Preference Action Mock Hearing

Litigants:

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Judges:

Hon. Dennis R. Dow
U.S. Bankruptcy Court (W.D. Mo.); Kansas City

Hon. Bruce A. Harwood
U.S. Bankruptcy Court (D. N.H.); Manchester

Hon. August B. Landis
U.S. Bankruptcy Court (D. Nev.); Las Vegas

UNITED STATES BANKRUPTCY APPELLATE PANEL
FOR THE CIRCUIT OF FIRST IMPRESSION

In re: Damp Dog, Inc.,	)	**Chapter 11**
Debtor.	)	
_____	)	
Damp Dog, Inc.,	)	
Plaintiff,	)	
v.	)	
Moustache Wax, Inc.,	)	
Defendant.	)	
_____	)	

PLAINTIFF'S BRIEF REGARDING THE VARIOUS DEFENSE ISSUES PRESENTED ON APPEAL

I. Ordinary Course of Business – Section 547(c)(2)(A)

A. The "Subjective" Ordinary Course of Business Defense is Not Available to the Defendant Because the Parties' Relationship was Not Long Enough to Establish a Benchmark for the Defense.

Avoidance of preferential transfers "promotes the 'prime bankruptcy policy of equality of distribution among creditors' by ensuring that all creditors of the same class will receive the same pro rata share of the debtor's estate . . . [as well as] discourages creditors from attempting to outmaneuver each other in an effort to carve up a financially unstable debtor and offers a concurrent opportunity for the debtor to work out its financial difficulties in an atmosphere conducive to cooperation."*Morrison v. Champion Credit Corp. (In re Barefoot),* 952 F.2d 795, 797-798 (4th Cir. 1991). Pursuant to Section 547(g), the trustee has the burden of proving the

avoidability of a transfer under § 547(b), and the creditor against whom recovery is sought has the burden of proving the nonavoidability of the transfer under § 547(c). 11 U.S.C. §547(g).

The defendant bears the burden of proving, by a preponderance of the evidence, that each payment satisfies one of the requisite section 547(c)(2) subsections. *Advo-System, Inc. v. Maxway Corp.*, 37 F.3d 1044 (4th Cir. 1994). "This inquiry is 'peculiarly factual.'" *Jeffrey Bigelow Design,* 956 F.2d 479, 486 (4th Cir. 1992).

Section 547(c)(2) of the Bankruptcy Code shields from recovery otherwise preferential payments that were made in "the ordinary course of business":

> The trustee may not avoid under this section a transfer . . . (2) to the extent such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (B) made according to ordinary business terms[.]

11 U.S.C. § 547(c)(2).

The purpose of the ordinary course of business exception is "to leave undisturbed normal financial relations which do not entail any unusual action taken by either the debtor or the creditor." *Harman v. First Am. Bank (In re Jeffrey Bigelow Design Group, Inc.)*, 956 F.2d 479, 487 (4th Cir. 1992). The ordinary course of business defense is narrowly construed. *See, e.g., Hasset v. Altai, Inc. (In re CIS Corp.)*, 214 B.R. 108, 119-20 (Bankr. S.D.N.Y. 1997); *In re Interstate Bakeries Corp.*, No. 09-4177, 2011 WL 96815 (Bankr. W.D. Mo. Jan. 12, 2011).

The Bankruptcy Code does not define the phrase "ordinary course of business." The legislative history discussing Section 547(c)(2) simply states that the "purpose of this exception is to leave undisturbed normal financial relations, because [permitting the continuation of normal relations] does not detract from the general policy of the preference section to discourage

unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." S. Rep. No. 989, 95th Cong., 2d Sess. 88 (1978), quoted in *Siegel v. Russellville Steel (In re Circuit City Stores, Inc.),* 479 B.R. 703, 707 (Bankr. E.D.Va. 2012). The "focus of [the] inquiry must be directed to an analysis of the business practices which were unique to the particular parties under consideration. . ." (quoting *Waldschmidt v. Ranier* (*In re Fulghum Constr. Corp.*), 872 F.2d 739, 743 (6th Cir. 1989)). *Id.*

The primary factors under section 547(c)(2)(A) include: (1) the length of time the parties engaged in the type of dealing at issue, (2) whether the subject transfer was in an amount more than usually paid, (3) whether the payments were tendered in a manner different than previous payments, (4) whether there appears to be any unusual action by the creditor or the debtor to collect on or pay the debt, and (5) whether the creditor gained an advantage in light of the debtor's deteriorating financial condition. *Troisio v. E.B. Eddy First Products Ltd, (In re Global Tissue)*, 302 B.R. 808, 812 (D. Del. 2003), *aff'd*, 106 Fed. App'x 99 (3d Cir. 2004). *See* 5 *Collier Bankruptcy Manual* ¶ 547.04[2][a] (3rd rev. ed. 2014).

The first step in this analysis is to establish a baseline course of dealing, with which the court will compare the parties' practices during the preference period to those in which they engaged prior thereto. *Conti v. Sampson-Blade Oil Co. (In re Clean Burn Fuels, LLC)*, 2014 WL 2987330 at **6-8 (Bankr. M.D.N.C. July 1, 2014); *Siegel*, 479 B.R. at 710. This baseline should take into account the entire course of dealings between the parties. *Brown v. Shell Canada Ltd. (In re Tennessee Chemical Co.)*, 112 F.3d 234, 237 (6th Cir. 1997); *Siegel*, 479 B.R. at 708-09.

A threshold inquiry is whether the parties' relationship prior to the preference period was long enough to establish a meaningful baseline against which to compare their preference period dealings. Some courts have held that, in the absence of any prior course of dealing, the transferee cannot satisfy the subjective test. *In re Allegheny Health, Educ. & Research Found.*, 292 B.R. 68, 84

(Bankr. W.D. Pa. 2003); *In re Brown Transport Truckload, Inc.*, 152 B.R. 690, 692 (Bankr. N.D. Ga. 1992). See, *In re Russell Cave Co., Inc.*, 259 B.R. 879 (Bankr. E.D. Ky. 2001); *In re Winters*, 182 B.R. 26 Bankr. E.D. Ky. 1995).

As several courts have held that the historical benchmark must be based on the parties' transactions prior to the debtor's insolvency, relationships of less than a year prior to the preference period often preclude the defendant from invoking the subjective ordinary course defense. *Circuit City Stores, supra,* 479 B.R. at 710, citing to *Advo-System, Inc. v. Maxway Corporation,* 37 F.3d 1044, 1047 (4th Cir. 1994).

Here, the parties' relationship began in March, 2013, only six months prior to the commencement of the preference period, and at or about the time that the debtor became insolvent. Thus, the parties' relationship was too short to establish a meaningful baseline of dealings, and defendant is precluded from employing the subjective ordinary course defense to shield the transfers from avoidance.

B. The $800K "Catch-up" Payments Made in Accordance with the Parties' Pre-Preference "Restructuring" Agreement and the Payments Made Pursuant to New, More Restrictive Invoice Terms Were Not "Ordinary" in Comparison to the Parties' Historical Course of Dealing.

If the length of the parties' pre-preference period relationship is sufficient to establish a baseline course of dealings, then the court will compare the parties' preference period conduct to their baseline conduct. Some courts have stated that if any one factor is "compellingly inconsistent" with prior transactions, the transfer should be considered outside of the ordinary course of business. *Concast Canada Inc. v. Laclede Steel Co. (In re Laclede Steel Co.*, 271 B.R. 127, 131 (BAP 8th Cir. 2002), *aff'd*, (8th Cir. Sept. 23, 2002)(unpublished disposition); *Seaver v. Allstate Sales & Leasing Corp. (In re Sibilrud)*, 308 B.R. 388, 395 (Bankr. D. Minn. 2002);

Babin v. Barry Cty. Livestock Auction, Inc. (*In re Stewart)*, 274 B.R. 503, 513 (Bankr. W.D. Ark.), *aff'd*, 282 B.R. 871 (8th Cir. BAP 2002).

Unusual creditor pressure or significant change in business terms will take payments outside of the ordinary course defense. *See, e.g., Hechinger Inv. Co. v. Universal Forest (In re Hechinger Inv. Co., 4*89 F.3d 568, 577 (3d Cir. 2007) (affirming that payments made after creditor reduced credit and switched payment terms were not protected by the ordinary course of business defense); *Mediaimaging Tech. Inc. v. Mallinckrodt, Inc. (In re Medimaging Tech,, Inc.)*, No. 03-8098, 2007 WL 3024068, at *13 (Bankr. D. Md. Oct. 12, 2007) (placing debtor on credit hold during preference period rendered payments outside the ordinary course of business); *Oakridge Consulting v. Placid Refining Co. (In re Jitney-Jungle Stores),* No. 01-1453, 2005 WL 4677831, at *4-5 (Bankr. E.D. La. Mar. 14, 2005) (finding payments made after creditor reduced credit limit to zero based on debtor's financial condition were not made in the ordinary course of business), *aff'd*, 203 Fed.Appx 572 (5th Cir. 2006).

"Whenever the bankruptcy court receives evidence of unusual collection efforts, it must consider whether the debtor's payment was in fact a response to those efforts." *Marathon Oil Co. v. Flatau (In re Craig Oil Co.)*, 785 F.2d 1563, 1566 (11th Cir. 1986). Payments made in response to unusual debt *collection* efforts by the creditor are considered outside the scope of the ordinary course of business exception. *Id.* For example, a defendant's repeated telephone calls regarding payment and a change in payment terms from monthly to weekly payments established that transfers were not ordinary. *Miller & Rhoads, Inc. v. Robert Abbey, Inc. (In re Miller & Rhoads, Inc.)*, 153 B.R. 725, 727 (Bankr. E.D. Va. 1992).

Moreover, a vendor cannot avoid the consequences of its unusual pressure and tightened credit terms simply by pointing to statistical similarities in timing of payment. *See, e.g., Menotte*

v. Oxyde Chemicals, Inc. (*In re JSL Chem. Corp.)*, 424 B.R. 573, 580-81 (Bankr. S.D. Fla. 2010) (holding that payments made within pre-preference payment range were not ordinary when viewed in light of changed terms and unusual creditor activity, including communications to the debtor by the defendant's chief financial officer); *Valley Petroleum LLC v. Garrow Oil Corp. (In re Valley Petroleum, LLC,)* No. 09-2328, 2010 WL 2746989, at *4 (Bankr. E.D. Wis. July 9, 2010) (finding that cash in advance payments for current deliveries which were contrary to previous practices, and payments made on invoices according to previous practices, were not in the ordinary course of business); *Peltz v. Merisel Americas, Inc. (In re Bridge Info. Sys.),* 383 B.R. 139, 149-50 (Bankr. E.D. Mo. 2008) (holding that unusual activity will take payments outside the ordinary course of business even if they are statistically similar to pre-preference transactions).

Shortly prior to the commencement of the preference period, prior to shipping any additional product to the Debtor, the Defendant (1) demanded that the Debtor make weekly $400,000 "catch up" payments on unpaid invoices in order to reduce the Defendant's account receivable exposure under a newly lowered credit limit, (2) reduced its credit terms for future invoices from net 30 days to 2% 5/net 10 days, and (3) reduced its credit limit from $2 million to $1 million. During the preference period, the Debtor made two scheduled $400,000 "catch-up" payments to the Defendant in compliance with "restructuring" regime, ordered and timely paid for new product on 2% 5/net 10 day invoice terms, and made a $900,000 "hostage" payment to release the Defendant's shipping hold just prior to the holidays. Prior to the preference period, the Debtor's paid Defendant's invoices in the invoice amounts (as opposed to even amounts), and paid the net 30 day invoices in a range from 45 to 70 days after the date of invoice. All of the

"catch-up"/"restructuring" payments, the "hostage" payment, and the payments on the 2% 5/net 10 invoice were clearly extraordinary when compared to the parties' baseline course of dealings.

Several courts have held that payments made in connection with settlement of indebtedness do not fall within the subjective ordinary course of business' defense. *Am. Honda Fin. Corp. v. A. Angelle, Inc. (In re A. Angelle, Inc.),* 230 B.R. 287, 299 (Bankr.W.D.La.1998) (holding that a payment by the debtor to a creditor made pursuant to a pre-petition settlement agreement was not protected by the provisions of section 547(c)(2)), *modified,* 230 B.R. 306 (Bankr.W.D.La.1998). S*ee also In re Saint Catherine Hosp. of Indiana, LLC*, 511 B.R. 117, 124-25 (S.D. Ind. 2014); *Ogle v. Advent, Inc. (In re Rotary Sales, LLC),* Bankr.No. 11–38053, 2013 WL 1316750, at *5 (Bankr.S.D.Tex. Apr.1, 2013) ("Payments made [pursuant to an agreed judgment] are certainly not made according to ordinary business terms.... 'For example, filing a lawsuit to enforce a debt may not be unusual when a debtor does not pay, but payments according to a settlement agreement are not according to ordinary business terms.' ") (citing *Clark v. Balcor Real Estate Fin. (In re Merideth Hoffman Partners,* 12 F.3d 1549, 1553 (10th Cir.1993); *In re Intercontinental Publ'ns, Inc.,* 131 B.R. 544, 550 (Bankr.D.Conn.1991) (citing *Energy Co-op., Inc. v. SOCAP Int'l, Ltd.,* 832 F.2d 997, 1004 (7th Cir.1987)(the ordinary course of business exception is intended to "protect recurring, customary trade transactions, but not one time payments in settlement of contractual claims").

In *Energy Co-op, supra,* 832 F.2d at 1004-05, the Seventh Circuit rejected application of the subjective ordinary course of business defense for settlement payments. The court held that, while a transaction need not occur often to be in the ordinary course of business, a creditor asserting the subjective ordinary course defense must show that the debtor incurred its debt and paid the creditor in ways similar to other transactions, *citing to In re Economy Milling,* 37 B.R.

914, 922 (D.S.C.1983) (debt not incurred and payment not made in the ordinary course of business because creditor did not show that he or other creditors had conducted similar transactions with the debtor before), *In re AOV Industries, Inc.*, 62 B.R. 968, 975 (Bankr.D.Colo.1986), and *In re Ewald Bros., Inc.*, 45 B.R. 52, 58 n. 14 (Bankr.D.Minn.1984). The defendant's evidence did not establish that the debtor normally breached oil purchase contracts and then paid settlements without receiving any oil or that the debtor had ever breached an oil purchase contract with and paid a settlement to the defendant.

Similarly, since the entire history of how a debt was incurred must be considered, simply restructuring a debt and receiving regular payments does not transform an extraordinary judgment following litigation into a series of ordinary payments within the meaning of section 547(c)(2)(A). *In re Gaines*, 502 B.R. 633, 644 (Bankr. N.D. Ga. 2013); *In re Indus. & Mun. Eng'g, Inc.*,127 B.R. 848, 850 (Bankr. C.D. Ill. 1990)(" If creditors could come within the meaning of the exception simply by entering into a restructuring agreement, we would likely see every defendant attempt to assert the ordinary course of business defense by arguing that a payment or payments made to it were pursuant to an agreement entered into and completed on the eve of bankruptcy. This Court does not believe Congress could have intended such a result."). *See also In re Swallen's, Inc.*, 266 B.R. 807, 814 (Bankr. S.D. Ohio 2000)("the evidence presented by the parties conclusively shows that the rigid schedule for current payments provided in the July 17, 1995 agreement is a marked departure from prior practice between these parties."); *In re Richardson*, 94 B.R. 56, 60 (Bankr. E.D. Pa. 1988).

Here, the Defendant forced the Debtor to make weekly "catch-up" payments and a "hostage" payment in order to reduce Defendant's accounts receivable exposure below a newly reduced credit limit, reduced invoice terms, reduced its credit limit, and refused to otherwise ship

additional product. All of these actions reflect unusual activity designed to force payment by the Debtor. The Debtor was no longer permitted to pay the outstanding invoices in accordance with their net 30 day terms. Payments are not made in the ordinary course of business where they were made pursuant to a new and different payment conditions imposed on a financially troubled party as a condition of continued business. *J.P. Fyfe, Inc. v. Bradco Supply Corp.*, 891 F.2d 66, 71-72 (3rd Cir. 1989). The Defendant's actions in forcing new terms and otherwise refusing to ship product was unprecedented and extraordinary in the history of the parties' relationship; the Debtor's payments pursuant to the new regime clearly fell outside of the parties' baseline course of dealings.

II. New Value – Section 547(c)(4

A. Invoices Paid During the Preference Period are Not Eligible as New Value.

A split exists among the Circuit Courts as to whether an invoice that would otherwise be eligible as new value under section 547(c)(4) is excluded if it was paid during the preference period. The Seventh and Eleventh Circuits have held that preference period invoices must remain unpaid in order to qualify for the new value defense. On the other hand, the Fourth, Fifth and Ninth Circuits have held that paid preference period invoices may qualify as new value as long as the invoice was not paid by an "otherwise unavoidable transfer." The Eighth Circuit has issued conflicting decisions, but would its most recent opinion would appear to align it with the Fourth, Fifth and Ninth Circuit view. The Third Circuit has issued decisions that would appear to require that the preference period invoice remain unpaid, but lower court decisions in the Circuit have questioned whether any binding precedent exists. The First, Second and Tenth Circuits have not directly addressed the issue.

The requirement in Section 547(c)(4)(B) that a transferee is not entitled to claim

new value for goods or services on account of which the debtor made an "otherwise unavoidable" transfer is intended to preclude a transferee from obtaining double credit, i.e., asserting new value for goods or services for which the debtor paid the transferee by an "otherwise unavoidable" transfer. *See IRFM*, 52 F.3d at 231-32 (quoting Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 Vand.L.Rev. 713, 788 (1985)); *In re Toyota of Jefferson, Inc.*, 14 F.3d 1088, 1092-93 (5th Cir. 1994) (same).

The Third, Seventh and Eleventh Circuits read the statute to require that invoices remain unpaid – that the preferred creditor advanced "new value" to the debtor (1) on an unsecured basis, and (2) that the new value invoices were not paid prior to the commencement of the debtor's bankruptcy case. *New York City Shoes v. Bentley International Inc. (In re New York City Shoes, Inc.)*, 880 F.2d 679, 680 (3rd Cir. 1989); *In re Prescott*, 805 F.2d 719 (7th Cir. 1986); *In re Jet Florida Sys., Inc.*, 861 F.2d 1555 (11th Cir. 1988).

B. Section 503(b)(9) Invoices Paid after the Petition Date Are Not Eligible as New Value.

There are few reported cases on this issue, and no Circuit level decision that directly addresses whether post-petition payment of a section 503(b)(9) administrative claim should be considered as an "otherwise unavoidable transfer" in determining the eligibility of the 503(b)(9) invoices as new value under Bankruptcy Code section 547(c)(4)(B). Perhaps the best-reasoned of the reported cases is *Circuit City Stores, Inc. v. Mitsubishi Digital Electronics America, Inc.*, 2010 BANKR. LEXIS 4398, at *25 (Bankr. E.D. Va. 2010)("*Mitsubishi*"). Under section 547(c)(4)(B), "the New Value Defense is only available if the new value was repaid with a subsequent transfer that is itself avoidable." *Id.*

The *Mitsubishi* decision analyzed all Bankruptcy Code statutes that might potentially give rise to avoidance of the debtors' payment of Mitsubishi's 503(b)(9) claim. Noting that

payment of the 503(b)(9) administrative claim would inherently occur post-petition, the decision notes that section 549 is the avoidance statute that applies to post-petition transfers, and that section 549 excludes from avoidance any transfer authorized by the Bankruptcy Code and the court. *Id.* at **28-29. As a result, the court concluded that the Debtors' post-petition payment of Mitsubishi's 503(b)(9) claim "is an 'otherwise unavoidable transfer' that § 547(c)(4)(B) of the Bankruptcy Code negates for qualification as new value." *Id.* at *29.

The court rejected Mitsubishi's argument that the post-petition timing of the transfer renders the "otherwise unavoidable transfer" language inapplicable. The court noted that the Fourth Circuit decision in *Chrysler Credit Corp. v. Hall (In re JKJ Chevrolet, Inc.)*, 412 F.3d 545, 553 n.6 (4th Cir. 2005), "clearly stated that 'post-petition transfers may be considered under section 547(c)(2)(B)." *Id.* n 18. In so holding, the Fourth Circuit cited *Moglia v. Am. Psych. Ass'n (In re Login Bros. Book Co.)*, 294 B.R. 297, 300 (Bankr. N.D.Ill. 2003)("both the plain language and policy behind the statue indicate that the timing of a repayment of new value is irrelevant.") *Id.* While the Fourth Circuit remanded the case to the bankruptcy court for a factual determination as to the avoidability of the transactions at issue, its clear and unequivocal statement is highly instructive.

In reaching its holding, the *Mitsubishi* court stated that allowing Mitsubishi to receive payment on its 503(b)(9) claim and use the underlying invoices as new value would result in a double payment for the goods that it supplied. *Id.* at *34. This result "would not give equal treatment to all creditors." *Id.* The *Mitsubishi* decision is squarely in agreement with the decision in *T.I. Acquisition, LLC v. Southern Polymer, Inc. (In re T.I. Acquisition, LLC)*, 429 B.R. 377, 384 (Bankr. N.D. Ga. 2010). In order to best advance the two policies that underlie section 547(c)(4), encouraging lending to troubled debtors in order to enhance the estate, and

promoting equality of treatment among creditors, *T.I. Acquisition* held that a creditor must either choose payment on a section 503(b)(9) claim or use it as new value; it cannot have it both ways.

The only subsequent decision to disagree with *Mitsubishi* and *T.I. Acquisition* is *Friedman's Liquidating Trust v. Roth Staffing Cos. (In re Friedman's, Inc.)*, 738 F.3d 547 (3rd Cir. 2013). Indeed, *Friedman's* notes an even split among district and bankruptcy courts as to whether post-petition activity should be considered under section 547(c)(4)(B). Several decisions have held that post-petition activity should be considered based on the same policy considerations upon which *Friedman's* determined the opposite. 738 F.3d at 553-554. The most recent of the noted decisions, *Gonzales v. Sun Life Ins. Co. (In re Furr's Supermarkets, Inc.)*, 485 B.R. 672, 733-34 (D.N.M. 2012), held that cutting off the preference calculation at the petition date "makes no economic sense."

The *Friedman's* decision constitutes only one voice among several, and its holding that the petition date should be a cutoff for all preference related analyses is based on inconsistent and unpersuasive reasoning. Moreover, the *Friedman's* decision, which did not concern section 503(b)(9) claims, expressly declines to extend its reach to such claims. *Friedman's* concerned pre-petition employment services that were paid post-petition pursuant to an early case pre-petition wage order. *Friedman's* expressly notes that it does not address whether 503(b)(9) or reclamation claims are eligible as new value. 738 F.3d at 561 n 9. *See also Stanziale v. Car-Ber Testing, Inc. (In re Conex Holdings, LLC)*, 2013 Bankr. LEXIS 5470 at 2 (Bankr. D. Del. Dec. 27, 2013)(the only case that cites *Friedman's* substantive ruling notes that it "withheld judgment as to whether post-petition payments under a reclamation claim would reduce the new value defense."). While in dicta, the *Friedman's* court noted that *Phoenix Restaurant Group v. Proficient Food Co. (In re Phoenix Restaurant Group, Inc.)*, 373 B.R. 541, 547-548 (M.D. Tenn.

2007), held that reclamation claims are not eligible as new value, this brief comment was apparently a passing observation. 738 F.3d at 551.[1]

For several reasons, *Friedman's* presents the less well reasoned holding when compared to the several other decisions that disagree with its approach. First, the plain language of section 547(c)(4)(B) does not include a limitation as to when new value may be repaid. As described above, the courts in *Mitsubishi, Furr's* and *Login Bros.* had no trouble holding that, as a result, preference analyses may include post-petition activities. *Friedman's*, however, engages in a very lengthy exploration of context and policy to find a rationale for adding "prior to the petition date" as a modifier of the statutory language.

None of the *Friedman's* contextual references justifies adding the modifying time limitation. The first notion, that the title of the section is "Preferences," cannot reasonably lead to the conclusion that, despite the statute's lack of such language, Congress intended to limit the new value eligibility determination to pre-petition activities. Indeed, this conclusion is directly contrary to the Third Circuit's decision in *In re Kiwi International Airlines, Inc.*, 344 F.3d 311, 314 (3rd Cir. 2003). *Kiwi* held that a post-petition contract assumption under Section 365, which requires the trustee to cure all pre-petition defaults, precludes an action to recover preference period payments made under the parties' contract.

Acknowledging that *Kiwi* requires the consideration of post-petition activities in the preference analysis, *Friedman's* attempts to limit its application to a "unique set of rights" in that case, even though section 365 is nowhere mentioned in section 547. There is no logical distinction between post-petition assumption activity and critical vendor or wage orders, all of which result in post-petition payment of the creditor's pre-petition claim after the conclusion of

[1] *Friedman's* notes that only three cases have decided whether 503(b)(9) claims are eligible as new value; two holding that the claims are not eligible, including the *Mitsubishi* and *T.I. Acquisitions* decisions discussed above. 738 F.3d at 553 n 2.

the preference period. Indeed, the *Friedman's* court strained unpersuasively to avoid the precedential binding effect of Third Circuit's holding in *Kiwi* that a preference analysis under section 547 is not limited to pre-petition activities.

Second, *Friedman's* looks to the Section 547(b)(5) hypothetical liquidation test, which is performed as of the petition date. This provision is a condition on the trustee's ability to establish a prima facie case. If the creditor would have been paid in full in a hypothetical chapter 7 case as of the petition date, there would be no purpose to the preference action; there would be no "preferential treatment" to avoid and recover for the benefit of all creditors. This provision plays a gatekeeper function; before even analyzing the substantive elements of the preference case, including the subsection (c) defenses, such creditors are excluded from the preference "net."

Third, *Friedman's* uses circular reasoning in relying on the two-year statute of limitations for preference actions found in section 546, which commences on the petition date. "If Congress had intended to allow for post-petition transactions to affect the impact on the estate, it is likely that it would have crafted a different statute of limitations." 738 F.3d at 556. This statement ignores that the statute of limitations is a procedural provision enacted to ensure that preference actions are brought without extensive delay, and does not in any manner relate to the substantive analysis of preference liability. Moreover, the court's statement directly conflicts with its own holding; if Congress had intended to limit the preference analysis to pre-petition activities, it would have so crafted the language of section 547.

Fourth, *Friedman's* discussion of the "improvement in position" test found in Section 547(c)(5) does not aid its analysis. Section 547(c)(5) includes the phrase "as of the date of the filing of the petition," while section 547(c)(4)(B) does not. 11 U.S.C. § 547(c)(5). In fact,

Friedman's acknowledges that the possibility that "this omission from § 547(c)(4) was intentional, since Congress knew how to set forth a relevant time period when it thought it applied." 738 F.3d at 556. Inexplicably, however, the decision finds to the contrary.

Finally, *Friedman's* relied on case law holding that a creditor cannot use post-petition goods or services as new value to reduce its potential preference exposure. The court does not, however, consider any of the reasons for that limitation on new value. Such an analysis would demonstrate a critical distinction. Creditors that provide post-petition goods and services are entitled to an administrative claim, as a result of which the creditor will be paid once for the value provided. If the creditor were also allowed to use the value to reduce its preference exposure, then it would be paid twice for the value, precisely the "double dipping" that *Mitsubishi, Furr's* and *Login Bros.* proscribed by including post-petition payment of section 503(b)(9) claims in their analysis of new value. The two scenarios are entirely consistent. *Friedman's* conclusion to the contrary is, indeed, inconsistent with the rationale behind this case law.

As to policy considerations, *Friedman's* notes, at 738 F. 3d at 557-558, that the Supreme Court decision in *Union Bank v. Wolas*, 502 U.S. 151, 161 (1991), recognized two policies underlying section 547. "First, . . . creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy . . . Second, *and more important,* the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor." (emphasis added).

Based on a Congressional committee report discussion that Section 547 is intended to discourage a preference period race to the courthouse, and requires "those who received 'a greater payment than others of his class to disgorge so that all may share equally,'" 738 F.3d at

558, *Friedman's* concludes, without meaningful explanation, that "it makes sense that the equality should be measured, and inequalities rectified, as of the petition date." *Id.*

The court then rejected the notion that, by receiving post-petition payment of its wage claim and the use of the claim as new value, the wage claimant would receive a windfall that would unjustly favor the claimant over other creditors. 738 F.3d at 559. Noting that *T.I. Acquisition* and *Login Bros.* held directly to the contrary in order to avoid inequity, the court called the "double dipping" argument "misleading because it implies that the creditor is receiving payment for goods or services that were never provided. . . . All of the money that the creditor received was for goods and services actually provided. The creditor, therefore, was never unjustly enriched . . ." *Id.*

This statement, however, ignores that *all* preferential payments are made to creditors for goods and services actually provided. The purpose of the preference statute is to bring equality of treatment by requiring creditors to disgorge preference period payments for the benefit of those creditors that did not receive payment in part or at all. As discussed at length in *Furr's*, the only way to achieve equal treatment of unsecured claimants is to analyze preferences with consideration of post-petition events that may create inequalities. 485 B.R. at 730-31. *Furr's* reached this conclusion after performing a very detailed analysis in which it applied a variety of possible rules that included and excluded possible post-petition payments to hypothetical preference recovery scenarios in order to determine which rule resulted in the greatest equality for creditors. *Id.*

Friedman's rejected *Furr's* as "misguided" because it supports an interpretation of section 547 that results in the "absolutely equal treatment of all unsecured claims." 783 F.3d at 560. In so doing, *Friedman's* stated that "[i]f it is a rule in bankruptcy that all creditors must be

treated equally, surely the exceptions swallow the rule." 783 F.3d at 560. The court then followed with a lengthy discussion of bankruptcy inequalities, but failed to explain how its reasoning supported the imposition of "prior to the petition date" language in section 547(c)(4)(B).

In sum, the best-reasoned cases are those holding that section 503(b)(9) invoices are not eligible as new value if they are paid post-petition – *Mitsubishi, T.I. Acquisition, Kiwi, Furr's and Login Bros.* Here, all of the Defendant's 503(b)(9) invoices were paid post-petition, and as a result, should not be eligible as new value to shield the Debtor's preference payments to the Defendant under section 547(c)(4).

Dated: March, 2015

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By: _____

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BANKRUPTCY APPELLATE PANEL
FOR THE CIRCUIT OF FIRST IMPRESSION

In re: Damp Dog, Inc.,	)	**Chapter 11**
Debtor.	)	
_____	)	
Damp Dog, Inc.,	)	
Plaintiff,	)	
v.	)	
Moustache Wax, Inc.,	)	
Defendant.	)	
_____	)	

DEFENDANT'S BRIEF ON APPEAL

Comes now Mustache Wax, Inc. (the "Defendant"), by counsel, and files this brief in support of its arguments that this Court should affirm the lower Court's ruling, which held that the Defendant was not liable to the above-captioned Debtor (the "Debtor") on account of the allegedly preferential transfers that the Defendant received from the Debtor during the ninety days prior to the filing of the Debtor's bankruptcy petition (the "Preference Period"). In submitting this brief, the Defendant relies upon the facts provided to this Court previously in the form of the *Joint Stipulation of Facts*.

PRELIMINARY STATEMENT

There are two primary areas of inquiry presented to the Court for consideration in this appeal. The issues presented require this Court to evaluate whether the lower Court properly

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permitted the Defendant to utilize certain statutory defenses set out in Section 547 of the United States Bankruptcy Code (the "Bankruptcy Code") to the preference allegations asserted by the Debtor in the preference litigation initiated in the Bankruptcy Court.

Based on its evaluation of the facts of this case, the applicable statutes, and the case law interpreting those statutes, the lower Court found that the Defendant had no preference liability to the Debtor. This Court should affirm that ruling.

In considering the applicability of the ordinary course of business defense (11 U.S.C. § 547(c)(2)) to the facts on appeal, there are a few subcategories that must be examined. They follow:

First, is the Defendant's ten-month relationship with the Debtor long enough to establish a bench mark permitting the Defendant to use the subjective ordinary course of business defense?

Second, can the Debtor's catch-up payments and other on-time payments made to the Defendant pursuant to the terms of the parties' pre-preference period restructuring agreement (the "Agreement") be treated as the subjective ordinary course of business between the parties and thereby used as an affirmative defense by the Defendant?

In considering the Defendant's ability to use the subsequent new value defense (11 U.S.C. § 547(c)(4)) to the preference allegations, this Court must examine the following issues:

First, if invoices providing new value from the Defendant to the Debtor are subsequently paid by the Debtor during the preference period, can such invoices be used as part of a new value defense?

Second, if certain unpaid invoices are treated as claims pursuant to Section 503(b)(9) of the Bankruptcy Code are those invoices eligible to be used as new value by the Defendant?

AUTHORITIES AND ARGUMENT

A. Background Information on the Affirmative Defense Known as the "Ordinary Course of Business Defense":

Congress decided that preferential transfers "enable[] a creditor to receive payment of a greater percentage of his claim against the debtor than he would have received if the transfer had not been made and he had participated in the distribution of the assets of the bankrupt estate." *Friedman's Liquidating Trust v. Roth Staffing Cos. LP* (*In re Friedman's Inc.*), 738 F.3d 547, 558 (3d Cir. Del. 2013) (quoting H.R. Rep. No. 95-595, at 177-78, U.S. Code Cong. & Admin. News 1978, pp. 6137, 6138).

> The purpose of the preference section [of the Bankruptcy Code] is two-fold. First, by permitting [a debtor] to avoid pre-bankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally. The operation of the preference section to deter "the race of diligence" of creditors to dismember the debtor before bankruptcy furthers the second goal of the preference section-that of equality of distribution.

In re Friedman's Inc., 738 F.3d at 558.

In the instant case, the parties had a short, ten-month business relationship. During their relationship, the Defendant provided the Debtor with unique and otherwise unavailable merchandise for its stores and thereby its customers. There was no other source by which the

Debtor could obtain the Defendant's products. The fact that the Debtor was able to stock the Defendant's product made the Debtor's stores more of a destination for its target customers, and sales of the product were profitable for both the Debtor and the Defendant. Further, Defendant extended significant unsecured credit to the Debtor for the duration of the parties' relationship, both before and after the Preference Period. Additionally, without the Defendant's product on its shelves, it is likely that the Debtor may have been forced to seek bankruptcy relief at an earlier date.

B. Should the Defendant be Permitted to Rely on the Subjective Ordinary Course of Business Defense?

The first issue the Court should examine is whether the Debtor's ten-month relationship with the Defendant is long enough to establish a bench mark permitting the Defendant the use of the ordinary course of business defense to the preference allegations. Pursuant to 11 U.S.C. § 547(c)(2), a debtor "may not avoid . . . under this section a transfer to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (B) made according to ordinary business terms." *Id.*

"The ordinary course of business exception protects 'recurring, customary credit transactions that are incurred and paid in the ordinary course of business of the debtor and the debtor's transferee.'" *Davis v. All Points Packaging & Distrib.* (*In re Quebecor World (USA) Inc.*), 491 B.R. 363, 368-69 (Bankr. S.D.N.Y. 2013) (citing *Official Comm. Of Unsecured Creditors of Enron Corp. v. Martin* (*In re Enron Creditors Recovery Corp.*), 376 B.R. 442, 459 (Bankr. S.D.N.Y. 2007) (quoting *Sender v. Heggland Family Trust* (*In re Hedged-Investments*

Assocs.), 48 F.3d 470, 475 (10th Cir. 1995)). "The purpose of the exception is to 'leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or [its] creditors during the debtor's slide into bankruptcy.'" *In re Quebecor World (USA) Inc.*, 491 B.R. at 369 (modifications in original) (citing *Lawson v. Ford Motor Co.* (*In re Roblin Indus., Inc.*), 78 F.3d 30, 41 (2d Cir. 1996) (quoting H.R. Rep. No. 95-595 (1978) at 373, *Reprinted in* 1978 U.S.C.C.A.N. 5963, 6329)).

> Prior to the enactment of the Bankruptcy Abuse and Prevention and Consumer Protection Act [] in 2005, a creditor was required to prove that a transfer was conducted both (i) in the ordinary course of business between the debtor and the transferee and (ii) according to ordinary business terms in the industry for the transfer to be protected from avoidance as having been made in the ordinary course of business under Section 547(c)(2).[1] After BAPCPA, the creditor need only prove either that the transfer was in the ordinary course of business between the debtor and the transferee, 11 U.S.C. §547(c)(2)(A), or that it was made according to ordinary business terms in the industry, 11 U.S.C. §547(c)(2)(B).

VCW Enters, Inc. v. United Concrete Products (*In re VCW Enters, Inc.*) Case No. 12-21304, Adv. No. 13-0224, * 14 (Bankr. E.D. Pa., March 11, 2014) (citing *Liebersohn v. WTAE-TV* (*In re Pure Weight Loss, Inc.*), 446 B.R. 197, 204 (Bankr. E.D. Pa. 2009)). "Subsection (A) [of Section 547(c)(2)] is a subjective test that is determined by whether the transaction was done in the ordinary course between the two parties, while subsection (B) [of Section 547(c)(2)] is an objective test that is determined by whether the transaction is ordinary for the industry." *In re*

[1] "While the 2005 amendments to the Bankruptcy Code made the ordinary course of business test disjunctive, the wording of the subparts has not changed. Thus, pre-2005 case law interpreting the requirements of Section 547 remains good law." *In re Quebecor World (USA) Inc*. 491 B.R. at 369; *see Jacobs v. Gramercy Jewelry Mfg. Corp.* (*In re M. Fabrikant & Sons, Inc.*), No. 06-12737, 2010 Bankr. LEXIS 3941, 2010 WL 4622449, at *2 (Bankr. S.D.N.Y. Nov. 4, 2010).

VCW Enters, Inc. Case No. 12-21304, Adv. No. 13-0224, at *14-15 (citing *Guiliano v. RPG Mgt., Inc.* (*NWL Holdings*), 2013 WL 2436667 at *7 (Bankr. D. Del. June 4, 2013)).

The Defendant asserts that the facts presented before this Court demonstrate that the payments made by the Debtor to the Defendant were made according to ordinary business terms as required by Section 547(c)(2)(B) of the Bankruptcy Code. Therefore, the Defendant will focus its argument on appeal on the applicability of the subjective ordinary course of business analysis to the facts before the Court.

In reviewing the subjective test of the ordinary course of business defense in Section 547(c)(2)(A),

> the following factors are relevant to the question whether the transfers were within the ordinary course of business between [p]laintiff and [d]efendant: (1) The length of time the parties had engaged in the type of dealing at issue; (2) whether the transfer was in an amount more than usually paid; (3) whether the payments were tendered in a manner different from prior payments; (4) whether any unusual action was taken by either party to collect or pay the debt; and (5) whether the creditor did anything to gain an advantage (such as taking additional security) in light of the debtor's deteriorating financial condition.

In re VCW Enters, Inc., Case No. 12-21304, Adv. No. 13-0224, at *15 (citing *Pure Weight Loss*, 446 B.R. at 205.); *In re Quebecor World (USA) Inc.*, 491 B.R. at 369; *In re Inland Global Medical Group, Inc.*, 362 B.R. 459 (Bankr. C.D. Cal. 2006); *In re Pillowtex Corp.*, 427 B.R. 301 (Bankr. D. Del. 2010); *Buchwald Capital Advisors LLC v. Metl-Span I., Ltd.* (*In re Pameco Corp.*), 356 B.R. 327, 340 (Bankr. S.D.N.Y. 2006); *Official Comm. of Unsecured Creditors of 360networks (USA) Inc. v. U.S. Relocation Servs.* (*In re 360networks (USA) Inc.*), 338 B.R. 194, 210 (Bankr. S.D.N.Y. 2005); *see also Hassett v. Goetzmann* (*In re CIS Corp.*), 195 B.R. 251, 258 (Bankr. S.D.N.Y. 1996) (stating that the court typically examines several factors including

the prior course of dealing between the parties, the amount of the payment, the timing of the payment, and the circumstances surrounding the payment).

In the case on appeal, the parties had a short relationship. During the seven months that preceded the Preference Period, the Defendant permitted the Debtor to exceed its $2 million dollar credit limit regularly. Similarly, the Debtor paid the Defendant on invoices an average of 59 days after invoice, instead of the thirty-day terms listed on the invoices. Finally in September of 2013, when the parties had allowed the credit limit to exceed the terms by $1.25 million, the parties agreed that their relationship needed a bit more structure, and the Defendant was willing to add incentives to procure timely payments from the Debtor.

The parties' Agreement reads as follows: the Debtor's credit limit is reduced to $1 million; the Debtor will make six $400k catch-up payments to get the credit limit down to the new agreed level; and provided the Debtor pays invoices within five days, the Defendant will give the Debtor a 2% discount on such invoices. Payments on invoices are otherwise due within ten days. Prior to the Preference Period the Debtor made two of the $400k catch-up payments pursuant to the terms of the Agreement, and the Debtor ordered goods and paid for goods within five days as agreed.

The Preference Period commenced on October 5, 2013. During the pre-preference period, the Debtor made payments to the Defendant on nine of thirteen issued invoices, the average payment on an invoice totaled $498k in amount, and the payments ranged from $490k to $1 million (These figures exclude the two catch-up payments made pursuant to the Agreement, both of which were for $400k.). During the Preference Period, the Debtor paid eleven of seventeen issued invoices, the average payment on invoice totaled $409k, and payments ranged from $245k to $980k (Again, these figures exclude the two catch-up payments the Debtor made

during the Preference Period pursuant to the Agreement, both of which were for $400k.). During the parties' entire relationship, the Debtor always tendered payments to the Defendant by check. The Agreement may be characterized as unusual activity or taking advantage, but the Defendant gave advantage to the Debtor in striking the deal, as it continued to provide product and credit terms to the Debtor. Further, the Defendant never had any knowledge that the Debtor was in financial distress at any time in their short relationship. The marketplace demand for the Defendant's product put more pressure on the creditor/debtor relationship more than any actions of the Defendant could have.

The fact of the parties' short relationship caused the lower Court to look beyond the required subjective ordinary course of business analysis. The lower Court looked to the opinion issued in the *VCW Enterprises* case, where the parties "had no prior business dealings with each other[,]" and found the court's analysis in the opinion to be instructive. *In re VCW Enters, Inc.,* Case No. 12-21304, Adv. No. 13-0224, at *15. In that opinion, the limited relationship between the parties did not prevent the Court from finding that the transfers that were the subject of the litigation could be within the ordinary course of business between the parties under Section 547(c)(2)(A). The *VCW Enterprises* Court adopted the explanation that "a business relationship lacking evidence of any pre-preference period history 'is not per se ineligible for protection from avoidance under section 547(c)(2).'" *Id.* (citing *Goldstein v. Starnet Capital Grp., LLC* (*In re Universal Marketing, Inc.*), 481 B.R. 318, 328 n.9 (Bankr. E.D. Pa. 2012) (citing *Quad Sys. Corp. v. H&R Ind. Inc.* (*In re Quad Sys. Corp.*), Adv. No. 02-0972, Case No. 00-35667F, 2003 WL 25947345, at *6 (Bankr. E.D. Pa. July 15, 2003). The opinion explains that "even if the defendant had no pre-preference period dealings with the debtor—and accordingly cannot establish a 'baseline of dealings'—the transfers may still be excepted from avoidance if the

defendant can otherwise establish that they were made in the ordinary course of the parties' business dealings." *In re VCW Enters, Inc.,* Case No. 12-21304, Adv. No. 13-0224, at *16 (citing *Quad Sys. Corp*., 2003 WL 25947345 at *6).

When faced with a lack of transaction history between the parties other Courts have adopted an "all[-]encompassing approach". *See Smith v. Shearman & Sterling* (*In re BCE WEST, L.P., et al.*) Case Nos. 98-12547 through 98-12570, Adv. No. 00-00648, at *4 (Bankr. Az., February 28, 2008) (citing *Wood v. Stratos Product Development, LLC* (*In re Ahaza Systems, Inc.*), (9th Cir. 2007))). The Court in the *BCE West* case explained that "[w]hen there are no prior transactions [between the parties] . . . , the court may analyze other indicia, including whether the transaction is out of the ordinary for a person in the debtor's position, or whether the debtor complied with the terms of the contractual arrangement, generally looking to the conduct of the parties, or to the parties' ordinary course of dealing in other business transactions." *Id.* at 5 (citing *Ahaza*, 482 F.3d at 1126 (quoting *Kleven v. Household Bank F.S.B.*, 334 F.3d 638, 642 (7th Cir. 2003)). When looking at the combined analysis suggested by *VCW Enterprises* and *BCE West,* the parties' substantial compliance with their Agreement both before and during the Preference Period should be viewed as subjectively ordinary. The Agreement allowed the Debtor to delay its bankruptcy filing, as the Agreement and the relationship kept high-demand stock on the Debtor's shelves, which in turn kept shoppers in the stores. There was no unusual collection activity by the Defendant during the Preference Period or otherwise, and the facts of this case suggest that the allegedly preferential transfers were subjectively ordinary in the business dealings of the parties and under the terms of the Agreement.

In addition to that analysis, the *BCE West* Court was guided by the Supreme Court's decision in *Barnhill v. Johnson,* 503 U.S. 393, 402 (1992), "which states that the purpose of

§547(c)(2) is 'designed to encourage creditors to continue to deal with troubled debtors on normal business terms by obviating any worry that a subsequent bankruptcy filing might require the creditor to disgorge as a preference an earlier received payment.'" *In re BCE WEST, L.P., et al.*) Case Nos. 98-12547 through 98-12570, Adv. No. 00-00648, at *7. In the case before the Court, the Defendant, in its short relationship with the Debtor, fulfilled the obligations and expectations explained in *Barnhill*. The Defendant provided product to a distressed company, on credit, without any security. The Defendant accepted the Debtor's credit demands, and continued to work with the Debtor even up through the petition date. The relationship between the parties, the Agreement between the parties, and the payments in question should all be validated by this Court as subjectively ordinary.

C. The Application of the Subjective Ordinary Course of Business Standards to the Preference Period Transfers from the Debtor to the Defendant.

Having established that the Defendant can rely on the subjective ordinary course of business defense despite the parties' short business relationship, the Court must examine next the applicability of the defense to the individual payments at issue. It is the Defendant's position that the historical days between invoice and payments for these parties is not relevant in light of the parties' pre-preference period Agreement, and in any case, the facts establish that the Debtor's payments to the Defendant were made on ordinary business terms. The Defendant asserts that the nature of the parties' Agreement establishes the subjective standard of ordinary course between these parties. Case law supports the Defendant's decision to apply a single, consistent theory or methodology when evaluating allegedly preferential transfers, provided that there is accuracy in the methodologies ultimately applied. *See Sparkman v. Queenscape, Inc.* (*In re Anderson Homes*), 2012 Bankr. LEXIS 5334, *12 (Bankr. E.D.N.C. Nov. 15, 2012).

The *Anderson Homes* opinion considered carefully the effect of a debtor's pre-preference period request for a change in terms on the defendant's subjective ordinary course of business defense. In examining whether such a set of facts could lead to subjectively ordinary transfers, the Court found that even if the parties had agreed to a change in terms, if the parties did not adhere to the new terms after the agreement, the payments could not be ordinary. *See id.* at *17-*18. The Court explained that for it to find "a change in the ordinary course of business between the parties, defendant needed to provide some evidence that subsequent to the [agreement], the payments changed to reflect this new understanding and remained consistent throughout the Preference Period." *Id.* at *18. In the case on appeal, the parties agreed to change their terms and substantially followed the terms of their Agreement, such that payments made by the Debtor pursuant to the terms of the Agreement should be treated as subjectively ordinary between the parties. The Defendant believes the terms of the Agreement should be used as the standard by which payments should be measured.

In the case before the Court, for several months prior to the Preference Period the Debtor made sporadic payments to the Defendant, which payments were late by an average of twenty-nine days. During the pre-preference period, the Debtor was also permitted to stray from its credit limit regularly. For a full payment history, please see the charts included with the *Joint Stipulation of Facts.*

Around September 1, 2013, the parties changed the terms of their relationship. Pursuant to the parties' Agreement, the Debtor was required to get its credit limit from $3.25 million down to $1 million; the Defendant resumed making shipments of product to the Debtor when the Debtor's borrowing was brought below the new $1 million credit limit; to get below the new credit limit, the Debtor agreed to make six $400k catch-up payments to the Defendant; finally,

when shipping by the Defendant resumed, if the Debtor paid invoices within five days, the Debtor could take a 2% discount off of the invoice total; the Debtor agreed to otherwise make payments on invoices within ten days.

As seen on the chart below, prior to the Preference Period the Debtor made two catch-up payments pursuant to the Agreement. Once the Debtor was back below the agreed credit limit, during the pre-preference period, the Debtor ordered more product from the Defendant, and the Debtor paid for the Defendant's product within the new terms of the Agreement, so as to earn a discount.

Ordinary Course of Business Analysis												
INV #	DATE	INV $ AMT	TERMS	INV # PAID	INV DATE	DATE PAID	INVOICE AMT	DAYS TO PAY	NET $ AMT PD PER INVOICE	OUTSTANDING $ BALANCE	PREFERENCE EXPOSURE (NET)	
715	8/30/2013	$500,000.00	Net 30	unpaid					Agreement	**$3,250,000.00**		
				461	6/25/2013	9/2/2013	$1,000,000.00	67	-$1,000,000.00	**$2,250,000.00**		
				485	6/30/2013	9/7/2013	$500,000.00	67	-$500,000.00	$1,750,000.00		
				Catch up	9/14/2013		$400,000.00		-$400,000.00	$1,350,000.00		
				533	7/6/2013	9/16/2013	$500,000.00	70	-$500,000.00	$850,000.00		
				Catch up	9/27/2013		$400,000.00		-$400,000.00	$450,000.00		
856	9/28/2013	$500,000.00	2%5/net 10							$950,000.00		
				856	9/28/2013	10/3/2013	$490,000.00	5	-$490,000.00	$450,000.00		
Preference Period										bold= over credit limit	OCB Agreement Credit for Payments on New Terms	OCB Agreement Credit for Catch-Up Payments by Agr.
857	10/5/2013	$500,000.00	2%5/net 10							$950,000.00	$0.00	$0.00
914	10/7/2013	$250,000.00	2%5/net 10							**$1,200,000.00**	$0.00	$0.00
				857	10/5/2013	10/10/2013	$500,000.00	5	-$490,000.00	$700,000.00	$0.00	$0.00
				914	10/7/2013	10/12/2013	$250,000.00	5	-$245,000.00	$450,000.00	$0.00	$0.00
926	10/14/2013	$750,000.00	2%5/net10							**$1,200,000.00**	$0.00	$0.00
				Catch up	10/14/2013		$400,000.00		-$400,000.00	$800,000.00	$400,000.00	$0.00
940	10/15/2013	$250,000.00	2%5/net10							**$1,050,000.00**	$400,000.00	$0.00
				669	7/27/2013	10/19/2013	$250,000.00	82	-$250,000.00	$800,000.00	$650,000.00	$250,000.00
				926	10/14/2013	10/19/2013	$750,000.00	5	-$735,000.00	$50,000.00	$650,000.00	$250,000.00
950	10/19/2013	$1,000,000.00	2%5/net10							**$1,050,000.00**	$650,000.00	$250,000.00
				Catch up	10/21/2013		$400,000.00		-$400,000.00	$650,000.00	$1,050,000.00	$250,000.00
952	10/24/2013	$500,000.00	2%5/net 10	unpaid						**$1,150,000.00**	$1,050,000.00	$250,000.00
996	10/30/2013	$250,000.00	2%5/net 10							**$1,400,000.00**	$1,050,000.00	$250,000.00
				950	10/25/2013	10/30/2013	$1,000,000.00	5	-$980,000.00	$400,000.00	$1,050,000.00	$250,000.00
				996	10/30/2013	11/4/2013	$250,000.00	4	-$245,000.00	$150,000.00	$1,050,000.00	$250,000.00
1040	11/5/2013	$750,000.00	2%5/net 10	unpaid						$900,000.00	$1,050,000.00	$250,000.00
1041	11/9/2013	$250,000.00	2%5/net10							**$1,150,000.00**	$1,050,000.00	$250,000.00
				940	10/15/2013	11/10/2013	$250,000.00	25	-$250,000.00	$900,000.00	$1,300,000.00	$500,000.00
				1041	11/9/2013	11/14/2013	$250,000.00	5	-$245,000.00	$650,000.00	$1,300,000.00	$500,000.00
1216	11/15/2013	$250,000.00	2%5/net 10							$900,000.00	$1,300,000.00	$500,000.00
1217	11/16/2013	$500,000.00	2%5/net 10							**$1,400,000.00**	$1,300,000.00	$500,000.00
				1216	11/15/2013	11/25/2013	$250,000.00	10	-$250,000.00	**$1,150,000.00**	$1,300,000.00	$500,000.00
				1217	11/16/2013	11/26/2013	$500,000.00	10	-$500,000.00	$650,000.00	$1,300,000.00	$500,000.00
1323	11/30/2013	$750,000.00	2%5/net10	unpaid						**$1,400,000.00**	$1,300,000.00	$500,000.00
1328	12/9/2013	$500,000.00	2%5/net10	unpaid						**$1,900,000.00**	$1,300,000.00	$500,000.00
1330	12/14/2013	$500,000.00	2%5/net10	unpaid					Credit Limit Discussion	**$2,400,000.00**	$1,300,000.00	$500,000.00
				Catch up Demanded	12/14/2013		$900,000.00		-$900,000.00	**$1,500,000.00**	$2,200,000.00	$1,400,000.00
				697	8/19/2013	12/14/2013	$250,000.00	115	-$250,000.00	**$1,250,000.00**	$2,450,000.00	$1,650,000.00
1386	12/15/2013	$500,000.00	2%5/net10	503(b)(9)						**$1,750,000.00**	$2,450,000.00	$1,650,000.00
1417	12/18/2013	$250,000.00	2%5/net10	503(b)(9)						**$2,000,000.00**	$2,450,000.00	$1,650,000.00
1418	12/19/2013	$500,000.00	2%5/net10	503(b)(9)						**$2,500,000.00**	$2,450,000.00	$1,650,000.00

The chart also shows that the Preference Period commenced on October 5, 2014. During the Preference Period the Debtor made a total of fourteen transfers to the Defendant. Two of

those payments were $400k catch-up payments made to the Defendant pursuant to the terms of the Agreement. Of the payments the Debtor made on invoices, one of the Preference Period payments was made in four days, five of the payments were made in five days, and two of the payments were made within ten days. The payments made in five days or less were paid by the Debtor at the agreed discounted rate. The Defendant did not dispute the Debtor's right to a discount. The payments made in ten days were also made within the terms of the Agreement. The Defendant asserts that all of those payments were made within terms and pursuant to the Agreement and should thereby be treated as part of the subjective ordinary course of business between the parties. The lower Court held, and the Defendant asserts that all of the payments made pursuant to the terms of the Agreement (the two catch-up payments, and the eight payments made in ten days or less) were subjectively ordinary between the parties.[2]

While the parties entered into the Agreement to change their business relationship prior to the Preference Period, the parties lived up to those changed terms for numerous, significant payments after it went into effect. Pursuant to the discussion in *Anderson Homes*, this Court should find the payments made pursuant to the Agreement are subjectively ordinary between the parties and thereby usable as a defense to the Debtor's preference allegations. The Court should affirm the lower Court's ruling on this issue.

D. Background Information on the Affirmative Defense of "Subsequent New Value":

The Bankruptcy Code defines the term "new value" in 11 U.S.C. § 547(a)(2) as "money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the

[2] The Defendant concedes that the other payments made during the Preference Period were made outside of the terms of the Agreement and thus were not subjectively ordinary.

debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation." *Id.* Section 547(c)(4) of the Bankruptcy Code permits defendants in preference litigation to use the affirmative defense of "new value" given to a debtor.

> [A] creditor is protected from avoidance of an allegedly preferential transfer to the extent that after the transfer, the creditor 'gave new value to or for the benefit of the debtor.' New value helps a creditor reduce its preference liability if that new value is not secured by an otherwise unavoidable security interest. 11 U.S.C. § 547(c)(4)(A). The reasoning behind this limitation is that a debtor 'is not enhanced if the new value given after the preferential transfer is subject to liens and would not balance the loss caused by the preferential transfer.'

Commissary Operations, Inc. v. Dot Foods, Inc. (*In re Commissary Operations, Inc.*), 421 B.R. 873, 877 (Bankr. M.D. Tenn. 2010); *see also In re Phoenix Restaurant Group, Inc., et al. v. Proficient Food Company* (*In re Phoenix Restaurant Group, Inc.*), 373 B.R. 541 (M.D. Tenn. 2007).

A creditor who raises a Section 547(c)(4) defense has the burden of proving that: "(1) new value was extended after the preferential payment sought to be avoided, (2) the new value is not secured with an otherwise unavoidable security interest; and (3) the new value has not been repaid *with an otherwise unavoidable transfer*." *In re Commissary Operations, Inc.,* 421 B.R. at 877. These requirements suggest an analysis more than just whether the subsequent new value given came after the allegedly preferential transfer. However, the language of the statute provides cold comfort in terms of determining what a creditor must do to take credit for subsequent new value that is later paid.

The affirmative defense set forth in Section 547(c)(4) "has been labeled the 'subsequent advance rule' in contrast to the 'net result rule', which was applicable to pre-Code cases. The effect of the 'net result rule' was to total all payments made by the debtor and all advances made

by the creditor and offset the one against the other." *In re American International Airways, Inc*., 56 B.R. 551, 553-554 (Bankr. E.D. Pa. 1986) (internal footnote omitted); *see McClendon v. Cal-Wood Door (In re Wadsworth Building Components, Inc.),* 711 F.2d 122, 124 (9th Cir. 1983). "Under the net result rule the total of new value given is subtracted from the total of the preference payments to determine the creditor's maximum exposure . . . [N]ew value could also apply to a preference given after the new value, contrary to the statutory language." *Boyd v. The Water Doctor* (*In re Check Reporting Sys., Inc*.)*,* 140 B.R. 425, 432 (Bankr. W.D. Mich. 1992). This theory is no longer applied, but it does show important historical considerations in the application of this affirmative defense and interpretation of the current statute.

> The net result rule was a simple, reliable embodiment of creditor equality. If a creditor enhanced the estate during the preference period the creditor got credit for it. If a creditor received a transfer from the estate the creditor was required to return it. Applying this simple rule to all creditors would put the debtor back to its position 90 days prior to bankruptcy in a simple but exact fashion. However, the net result rule did not further the policy of encouraging creditors to deal with the struggling debtor. In fact, it discouraged further dealings by the creditor who had 'banked' a significant amount of new value early in the preference period. Until this entire transfer was reimbursed, the creditor had no incentive to deal with the debtor. To remedy this, the net result rule was modified so that new value could only be used to set off preferences received earlier. Thus, the only sure defense to a preference was to continue dealing with the debtor by supplying additional new value after receiving each preference.
>
> Though simple in concept, this modification to the net result rule had some complications in application. The order of the transfers did not matter under the net result rule because all new value and all preferences would simply be totalled [sic] in the end. But by requiring that new value be given after the preference, the positional relationship of each new value transfer to the preferences before and after became significant. Section 547(c)(4), the embodiment of a test which would address the relationship of the asserted new value to previous and subsequent transfers from the debtor, is not simple. But it is comprehensible, and once comprehended, it does effectuate the twin policy concerns expressed by its drafters.

In re Check Reporting Serv., 140 B.R. at 437.

When comparing the "net result rule" to the "subsequent advance rule," as it is to be applied in Section 547(c)(4), "new value given is to be netted only against a previous preferential transfer, not against any subsequent transfers." *In re American International Airways, Inc*., 56 B.R. at 553-554 (citing *Leathers v. Prime Leather Finishes Co.,* 40 B.R. 248, 250 (D.Me. 1984)). Further, "Section 547(c)(4) protects a transfer from preference attack only to the extent that a creditor thereafter replenishes the estate. The purpose of Section 547(c)(4) is to encourage trade creditors to continue dealing with troubled businesses." *Id.* (citing *Leathers,* 40 B.R. at 250; *Gold Coast Seed Co. v. Spokane Seed Co.* (*In re Gold Coast Seed Co.*), 30 B.R. 551 (Bankr. 9th Cir. 1983)).

Beyond the "net result" and "subsequent advance" methods of calculating the extent of a new value defense, there is some dispute as to whether new value needs to remain unpaid in order for it to be used as an affirmative defense to preference allegations.

> There is a recognized split in the Courts of Appeals in how the various courts interpret and apply *§ 547(c)(4)(B)*, which has been described as follows: Of the seven Circuits that have dealt with this provision of the Code, three (the Third, Seventh, and Eleventh) have concluded that *§ 547(c)(4)(B)* should be read to mean that new value *must remain unpaid* at the end of the preference period in order to be effectively used by the creditor to offset his preference liability. .. . Conversely, three Circuits (the Fourth, Fifth, and Ninth) have determined that *§ 547(c)(4)(B)* does not mandate a "remains unpaid" requirement, and that rather, the statute must be interpreted in accordance with its plain - - albeit complex - - meaning. This method of interpretation has been dubbed the "subsequent advance" approach, and is both the emerging and more doctrinally sophisticated view. The issue is seemingly unresolved in the Eighth Circuit, where the Court has come down with conflicting opinions at once acknowledging the doctrinal advantages of the "subsequent advance" approach, while upholding results it reached employing the "remains unpaid" approach.

Wahoski v. Am. & Efrid, Inc. (*In re Pillowtex Corp*.), 416 B.R. 123, 127 (Bankr. D. Del. 2009) (quoting Noah Falk, *Section 547(c)(4): The Subsequent New Value Exception Defense To Preferences*, 2004 Ann. Surv. Of Bankr. Law Part I, § Q (Norton October 2004)).

The *Pillowtex* opinion goes on to explain that "most of the courts that are cited as requiring that subsequent new value be 'unpaid,' have not actually held as much, but, . . . have only repeated that requirement in *dicta*. This explains those Courts' employment of the term 'unpaid' not as a statement of law, but rather as a shorthand requirement of *§ 547(c)(4)(B).*'" *In re Pillowtex Corp*., 416 B.R. at 127 (citing *Official Committee of Unsecured Creditors of Maxwell Newspapers, Inc. v. The Travelers Indemnity Co.* (*In re Maxwell Newspapers, Inc.*),192 B.R. 633, 639-40 (Bankr.S.D.N.Y.1996) (citations omitted). The opinion in *Pillowtex* also considers Professor Countryman's meaningful explanation of the paid/unpaid new value conundrum:

> If the debtor has made payments for goods or services that the creditor supplied on unsecured credit after an earlier preference, and if these subsequent payments are themselves voidable as preferences (or on any other ground), then under *section 547(c)(4)(B)* the creditor should be able to invoke those unsecured credit extensions as a defense to the recovery of the earlier voidable preference. On the other hand, the debtor's subsequent payments might not be voidable on any other ground and not voidable under *section 547*, because the goods and services were given C.O.D. rather than on credit, or because the creditor has a defense under *section 547(c)(1)*, *(2)*, or *(3)*. In this situation, the creditor may keep his payments but has no *section 547(c)(4)* defense to the trustee's action to recover the earlier preference. In either event, the creditor gets credit only once for goods and services later supplied.

In re Pillowtex Corp., 416 B.R. at 129 (citing Falk, quoting Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 788 (May 1985)). In its additional exploration of the issue, the Court in *Pillowtex* also considered the opinion written in *Check Reporting Services*, which explained that

> [A] creditor should not be able to assert a new value transfer as a defense to a preference if the transfer was paid for by the debtor because the estate was not made whole by the new value transfer. But, . . . by the same token, the trustee should not be able to assert the new value was paid if the trustee is asserting that the paying transaction was in fact a preference which the trustee can avoid. By doing so, the trustee will be able to eliminate the effect of the payment for the new value when he recaptures the preferential transfer.

In re Pillowtex Corp., 416 B.R. at 129-30 (quoting *In re Check Reporting Services, Inc.*, 140 B.R. at 433 (Bankr. W.D.Mich. 1992); *see also In re Maxwell Newspapers,Inc.,* 192 B.R. 633, 639.

The *Pillowtex* opinion puts all of these concepts together in a way that explains why paid new value should be permitted in a new value defense, and that the defense should not just be limited to new value that remains unpaid during the Preference Periods. Underscoring all of that analysis, paid new value exists as a matter of course in a relationship like the one before the Court where the Defendant is continuing to ship and invoice the Debtor. As long as the Defendant continued to ship to the Debtor, the Debtor benefitted from "new value" which in turn provided great benefit to the Debtor's business operations. The lower Court agreed that the Defendant should be permitted to use its paid new value as an affirmative defense in the preference litigation, and this Court should affirm that holding.

Subsequent New Value Analysis												
INV #	DATE	INV $ AMT	TERMS	INV # PAID	INV DATE	DATE PAID	Invoice AMT	DAYS TO PAY	NET $ AMT PD PER INVOICE	OUTSTANDING $ BALANCE	PREFERENCE EXPOSURE (NET)	
Preference Period										bold= over credit limit	Credit for SNV-PAID + UNPAID	Credit for SNV-UNPAID ONLY
857	10/5/2013	$500,000.00	2%5/net 10							$950,000.00	$0.00	$0.00
914	10/7/2013	$250,000.00	2%5/net 10							**$1,200,000.00**	$0.00	$0.00
				857	10/5/2013	10/10/2013	$500,000.00	5	-$490,000.00	$700,000.00	$490,000.00	$490,000.00
				914	10/7/2013	10/12/2013	$250,000.00	5	-$245,000.00	$450,000.00	$735,000.00	$735,000.00
926	10/14/2013	$750,000.00	2%5/net10							**$1,200,000.00**	$0.00	$735,000.00
				Catch up	10/14/2013		$400,000.00		-$400,000.00	$800,000.00	$400,000.00	$1,135,000.00
940	10/15/2013	$250,000.00	2%5/net10							**$1,050,000.00**	$150,000.00	$1,135,000.00
				669	7/27/2013	10/19/2013	$250,000.00	82	-$250,000.00	$800,000.00	$400,000.00	$1,385,000.00
				926	10/14/2013	10/19/2013	$750,000.00	5	-$735,000.00	$50,000.00	$1,135,000.00	$2,120,000.00
950	10/19/2013	$1,000,000.00	2%5/net10							**$1,050,000.00**	$135,000.00	$2,120,000.00
				Catch up	10/21/2013		$400,000.00		-$400,000.00	$650,000.00	$535,000.00	$2,520,000.00
952	10/24/2013	$500,000.00	2%5/net 10	unpaid						**$1,150,000.00**	$35,000.00	$2,020,000.00
996	10/30/2013	$250,000.00	2%5/net 10							**$1,400,000.00**	$0.00	$2,020,000.00
				950	10/25/2013	10/30/2013	$1,000,000.00	5	-$980,000.00	$400,000.00	$980,000.00	$3,000,000.00
				996	10/30/2013	11/4/2013	$250,000.00	4	-$245,000.00	$150,000.00	$1,225,000.00	$3,245,000.00
1040	11/5/2013	$750,000.00	2%5/net 10	unpaid						$900,000.00	$475,000.00	$2,495,000.00
1041	11/9/2013	$250,000.00	2%5/net10							**$1,150,000.00**	$225,000.00	$2,495,000.00
				940	10/15/2013	11/10/2013	$250,000.00	25	-$250,000.00	$900,000.00	$475,000.00	$2,745,000.00
				1041	11/9/2013	11/14/2013	$250,000.00	5	-$245,000.00	$650,000.00	$720,000.00	$2,990,000.00
1216	11/15/2013	$250,000.00	2%5/net 10							$900,000.00	$470,000.00	$2,990,000.00
1217	11/16/2013	$500,000.00	2%5/net 10							**$1,400,000.00**	$0.00	$2,990,000.00
				1216	11/15/2013	11/25/2013	$250,000.00	10	-$250,000.00	**$1,150,000.00**	$250,000.00	$3,240,000.00
				1217	11/16/2013	11/26/2013	$500,000.00	10	-$500,000.00	$650,000.00	$750,000.00	$3,740,000.00
1323	11/30/2013	$750,000.00	2%5/net10	unpaid						**$1,400,000.00**	$0.00	$2,990,000.00
1328	12/9/2013	$500,000.00	2%5/net10	unpaid						**$1,900,000.00**	$0.00	$2,490,000.00
1330	12/14/2013	$500,000.00	2%5/net10	unpaid					Credit Limit Discussion	**$2,400,000.00**	$0.00	$1,990,000.00
				Catch up	12/14/2013		$900,000.00		-$900,000.00	**$1,500,000.00**	$900,000.00	$2,890,000.00
				697	8/19/2013	12/14/2013	$250,000.00	115	-$250,000.00	**$1,250,000.00**	$1,150,000.00	$3,140,000.00
1386	12/15/2013	$500,000.00	2%5/net10	503(b)(9)						**$1,750,000.00**	$1,150,000.00	$3,140,000.00
1417	12/18/2013	$250,000.00	2%5/net10	503(b)(9)						**$2,000,000.00**	$1,150,000.00	$3,140,000.00
1418	12/19/2013	$500,000.00	2%5/net10	503(b)(9)						**$2,500,000.00**	$1,150,000.00	$3,140,000.00

Reflecting back to the "net result" rule, while that is not an applicable standard at this time, it is a helpful way to look at our facts. As is shown in the chart above, and as is summarized in the chart included with the *Joint Stipulation of Facts,* in the instant case, the Defendant shipped more than $8.25 million in goods to the Debtor, for which the Debtor tendered only $6.14 million in payments. On that basis alone it is clear that the Defendant was invested in the Debtor's success, and extended a great deal of unsecured credit to the Debtor for that purpose. Furthermore, as the Defendant's unpaid invoices occur more frequently as we get closer to the petition date, the Defendant clearly continued its dealings with the Debtor in an expanding manner. The lower Court agreed with the *Pillowtex* analysis and held that the Defendant should be permitted to use its paid subsequent new value defense in this matter, and this Court should affirm that holding.

E. Analysis of Subsequent New Value that will receive priority treatment pursuant to Section 503(b)(9) of the Bankruptcy Code

Beyond the analysis of the parameters and applicability of paid and unpaid subsequent new value as set out above, there is a yet a narrower subset of analysis required in this appeal. The invoices on the last three shipments from the Defendant to the Debtor remained unpaid, but the claims arising from the unpaid shipments will be permitted priority treatment in the Debtor's bankruptcy case pursuant to Section 503(b)(9). There is a split of authority regarding a Defendant's ability to use such invoices in a new value defense when those yet unpaid invoices will be paid post-petition.

Section 503(b)(9) provides that an allowed administrative expense includes "the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business." *Id.* "A creditor's right to assert an administrative expense claim under 11

U.S.C. § 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)." *Commissary Operations, Inc. v. Dot Foods, Inc., et al.*, (*In re Commissary Operations, Inc.*), 421 B.R. 873, 877 (M.D. Tenn., 2010) (citing *ASM Capital, LP v. Ames Dep't Stores, Inc.* (*In re Ames Dep't Stores, Inc.*), 582 F.3d 422, 424 n.2 (2d Cir. 2009) (Congress "amended section 546(c)(2) to provide that '[i]f a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9)'") (citation omitted)).

"While 11 U.S.C. § 503(b)(9) affords a creditor the opportunity to receive payment for goods delivered within the 20-day period before the bankruptcy filing," that right is not the same as the rights a creditor has pursuant to a reclamation claim. *In re Commissary Operations, Inc.*, 421 B.R. at 877. The opinion in *Commissary Operations* goes on to distinguish the rights a creditor has pursuant to a reclamation claim versus a Section 503(b)(9) claim, and finds that a Section 503(b)(9) claim does not give the debtor an obligation to segregate and return the creditor's belongings, or create a lien on the goods in favor of the creditor. *Id.* at 877-78. Instead, Section 503(b)(9) allows the debtor to retain and sell the product, and the creditor is "only entitled to request priority payment for goods that are in the debtor's possession pre-petition and then used by the debtor-in-possession post-petition to continue operations." *Id.*

The Court goes on to explain why Section 503(b)(9) claims should not be excluded from a creditor's new value defense by arguing that

> [t]o force a creditor to choose between asserting a § 503(b)(9) claim and preserving its right to assert a subsequent new value defense that includes deliveries made to the debtor within the 20 days prior to the bankruptcy filing would work a disservice on Congress' inherent policy goals when enacting 11 U.S.C. §§ 503(b)(9) and 547(c)(4). Requiring creditors to make such a choice would chill their willingness to do business with troubled entities. In addition, requiring creditors to make this choice in essence deprives sellers of goods of the benefits Congress conferred upon them when it enacted 11 U.S.C. § 503(b)(9).

> This policy is supported by the fact that when 11 U.S.C. § 503(b)(9) was added, Congress did not amend 11 U.S.C. § 547(c)(4) to include a new subsection reducing new value by the amount of any § 503(b)(9) claim. There is nothing in the plain language of 11 U.S.C. § 503(b)(9) or 11 U.S.C. § 547(c)(4) 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.

Id. at 879. The lower Court in this matter followed the reasoning explained by the Court in *Commissary Operations*, and that reasoning should be affirmed by this Court.

Beyond the statutory analysis, the Courts in *Commissary Operations* and *Friedman's* held that "post-petition payments by a debtor do not affect a creditor's new value defense." *Friedman's Liquidating Trust v. Roth Staffing Cos. LP* (*In re Friedman's Inc*.), 738 F.3d 547, 557 (3d Cir. Del. 2013). The opinion further states

> The new value defense as part of the preference analysis serves two underlying purposes. As we stated in *New York City Shoes*, "First, the section is designed 'to encourage trade creditors to continue dealing with troubled businesses. . .. Second, [it] is designed to treat fairly a creditor who has replenished the estate after having received a preference."

Id. at 560-61 (citing *New York City Shoes,* 880 F.2d 679, 680-81 (3d Cir. 1989) (emphasis omitted) (quoting *In re Almarc Mfg*., 62 B.R. 684, 688 (Bankr. N.D. Ill. 1986)); *see also In re Commissary Operations*, 421 B.R. at 877; *Phoenix Rest. Group, Inc. v. Ajilon Prof'l Staffing LLC* (*In re Phoenix Rest. Group, Inc.*), 317 B.R. 491, 496 (Bankr. M.D. Tenn. 2004); *Kaye v. Accord Mfg., Inc.,* No. 05-0732, 2007 Bankr. LEXIS 4738, 2007 WL 5595447 (Bankr. M.D. Tenn. June 6, 2007) .

Upon a review of the subsequent new value chart, above, if the Defendant is allowed to use the subsequent new value that it gave in the twenty days prior to the petition, the Defendant's preference exposure will be reduced by $1.25 million. The lower Court held that the Defendant

should be able to reduce its exposure for the reasons described in *Commissary Operations* and *Friedman's*, and this Court should affirm that ruling.

WHEREFORE, the Defendant prays that the Court enter an order affirming the lower Court's ruling, and finding that the Defendant's facts establish that the Defendant is entitled to rely on the ordinary course of business defense as the transfers between the parties were made pursuant to ordinary business terms pursuant to Section 547(c)(2)(B), that the Defendant established its entitlement to rely on the subjective ordinary course of business pursuant to Section 547(c)(2)(A) as an affirmative defense to the Debtor's preference allegations; that the Defendant established that its catch-up payments and other payments made pursuant to its Agreement with the Debtor were each subjectively ordinary pursuant to Section 547(c)(2)(A) of the Bankruptcy Code; that the Defendant is entitled to rely on its paid new value to assert a subsequent new value defense pursuant to Section 547(c)(4) of the Bankruptcy Code to the Debtor's preference allegations; that the Defendant is entitled to rely on its subsequent new value defense for the unpaid invoices that were issued in the twenty days prior to the petition date, which should be afforded priority repayment pursuant to Section 503(b)(9); and granting the Defendant such other and further relief as is deemed just and proper.

Date: March 13, 2015 **Mustache Wax, Inc.**

By: /s/ Jennifer M. McLemore

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UNITED STATES BANKRUPTCY APPELLATE PANEL
FOR THE CIRCUIT OF FIRST IMPRESSION

In re: Damp Dog, Inc.,	)	**Chapter 11**
Debtor.	)	
_____	)	
Damp Dog, Inc.,	)	
Plaintiff,	)	
v.	)	
Moustache Wax, Inc.,	)	
Defendant.	)	
_____	)	

AGREED STATEMENT OF FACTS

Damp Dog, Inc., together with its affiliated debtors and debtors in possession (collectively, the "Debtors" or the "Company") is a nationwide retailer of young men's clothing. The Company operates in all fifty states, and is the nation's largest retailer of hoodies and skinny jeans among other cutting-edge young men's apparel. The Company filed for chapter 11 bankruptcy protection on January 5, 2014, after entering into its pre-insolvency period in March/April of 2013.

The Company is prosecuting preference cases against many of its pre-petition vendors, including Mustache Wax ("Mustache Wax" or the "Defendant"), who supplied the Company with the ultimate, must-have skinny jeans, which come in cuts ranging from the Villain to the Handlebar. The Company could hardly keep Mustache Wax jeans on its shelves as every hip young man found the jeans to be the ultimate companion for their facial hair experiments.

Mustache Wax first came on the scene in late 2012, and Damp Dog was able to get Mustache Wax jeans on its shelves in March of 2013. Mustache Wax provided jeans to Damp Dog on initial credit terms of Net 30 day, with a credit limit of $2 million. Damp Dog always paid Mustache Wax's invoices late through August, 2014 (within 45-70 days, with an average of 59 days). Mustache Wax continued to sell large volumes of jeans to Damp Dog in July/August (exceeding the $2 million credit limit) to allow the Debtor to stock up for Back-to-School season.

In early September, Damp Dog had an outstanding accounts payable balance due to Mustache Wax in the amount of $3.25 million. Mustache Wax demanded a restructuring

agreement by which Damp Dog was required to make six weekly payments of $400k until the accounts payable balance was paid in full. In addition, Mustache Wax imposed a change in its invoice terms from Net 30 days to 2% 5/Net 10 days, and withheld new shipments until the accounts payable balance was reduced under the new credit limit of $1 million.

Damp Dog only agreed to the restructuring agreement because without Mutton Chops, Villains, and Handlebar cut jeans in their stores, Damp Dog would cease to be a shopping destination for its desired clientele. Mustache Wax's jeans were still the hottest items for young men in the know at that time.

After Back-to-School season, Damp Dog had some available cash with which to pay down its accounts payable balances before needing to stock up for holiday season. Damp Dog made three of the weekly payments of $400k to Moustache Wax between September 15 and October 15 pursuant to the parties' agreement (the last of these payments was made during the preference period). Mustache Wax began to release shipments, with all new orders on 2% 5/Net 10 terms. Damp Dog made one more $400k catch-up payment to the Defendant on October 21 (also during the preference period), but did not make the last two agreed upon catch up payments. Thus, the Debtor made two restructuring agreement payments during the preference period.

From October 15 through November 30, Damp Dog paid for most of its new orders within 5 days and took the available 2% discount. Damp Dog then stopped paying invoices for over two weeks, at which time the accounts payable due to Mustache Wax had reached $2.4 million. Defendant demanded an immediate payment of $900k and refused to ship otherwise. The Company made a $900k payment on December 15. Defendant shipped $1.25 million in goods to the Company between December 16 and December 20 (within 20 days of the bankruptcy petition date). The Company made no payments to the Defendant after December 15th.

Total preference period invoices: $8.25 million in goods were shipped by Mustache Wax to Damp Dog. $4.25 million of these invoices were unpaid on the Petition Date (including $1.25 million in invoices issued during the twenty days prior to the bankruptcy petition date- 503(B)(9) invoices).

Total preference period payments: Damp Dog made $6.14 million in preference-period payments to Moustache Wax.

[Attached hereto are (1) a chart that summarizes Moustache Wax's potential exposure in various issue outcome scenarios, and (2) a chart showing all shipments made by Mustache Wax to Damp Dog, and all payments made by Damp Dog to Mustache Wax.]

Net Exposure After Application of Defenses in Various Scenarios

Issue	Only Unpaid NV eligible	Unpaid & Paid NV Eligible	503(b)(9) NV Also Eligible
All payments NOT OCB	$3,140,000.00	$1,150,000.00	$0.00
Catch-up payments are OCB	$2,340,000.00	$350,000.00	$0.00
5/10 day Inv payments are OCB	$0.00	$0.00	$0.00

Transactions between Damp Dog and Mustache Wax in 2013				INV #	INV	DATE		DAYS	NET $ AMT PD	OUTSTANDING
INV #	DATE	INV $ AMT	TERMS	PAID	DATE	PAID	INVOICE $ AMT	TO PAY	PER INVOICE	$ BALANCE
3036	3/14/2013	$500,000.00	Net 30							$500,000.00
249	4/1/2013	$500,000.00	Net 30							$1,000,000.00
260	4/11/2013	$500,000.00	Net 30							$1,500,000.00
288	4/20/2013	$500,000.00	Net 30							$2,000,000.00
				3036	3/14/2013	4/28/2013	$500,000.00	44	-$500,000.00	$1,500,000.00
367	5/11/2013	$500,000.00	Net 30							$2,000,000.00
				249	4/1/2013	5/30/2013	$500,000.00	59	-$500,000.00	$1,500,000.00
				260	4/11/2013	5/30/2013	$500,000.00	49	-$500,000.00	$1,000,000.00
				288	4/20/2013	6/20/2013	$500,000.00	60	-$500,000.00	$500,000.00
461	6/26/2013	$1,000,000.00	Net 30							$1,500,000.00
485	7/1/2013	$500,000.00	Net 30							$2,000,000.00
533	7/7/2013	$500,000.00	Net 30						Over Credit Limit	**$2,500,000.00**
				367	5/11/2013	7/9/2013	$500,000.00	58	-$500,000.00	$2,000,000.00
669	7/28/2013	$250,000.00	Net 30							**$2,250,000.00**
697	8/20/2013	$250,000.00	Net 30							**$2,500,000.00**
701	8/25/2013	$250,000.00	Net 30	unpaid						**$2,750,000.00**
715	8/31/2013	$500,000.00	Net 30	unpaid					Agreement	**$3,250,000.00**
				461	6/26/2013	9/3/2013	$1,000,000.00	67	-$1,000,000.00	$2,250,000.00
				485	7/1/2013	9/8/2013	$500,000.00	67	-$500,000.00	**$1,750,000.00**
				Catch up	9/15/2013		$400,000.00		-$400,000.00	**$1,350,000.00**
				533	7/7/2013	9/17/2013	$500,000.00	70	-$500,000.00	$850,000.00
				Catch up	9/28/2013		$400,000.00		-$400,000.00	$450,000.00
856	9/29/2013	$500,000.00	2%5/net 10							$950,000.00
				856	9/29/2013	10/4/2013	$490,000.00	5	-$490,000.00	$450,000.00
Preference Period										
857	10/6/2013	$500,000.00	2%5/net 10							$950,000.00
914	10/8/2013	$250,000.00	2%5/net 10							**$1,200,000.00**
				857	10/6/2013	10/11/2013	$500,000.00	5	-$490,000.00	$700,000.00
				914	10/8/2013	10/13/2013	$250,000.00	5	-$245,000.00	$450,000.00
926	10/15/2013	$750,000.00	2%5/net10							**$1,200,000.00**
				Catch up	10/15/2013		$400,000.00		-$400,000.00	$800,000.00
940	10/16/2013	$250,000.00	2%5/net10							**$1,050,000.00**
				669	7/28/2013	10/20/2013	$250,000.00	82	-$250,000.00	$800,000.00
				926	10/15/2013	10/20/2013	$750,000.00	5	-$735,000.00	$50,000.00
950	10/20/2013	$1,000,000.00	2%5/net10							**$1,050,000.00**
				Catch up	10/22/2013		$400,000.00		-$400,000.00	$650,000.00
952	10/25/2013	$500,000.00	2%5/net 10	unpaid						**$1,150,000.00**
996	10/31/2013	$250,000.00	2%5/net 10							**$1,400,000.00**
				950	10/26/2013	10/31/2013	$1,000,000.00	5	-$980,000.00	$400,000.00
				996	10/31/2013	11/5/2013	$250,000.00	5	-$245,000.00	$150,000.00
1040	11/6/2013	$750,000.00	2%5/net 10	unpaid						$900,000.00
1041	11/10/2013	$250,000.00	2%5/net10							**$1,150,000.00**
				940	10/16/2013	11/11/2013	$250,000.00	25	-$250,000.00	$900,000.00
				1041	11/10/2013	11/15/2013	$250,000.00	5	-$245,000.00	$650,000.00
1216	11/16/2013	$250,000.00	2%5/net 10							$900,000.00
1217	11/17/2013	$500,000.00	2%5/net 10							**$1,400,000.00**
				1216	11/16/2013	11/26/2013	$250,000.00	10	-$250,000.00	**$1,150,000.00**
				1217	11/17/2013	11/27/2013	$500,000.00	10	-$500,000.00	$650,000.00
1323	12/1/2013	$750,000.00	2%5/net10	unpaid						**$1,400,000.00**
1328	12/10/2013	$500,000.00	2%5/net10	unpaid						**$1,900,000.00**
1330	12/15/2013	$500,000.00	2%5/net10	unpaid					Credit Limit Discussion	**$2,400,000.00**
				Catch up	12/15/2013		$900,000.00		-$900,000.00	**$1,500,000.00**
				697	8/20/2013	12/15/2013	$250,000.00	115	-$250,000.00	**$1,250,000.00**
1386	12/16/2013	$500,000.00	2%5/net10	503(b)(9)						**$1,750,000.00**
1417	12/19/2013	$250,000.00	2%5/net10	503(b)(9)						**$2,000,000.00**
1418	12/20/2013	$500,000.00	2%5/net10	503(b)(9)						**$2,500,000.00**
	Total Invoices:	**$8,250,000.00**						**Total Payments:**	**-$6,140,000.00**	