its January 5 advance against the preference, and does not have to disgorge the payment. But what if the court approves the debtor's critical vendor motion and the debtor pays the vendor for the January 5 shipment pursuant to the order? Does the vendor lose its new value defense?

**Friedman's v. Roth Staffing**

During the preference period, Friedman's paid $81,997.57 to Roth.  Subsequently, but before the bankruptcy, Roth provided $100,660.88 of services to Friedman's for which Roth was not paid.  Through the approval of a wage motion, the Court authorized Friedman's to pay Roth for pre-petition staffing services and Roth was paid $72,412.71.

In February of 2009, Friedman's filed a complaint against Roth to recover $81,997.57 as a preference.  Friedman's filed a motion for summary judgment, arguing that post-petition payment under the motion relates back to the preference period and reduces the amount of Roth's subsequent new value defense from $100,660.88 to $28,248.17, leaving a preference claim of $53,749.40.

The issue before the court is whether or not the post-petition payment of pre-petition new value affects the preference defense.  The parties disagree as to whether calculation is "fixed" as of the petition date (our position), or remains subject to post-petition events such as payments made to Roth under the motion (Friedman's position).

In resolving this issue, the Court cites the Third Circuit's holding in *New York City Shoes, Inc. v. Bentley International Inc.*  Although the Circuit did not address this particular issue in this case, their definition of the subsequent new value defense is relevant and compels the conclusion that the "fixed" approach is correct. The Circuit held that one of the three elements of the subsequent new value defense is that the debtor must not have fully compensated the creditor for the "new value" **as of the date that it filed its bankruptcy petition**.  The inclusion of the last clause implicates that subsequent provision or payment of new value doesn't affect preference analysis even if the debtor completely compensates the creditor for its pre-petition claim.  It clearly supports fixing the entirety of the preference analysis as of the petition date.

The Delaware court held that the filing of bankruptcy "fixes" the preference analysis as of petition date, and the Court denied Friedman's motion for summary judgment.

The decision clearly provides comfort and extra motivation for creditors to agree to continue to provide post-petition goods or services under a critical vendor motion.  How does this ruling effect a vendor's new value defense in relation to 503(b)(9)? I will examine the issue thoroughly in my next article, but it certainly could have an impact.