A-&-P, 1-2-3:
Two Wins and One Quagmire from Recent Preference Decision

Business CREDIT
APRIL 2024

IN JANUARY 2024, THE UNITED STATES BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK ISSUED AN OPINION IN THE *THE GREAT ATLANTIC & PACIFIC TEA COMPANY, INC.* BANKRUPTCY CASE THAT TACKLED THREE FASCINATING PREFERENCE-RELATED ISSUES. TRADE CREDITORS GOT A COUPLE OF WINS, AND ONE INTERESTING QUAGMIRE TO PONDER OVER.

The two wins? First, the Bankruptcy Court held that a preference defendant can successfully invoke the subsequent new value defense even if the subsequent new value was paid before the bankruptcy filing. Second, the Bankruptcy Court held the defendant may setoff its allowed administrative expense priority claim for the goods sold to and received by the debtor in the 20 days before the bankruptcy filing (a 503(b)(9) claim, discussed below) against any preference liability.

The quagmire? The Bankruptcy Court rejected the defendant's argument that its claim arising under section 502(h) of the Bankruptcy Code for amounts recovered as a preference should be entitled to section 503(b)(9) priority to the extent the preference payments were on account of goods sold and delivered to the debtor during the 20 days before the bankruptcy filing. The court held that claim should instead be treated as a low priority, prepetition general unsecured claim.

This begs the question: is accepting payment during what may be the 20-day period before a bankruptcy filing worth potentially losing a 503(b)(9) claim if the payment is recovered as a preference? The logical answer: take the payment. A bird in the hand is worth a 503(b)(9) claim in the bush! A creditor most likely won't know precisely when a customer will file for bankruptcy and therefore may not know in real time whether the parties are in the 20-day period before the filing, and, as such, the amount of the creditor's 503(b)(9) claim. Also, 503(b)(9) claims are not always paid in full and any payment may be delayed for a considerable amount of time after the bankruptcy filing.

THE 503(B)(9) CLAIM: A PRIMER

Section 503(b)(9) grants a trade creditor an administrative expense priority claim (a "503(b)(9) claim") for goods sold on credit and received by a customer within the 20 days before the customer's bankruptcy filing. This elevates what would otherwise be a general unsecured claim at the bottom of the bankruptcy claims priority ladder to an administrative claim near the top of the claim's priority ladder. A debtor must generally pay all administrative claims in order to confirm a Chapter 11 plan and exit chapter 11.

PREFERENCE CLAIMS: THE ELEMENTS AND DEFENSES

Section 547(b) of the Bankruptcy Code establishes a statutory cause of action by a debtor, trustee or other estate fiduciary in a bankruptcy case to recover, as a "preference," certain transfers by a debtor to a creditor before the bankruptcy filing. The plaintiff must prove all of the following to avoid and recover a pre-petition transfer as a "preference:"

1. The debtor had transferred property of the debtor's estate (such as a debtor's payment from its bank account);
2. To or for the benefit of a creditor;
3. On account of an antecedent debt (based on credit extended to a debtor so cash in advance payments are not preferences!);
4. On or within the 90 days before the bankruptcy filing (or within a year before the filing, if the transfer was to an "insider");

5. While the debtor was insolvent (which is presumed during the 90-day preference period); and
6. Enabled the creditor to recover more than the creditor otherwise would have received in a hypothetical Chapter 7 bankruptcy case.

Section 547(c) of the Bankruptcy Code arms creditors with affirmative defenses they can assert to minimize or eliminate preference liability where the plaintiff has otherwise proven the elements of a preference claim (*see* cheat sheet below). The affirmative defenses are intended to encourage creditors to continue doing business with and extending credit to financially distressed customers.

The subsequent new value defense was at issue in the *A&P* case. Also at issue was the defendant's right to setoff unpaid and allowed administrative expense claims (the defendant's 503(b)(9) claim) to reduce preference liability on a dollar-for-dollar basis. Notably, there must be "mutuality" to effectuate a setoff—that is, the claim owing to the creditor and the claim owing to the debtor's estate must have both arisen before the bankruptcy filing or must have both arisen after the bankruptcy filing (i.e., a prepetition claim cannot be setoff against a post-petition claim). In addition, the Bankruptcy Court in the *A&P* case grappled with the defendant's right to invoke section 502(h) of the Bankruptcy Code to assert a claim against the bankruptcy estate for the amount recovered as a preference. Section 502(h) provides for the allowance of a claim arising from such recovery as if such claim had arisen before the date of the bankruptcy filing.

RELEVANT BACKGROUND REGARDING THE A&P DECISION

A&P and its affiliates (collectively, "A&P") filed Chapter 11 bankruptcy cases on July 19, 2015. McKesson Corporation had supplied A&P with prescription and OTC drugs, health and beauty aids, and sundries pursuant to a prepetition supply agreement between the parties. McKesson filed a proof of claim, asserting a 503(b)(9) claim for at least $1.75 million against A&P. McKesson's proof of claim also stated that "to the extent any of the payments received by McKesson during the Administrative Claim Period are determined to be avoidable as a preference or otherwise, McKesson's administrative expense (503(b)(9)) claim should be increased by that amount."

The Creditors' Committee appointed in the Chapter 11 cases filed a complaint seeking to avoid and recover approximately $67.8 million in alleged preference payments by A&P to McKesson during the 90 days before the Chapter 11 filing.

After McKesson filed an answer and the parties engaged in an initial round of discovery, McKesson filed a motion for summary judgment seeking a ruling that the alleged preference payments were shielded by various preference defenses, including the subsequent new value and setoff defenses. At a hearing held on September 16, 2019, the court granted the motion, in part, holding that McKesson had the right to setoff any allowed 503(b)(9) claim against any judgment for avoidance and recovery of preferential transfers.

After further discovery, McKesson filed another motion for summary judgment. McKesson argued that:

- Subsequent new value during the preference period totaling approximately $58.8 million protected all but six of the alleged preference period payments; and
- Of the six remaining alleged preference payments, five were on account of goods delivered to A&P during the 20 days before the bankruptcy filing, and McKesson's 503(b)(9) claim should be increased by the amount avoided as a preference pursuant to section 502(h) of the Bankruptcy Code. McKesson then sought to set off this additional 503(b)(9) priority claim dollar-for-dollar against any preference liability.

The Committee opposed summary judgment, arguing that:

- The subsequent new value defense should not be available to McKesson because A&P

AFFIRMATIVE DEFENSES ARE INTENDED TO ENCOURAGE **CREDITORS TO CONTINUE DOING BUSINESS WITH AND EXTENDING CREDIT TO FINANCIALLY DISTRESSED CUSTOMERS.**

PREFERENCES: THE AFFIRMATIVE DEFENSES CHEAT SHEET

Affirmative Defense	Description
Contemporaneous Exchange of New Value	*Payment was intended to be a contemporaneous exchange of new value (e.g., a COD transaction) and in fact was a **substantially contemporaneous** exchange.*
Subsequent New Value	*Creditor provided new value (e.g., extensions of credit, such as goods sold on credit) to the debtor **after receiving the preferential transfer**, thereby entitling the creditor to a dollar-for-dollar reduction in preference liability based on the amount of new value provided.*
Ordinary Course of Business	*Transfer was payment of a **debt incurred in the ordinary course of business or financial affairs of the debtor and creditor, and*** • *Made in the ordinary course of business or financial affairs of the debtor and the creditor (the "**subjective**" test), **or*** • *Made according to ordinary business terms (the "objective" test).*

had paid many of the invoices relating to the subsequent new value provided. The Committee also argued that McKesson was inequitably seeking a "double payment" by asserting the subsequent new value defense while simultaneously seeking full payment of its 503(b)(9) claim arising from the subsequent new value McKesson had provided during the 20 days before the bankruptcy filing.

- McKesson could not setoff any of its 503(b)(9) claim against its preference liability because there is no mutuality where McKesson's 503(b)(9) claim arose prepetition while the preference claim arose post-petition.
- McKesson could not assert a 503(b)(9) claim as part of its claim under section 502(h) for payments recovered as a preference on account of goods delivered during the 20 days before the bankruptcy filing. Section 502(h) states that the claim for recovered payments is treated as if it had arisen prepetition—therefore, 502(h) creates a low priority general unsecured claim.

THE BANKRUPTCY COURT'S RULING

The Bankruptcy Court distilled the dispute down to three issues:[1]

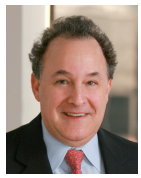
1. Could McKesson include new value that was paid prepetition as part of its subsequent new value defense?
2. Could McKesson setoff its 503(b)(9) claim against preference liability?
3. Was McKesson's section 502(h) claim for amounts recoverable as a preference entitled to 503(b)(9) priority to the extent the preference payments were on account of goods sold and delivered during the 20 days before the bankruptcy filing?

The Bankruptcy Court held that subsequent new value need not remain unpaid in order to be applied against preference liability. The U.S. Court of Appeals for the Second Circuit (which governs the Southern District of New York, where the *A&P* case is pending) has not ruled on the issue, and there is a split on the issue among the lower courts in the Second Circuit. So, the Bankruptcy Court was persuaded to follow the majority of Circuit-level courts that have addressed the issue (the Fourth, Fifth, Eighth, Ninth and Eleventh Circuits), which hold the subsequent new value defense may include paid new value.

The Bankruptcy Court declined to revisit its earlier ruling that McKesson could setoff an allowed 503(b)(9) claim against any judgment for avoidance and recovery of preferential transfers. The court relied on prior decisions by the Delaware bankruptcy court that mutuality exists between an administrative expense claim (e.g., a 503(b)(9) claim) and a preference claim because both claims arise post-petition by operation of the Bankruptcy Code (even though the facts that gave rise to a 503(b)(9) claim and preference claim occur prepetition).

However, McKesson wasn't as fortunate regarding its section 502(h) claim. The Bankruptcy Court focused on the language of section 502(h) in holding that a claim asserted pursuant to section 502(h) is not entitled to 503(b)(9) priority. The Bankruptcy Court relied heavily on the fact that section 502(h) states that the allegedly preferred creditor is entitled to a *prepetition* claim, not a post-petition claim, for any preference recovery. The Bankruptcy Court held that while it is "sympathetic" to the argument that section 502(h) should put McKesson in the position it would have been in had the preference payment not been made (holding a 503(b)(9) claim), the court could not contradict its own holding with respect to setoff—if a 503(b)(9) claim is a post-petition claim for purposes of mutuality for setoff, then it cannot also be a prepetition claim in the context of section 502(h). BC

1 The Bankruptcy Court only addressed the issues discussed in this article. The Bankruptcy Court did not rule on various issues of fact, such as the amount of McKesson's subsequent new value defense, the allowed amount of McKesson's 503(b)(9) claim, and the amount of any setoffs A&P may assert. The Bankruptcy Court also did not rule on McKesson's ordinary course of business defense to the preference claims.



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