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## Defeating the Preference System: Using the Subsequent New Value Defense and Administrative Expense Claims to "Double Dip"

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# DEFEATING THE PREFERENCE SYSTEM: USING THE SUBSEQUENT NEW VALUE DEFENSE AND ADMINISTRATIVE EXPENSE CLAIMS TO “DOUBLE DIP”

## INTRODUCTION

The Bankruptcy Code (Code) provides a mechanism called “preference avoidance” through which a creditor can be forced to disgorge payments received from a debtor during the ninety days prior to the filing of the debtor’s bankruptcy case.<sup>1</sup> A preferential transfer is “[a] prebankruptcy transfer made by an insolvent debtor to or for the benefit of a creditor, thereby allowing the creditor to receive more than its proportionate share of the debtor’s assets.”<sup>2</sup> To defend against disgorgement, a creditor may assert that it gave the debtor “subsequent new value” in the form of goods shipped by the creditor to the debtor that balance out the net effect to the debtor’s estate from the creditor’s preference.<sup>3</sup> The Code also allows a creditor to receive priority payment from the debtor’s estate for goods shipped twenty days before the bankruptcy filing.<sup>4</sup> What if a creditor could ensure that it keep its preferences and receive a priority position on payments owed to it? Would that comply with the policy goals behind the Code?

The argument for using the same goods as both an administrative expense and as subsequent new value appeared for the first time in *In re Commissary Operations*.<sup>5</sup> In *In re Commissary Operations*, the bankruptcy court for the Middle District of Tennessee allowed a creditor to claim both a subsequent new value defense and an administrative expense for the same goods.<sup>6</sup>

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<sup>1</sup> 11 U.S.C. § 547(b) (2006) (“Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property . . . made on or within 90 days before the date of the filing of the petition . . .”).

<sup>2</sup> BLACK’S LAW DICTIONARY 1217 (8th ed. 2004).

<sup>3</sup> 11 U.S.C. § 547(c)(4) (“The trustee may not avoid under this section a transfer to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor . . .”).

<sup>4</sup> *Id.* § 503(b)(9) (“After notice and a hearing, there shall be allowed administrative expenses . . . including 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.”).

<sup>5</sup> *Commissary Operations, Inc. v. Dot Foods, Inc. (In re Commissary Operations, Inc.)*, 421 B.R. 873, 879 (Bankr. M.D. Tenn. 2010).

<sup>6</sup> *Id.*

However, less than a year later, the bankruptcy court for the Northern District of Georgia encountered the same argument in the 2010 case *TI Acquisition, LLC v. Southern Polymer* and concluded to the contrary.<sup>7</sup> Both courts reached their conclusions by viewing the matter from the perspective of the creditor.<sup>8</sup> The first court justified its decision as being based on a plain language interpretation of the Code and pursued a formalistic approach in distinguishing the case from earlier decisions.<sup>9</sup> In contrast, the second court put stronger emphasis on policy and took a functionalist approach to the Code, concluding that allowing a creditor to assert both a subsequent new value defense and an administrative expense for the same goods would upset the bankruptcy policy goal of equality among creditors.<sup>10</sup>

This Comment will refer to the use of the § 547(c)(4) subsequent new value defense for the same goods that a creditor claims a § 503(b)(9) administrative expense for as “double dipping,” a term used by some in the bankruptcy community to describe this issue.<sup>11</sup> This Comment addresses two primary issues: whether courts should allow creditors to double dip and, if not, what legal tools judges and lawyers can use to fight the practice.

It may be years before the appellate courts answer these questions. Some commentators have argued that district courts, charged with overseeing the decisions of the bankruptcy courts, “neglect their bankruptcy appeals” and simply “rubber stamp the bankruptcy court.”<sup>12</sup> Frequently, creditors do not appeal bankruptcy decisions. Given the need for speedy resolution of bankruptcy issues, the matter may become moot by the time the creditor gets to the district court, much less the courts of appeals. Thus, resolution of the issue in higher courts might be years away.

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<sup>7</sup> *TI Acquisition, LLC v. S. Polymer, Inc. (In re TI Acquisition, LLC)*, 429 B.R. 377, 385 (Bankr. N.D. Ga. 2010).

<sup>8</sup> See generally *In re TI Acquisition*, 429 B.R. 377; *In re Commissary Operations*, 421 B.R. 873.

<sup>9</sup> See *In re Commissary Operations*, 421 B.R. at 878–79.

<sup>10</sup> See *In re TI Acquisition*, 429 B.R. at 385. See generally H.R. REP. NO. 95-595, at 177–79 (1978), reprinted in 1978 U.S.C.A.N. 5785, 6138–40.

<sup>11</sup> See, e.g., Rudolph J. Di Massa Jr. & Laura D. Bonner, ‘Double Dipping’ New Value Defense and Administrative Expense Claims, LEGAL INTELLIGENCER, May 7, 2010, available at [http://www.duanemorris.com/articles/double\\_dipping\\_new\\_value\\_defense\\_administrative\\_expense\\_claims\\_3666.html](http://www.duanemorris.com/articles/double_dipping_new_value_defense_administrative_expense_claims_3666.html).

<sup>12</sup> *Commission Considers Venue, Jurisdiction, Appellate Changes at February Meeting*, 15 AM. BANKR. INST. J., Apr. 1996, at 1, 13; see also Jennifer M. D’Angelo, Comment, *If You Can’t Beat Them, Join Them: Inclusive Joinder and the Filtering of Article III Status into the Bankruptcy Courts*, 22 EMORY BANKR. DEV. J. 603, 610 (2006) (noting that, between 1978 and 1984, the Emergency Rule had stripped bankruptcy judges of Article III power, but that bankruptcies continued “with the bankruptcy courts deciding almost everything and with review by the district judges usually being little more than a cursory ‘rubber stamp’ procedure” (quoting CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY § 4.2, at 227–28 (1997))).

This Comment will focus on two options that a bankruptcy court should use to prevent double dipping: (1) ban double dipping outright, or (2) use § 502(d) to disallow an administrative expense claim until the creditor has disgorged the preference.

*In re Circuit City Stores* held that § 502(d) could be used to disallow § 503(b)(9) administrative expense claims by virtue of the fact that § 503(b)(9) claims arose prior to the petition date, making those seeking to double dip “creditors” under the Code.<sup>13</sup> Because the § 503(b)(9) claimants were considered creditors, the Bankruptcy Court reasoned that they must file a proof of claim.<sup>14</sup> In filing the proof of claim, the administrative expense claimant is brought into compliance with § 501(a) and thus § 502(a).<sup>15</sup> Therefore, the Court determined that § 502(d) can be used to disallow proofs of claims by § 503(b)(9) creditors.<sup>16</sup> The *Circuit City* court reasoned that “[t]he goals of equitable distribution and efficiency support the conclusion that § 502(d) may be employed to temporarily disallow the [c]laimant’s [c]laims.”<sup>17</sup>

Although *In re Circuit City* allowed § 502(d) disallowance of § 503(b)(9) administrative expense claims, the scope of the decision remains unclear. The court employed certain modifiers in its framing of the issue that might be used in the future to limit its holding. Namely, the court distinguished between transfers that are avoidable and those that are “potentially recoverable.”<sup>18</sup>

However, requests to use § 502(d) to disallow a § 503(b)(9) administrative expense claim have been denied by many bankruptcy courts that have noted that nothing in § 502(d) explicitly pertains to § 503(b)(9).<sup>19</sup> Further, at least one bankruptcy court has suggested that § 502(d) is only applicable to prepetition claims.<sup>20</sup> This court reasoned that § 503(b)(9) claims are not

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<sup>13</sup> *In re Circuit City Stores, Inc.*, 426 B.R. 560, 571 (Bankr. E.D. Va. 2010).

<sup>14</sup> *Id.*

<sup>15</sup> See 11 U.S.C. §§ 501(a), 502(a) (2006).

<sup>16</sup> *In re Circuit City Stores*, 426 B.R. at 571.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 566.

<sup>19</sup> See, e.g., *S. Polymer, Inc. v. TI Acquisition, LLC* (*In re TI Acquisition, LLC*), 410 B.R. 742, 750 (Bankr. N.D. Ga. 2009); *In re Plastech Engineered Prods., Inc.*, 394 B.R. 147, 162 (Bankr. E.D. Mich. 2008); *Roberds, Inc. v. Broyhill Furniture* (*In re Roberds, Inc.*), 315 B.R. 443, 476 (Bankr. S.D. Ohio 2004); *Beasley Forest Prods., Inc. v. Durango Ga. Paper Co.* (*In re Durango Ga. Paper Co.*), 297 B.R. 326, 330–31 (Bankr. S.D. Ga. 2003); *In re Lids Corp.*, 260 B.R. 680, 683–84 (Bankr. D. Del. 2001); *Camelot Music, Inc. v. MHW Adver. & Pub. Relations, Inc.* (*In re CM Holdings, Inc.*), 264 B.R. 141, 157–58 (Bankr. D. Del. 2000).

<sup>20</sup> See, e.g., *In re TI Acquisition*, 410 B.R. at 751 (reasoning that § 503(b)(9) claims are administrative expenses and not prepetition claims and, therefore, not subject to disallowance under § 502(d)).

prepetition claims.<sup>21</sup> Section 503(b)(9) claims are unique because they are administrative expenses—typically reserved for postpetition claims—but arise out of prepetition activities.<sup>22</sup> Bankruptcy courts should categorize § 503(b)(9) claims as prepetition contingent claims, the underlying substance of which arises from prepetition activities but whose status as an administrative expense is contingent on particular activity from the debtor. The particular activity from the debtor in this situation would be the filing of bankruptcy within twenty days of having received a shipment of goods from the creditor.

For courts that permit the use of § 502(d) to disallow a § 503(b)(9) claim, the only option is to forbid double dipping altogether. However, the Code does not explicitly prevent a creditor from claiming both § 547(c)(4) subsequent new value in the context of a preference action and a § 503(b)(9) administrative expense for the same goods.<sup>23</sup> It seems that formalism does not resolve the issue.

The goal of this Comment is to advocate against allowing creditors to double dip in bankruptcy proceedings and to give courts tools to prevent creditors from doing so. Permitting double dipping will lead to unequal treatment among creditors in bankruptcy proceedings and, on rare occasions, allow savvy debtors to protect favored creditors in the weeks leading up to bankruptcy filings.

This Comment will use two different proceedings from one bankruptcy case pending in the United States Bankruptcy Court for the Northern District of Georgia: *In re TI Acquisition, LLC*, Case No. 08-42370-MGD. In late 2009, the court in *TI Acquisition* issued an opinion addressing § 502(d) just before *In re Commissary Operations* was decided.<sup>24</sup> In 2010, after the decision in *In re Commissary Operations*, the *TI Acquisition* court issued its opinion in a preference action arising out of the main bankruptcy case, Adversary Proceeding No. 09-04009-MGD, with regard to whether the creditor was entitled to a § 503(b)(9) administrative expense claim for the same goods for

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<sup>21</sup> See, e.g., *id.* at 749.

<sup>22</sup> Compare 11 U.S.C. § 503(b)(9) (2006) (governing the shipment of goods twenty days before the bankruptcy filing, an action that can only occur prepetition), with *id.* § 503(b)(1)–(8) (governing actions taken by the debtor that can only occur postpetition).

<sup>23</sup> But see *In re TI Acquisition*, 410 B.R. at 749 (holding that § 502(d) cannot disallow an administrative expense claim). Less than a year later, the same judge held that a creditor cannot claim both a § 547(c)(4) subsequent new value defense and a § 503(b)(9) administrative expense for the same goods. See *TI Acquisition, LLC v. S. Polymer, Inc. (In re TI Acquisition, LLC)*, 429 B.R. 377, 385 (Bankr. N.D. Ga. 2010).

<sup>24</sup> See *Commissary Operations, Inc. v. Dot Foods, Inc. (In re Commissary Operations, Inc.)*, 421 B.R. 873 (Bankr. M.D. Tenn. 2010); *In re TI Acquisition*, 410 B.R. 742.

which that same creditor was asserting the § 547(c)(4) subsequent new value defense.<sup>25</sup> For ease of reference, the 2009 decision regarding § 502(d) is referred to as “*TI Acquisition I*”<sup>26</sup> and the 2010 decision regarding § 503(b)(9) and § 547(c)(4) is referred to as “*TI Acquisition II*.”<sup>27</sup>

This Comment addresses four distinct bankruptcy court opinions: *In re Commissary Operations*, *TI Acquisition I*, *TI Acquisition II*, and *In re Circuit City*. The courts in *In re Commissary Operations* and *TI Acquisition II* are in direct conflict with one another with regard to whether the same new value goods may be used for a § 547(c)(4) subsequent new value defense and a § 503(b)(9) administrative expense claim.<sup>28</sup> This Comment will first argue that the *TI Acquisition II* court’s decision to ban double dipping altogether is the better approach. This Comment argues that if the court refuses to ban double dipping, the challenging party should try to use § 502(d) to disallow a creditor’s § 503(b)(9) administrative expense claim until the creditor repays the preference it received. The second issue that this Comment addresses is the remaining two cases, *TI Acquisition I* and *In re Circuit City*, which stand in conflict with each other as to whether § 502(d) may be used to disallow administrative expense claims when the same new value goods are used for a subsequent new value defense.<sup>29</sup>

## I. BACKGROUND

### A. General Background of § 547

Section 547 of the Code allows a trustee or a debtor to demand repayment of any preferential transfer paid to a creditor.<sup>30</sup> A preferential transfer is a “prebankruptcy transfer made by an insolvent debtor to or for the benefit of a creditor, thereby allowing the creditor to receive more than its proportionate share of the debtor’s assets.”<sup>31</sup> A preferential transfer must occur within ninety days of the bankruptcy filing (in the case of a non-insider creditor) or a year

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<sup>25</sup> See *In re TI Acquisition*, 429 B.R. at 379.

<sup>26</sup> *In re TI Acquisition*, 410 B.R. 742.

<sup>27</sup> *In re TI Acquisition*, 429 B.R. 377.

<sup>28</sup> Compare *In re Commissary Operations*, 421 B.R. at 879, with *In re TI Acquisition*, 429 B.R. at 385.

<sup>29</sup> Compare *In re TI Acquisition*, 410 B.R. at 751, with *In re Circuit City Stores, Inc.*, 426 B.R. 560, 579 (Bankr. E.D. Va. 2010).

<sup>30</sup> 11 U.S.C. § 547 (2006).

<sup>31</sup> BLACK’S LAW DICTIONARY, *supra* note 2, at 1217.

before the bankruptcy filing (in the case of an insider creditor).<sup>32</sup> Section 547 grants the trustee the power to void any preferential transfer that occurred under the conditions of § 547(b).<sup>33</sup> When a trustee exercises this power, the creditor must then return whatever it received during the preference period to the debtor's estate.

Once the creditor has turned over the property it received during the preference period to the debtor's estate, § 502(h) affords that creditor the opportunity to assert a claim against the debtor's estate for the amount disgorged, putting that creditor on an even playing field with other general unsecured creditors<sup>34</sup> whose claims will be paid on a pro rata basis out of the estate's assets.<sup>35</sup> Often, the pro rata distribution a creditor receives is significantly less than the face value of its claim because there are not enough funds in the estate to pay all claims in full.<sup>36</sup> Accordingly, the ability to assert a § 502(h) claim for any returned preferential payments provides little comfort to a creditor, who might utilize every weapon in its arsenal to reduce its preference liability and avoid paying cash into the debtor's estate. One such weapon is the subsequent new value defense.

### *1. The Subsequent New Value Defense*

The Code provides a number of defenses to preference actions, including the "subsequent new value defense" under § 547(c)(4).<sup>37</sup> The Code defines "new value" as "money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to [a] transferee in a transaction that is neither void nor voidable by the debtor or the trustee under

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<sup>32</sup> The date of the transfer is the date the check was received by the creditor, contrary to the legislative history of § 547(c), which had said that the date would be when the check was delivered. 5 COLLIER ON BANKRUPTCY ¶ 547.04[4][b] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011); *id.* ¶ 547.04 n.99; *see* Barnhill v. Johnson, 503 U.S. 393, 401 (1992).

<sup>33</sup> 11 U.S.C. § 547(b) ("[T]he trustee may avoid any transfer of an interest of the debtor in property—(1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made [on or within 90 days before the bankruptcy filing or one year before the bankruptcy filing in the case of an insider]; and (5) that enables such creditor to receive more than such creditor would receive if—(A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provision of this title.").

<sup>34</sup> *Id.* § 502(h).

<sup>35</sup> *Id.* § 726(b).

<sup>36</sup> 4 COLLIER, *supra* note 32, ¶ 507.02[1].

<sup>37</sup> 11 U.S.C. § 547(c)(4) ("The trustee may not avoid under this section a transfer . . . to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor.").

any applicable law.”<sup>38</sup> The subsequent new value defense usually applies when a debtor and a creditor have an open account together and the creditor regularly extends credit to the debtor.<sup>39</sup> During the preference period, the creditor receives a transfer from the debtor and then, subsequently, ships new goods to the debtor before the debtor files for bankruptcy.<sup>40</sup> When the estate of the debtor approaches the creditor to force the creditor to disgorge the preference under § 547(b), the creditor asserts that the goods shipped to the debtor after his preferential transfer offset the loss of value to the debtor’s estate caused by the purported preferential transfer.<sup>41</sup> Thus, the net value of the debtor’s estate remained unchanged during the preference period.

As an example, consider a debtor who orders \$100,000 worth of goods on credit 100 days before filing for bankruptcy. At ninety days before bankruptcy, he pays \$100,000 for those goods and orders \$100,000 more of goods. The creditor ships those goods eighty days before the debtor files for bankruptcy. When the debtor finally does file for bankruptcy, the trustee will approach the creditor to disgorge the \$100,000 it received during the preference period that began ninety days before the debtor’s filing. Using the subsequent new value defense of § 547(c)(4), the creditor will argue that it does not have to disgorge the \$100,000 it received on day ninety because it already sent \$100,000 worth of goods to the debtor on day eighty. While this will block attempts by the trustee to force the creditor to disgorge the day-ninety \$100,000 the creditor received, the creditor is still out the day-eighty \$100,000 worth of goods. The essential feature of this defense is that two different transactions, one that depletes the estate for a certain amount and another that replenishes the estate for that same amount in goods, will “net out” and cancel each other with regard to their effect on the debtor’s estate.<sup>42</sup>

The subsequent new value defense has limits on its applicability. The first limitation is that the goods that constitute the subsequent new value must not be secured by a security interest that is otherwise unavoidable in bankruptcy.<sup>43</sup> However, the subsequent new value defense may still be applicable in

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<sup>38</sup> *Id.* § 547(a)(2).

<sup>39</sup> Robert S. Bernstein, *A Primer on Preferential Transfers in Bankruptcy*, BERNSTEIN LAW FIRM, <http://www.bernsteinlaw.com/publications/preferential/pref11.htm> (last visited Mar. 13, 2012).

<sup>40</sup> *Id.*

<sup>41</sup> *See* 5 COLLIER, *supra* note 32, ¶ 547.04[4].

<sup>42</sup> *See id.*

<sup>43</sup> 4 WILLIAM L. NORTON, JR. & WILLIAM L. NORTON III, *NORTON BANKRUPTCY LAW AND PRACTICE* 3D § 66:36, at 66-167 (2008).

situations in which the goods are only partially secured.<sup>44</sup> The defense would cover the unsecured value of the partially secured goods. There is no consensus yet among the courts as to which view is correct.<sup>45</sup>

The second limitation on the subsequent new value defense is that any payment due for the goods shipped as subsequent new value must be unavoidable in bankruptcy.<sup>46</sup> Section 547(c)(4)(B) bars a party from using the subsequent new value defense if the debtor made “an otherwise unavoidable transfer to or for the benefit of [the] creditor.”<sup>47</sup> In other words, any new value the creditor sends the debtor must not be secured by something else in the debtor’s estate.<sup>48</sup>

While the definition of “new value” may seem clear from the statute,<sup>49</sup> there is a split in the courts as to whether a forbearance of a debtor’s obligation to pay can constitute new value. The majority of courts have reasoned that such forbearance will not constitute new value,<sup>50</sup> though some allow the continued use of items like rental property to be new value.<sup>51</sup> In none of those jurisdictions will mere forgiveness of a preexisting debt or obligation on the part of the creditor create new value for the debtor’s estate.

## 2. *Claims for Administrative Expenses for Goods Shipped Within Twenty Days Prior to the Filing of the Bankruptcy Petition*

The subsequent new value defense is not the only tool a creditor has at its disposal to get and maintain an edge over other creditors. Congress added § 503(b)(9) to the Code with the Bankruptcy Abuse and Consumer Protection Act of 2005,<sup>52</sup> allowing suppliers of goods an administrative expense claim

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<sup>44</sup> See, e.g., *In re Hygrade Envelope Corp.*, 393 F.2d 60, 63 (2d Cir. 1968).

<sup>45</sup> See 4 NORTON, *supra* note 43, § 66:36, at 66-167.

<sup>46</sup> *Id.*

<sup>47</sup> 11 U.S.C. § 547(c)(4)(B) (2006).

<sup>48</sup> See 5 COLLIER, *supra* note 32, ¶ 547.04[4].

<sup>49</sup> See 11 U.S.C. § 547(a)(2).

<sup>50</sup> *In re ABC-NACO, Inc.*, 483 F.3d 470, 473–74 (7th Cir. 2007); see also *Jones Truck Lines v. Cent. States (In re Jones Truck Lines)*, 130 F.3d 323, 327 (8th Cir. 1997) (“[A] forbearance is usually not new value.”); *Am. Bank of Martin Cnty. v. Leasing Serv. Corp. (In re Air Conditioning, Inc. of Stuart)*, 845 F.2d 293, 298 (11th Cir. 1988) (“An agreement by an undersecured creditor to forgo its right to foreclose on collateral cannot be treated as a new value under [§] 547.”); *Charisma Inv. Co. v. Airport Sys., Inc. (In re Jet Fla. Sys., Inc.)*, 841 F.2d 1082, 1084 (11th Cir. 1988).

<sup>51</sup> See, e.g., *In re Air Conditioning, Inc.*, 845 F.2d at 298 (holding that continued use of rental property by the debtor constituted new value for purposes of § 527(c)(4)).

<sup>52</sup> Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1227(b), 119 Stat. 23, 200.

against the debtor's estate for goods shipped to the debtor within twenty days of the petition date to prevent the proverbial "race to the courthouse" from occurring when the creditors smell blood in the water.<sup>53</sup> Administrative expenses occupy the second highest priority of all unsecured claims<sup>54</sup> with only secured creditors and unsecured domestic support obligations being paid first.<sup>55</sup> With the exception of these new § 503(b)(9) claims, all administrative expenses can be thought of as falling into one of two categories: (1) those necessary for the continuing operation of the reorganizing debtor, and (2) those needed to pay the costs associated with the bankruptcy itself.<sup>56</sup> Section 503(b)(9) claims fall into neither of the older, pre-2005 categories for administrative expenses and stand alone among the other administrative expenses because § 503(b)(9) claims are essentially prepetition claims that are lumped together with and treated the same as postpetition claims.<sup>57</sup>

A notable aspect of § 503(b)(9) is that it only applies to "goods."<sup>58</sup> Bankruptcy courts follow the Uniform Commercial Code's (U.C.C.'s) definition of "goods"<sup>59</sup> when examining administrative expense claims.<sup>60</sup> Additionally, the debtor must have physically received the goods for the creditor's claim to qualify as an administrative expense.<sup>61</sup> Thus, courts will not entertain administrative expense claims under § 503(b)(9) that were services performed or the forgiveness of a preexisting debt. While the Code accepts the U.C.C. definition of "goods," it does not accept its definition of "value."<sup>62</sup> The Code distinguishes itself from the U.C.C. by requiring that the transfer for which "value" is sought not be voidable under applicable law.<sup>63</sup> Moreover, the

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<sup>53</sup> See *In re Bookbinders' Rest.*, No. 06-12302ELF, 2006 WL 3858020, at \*4 (Bankr. E.D. Pa. Dec. 28, 2006) (citing *In re HQ Global Holdings*, 282 B.R. 169, 173 (Bankr. D. Del. 2002)).

<sup>54</sup> 11 U.S.C. § 507(a)(2).

<sup>55</sup> *Id.* § 507(a).

<sup>56</sup> *In re Bookbinders' Rest.*, 2006 WL 3858020, at \*3.

<sup>57</sup> Compare 11 U.S.C. § 503(b)(9), with *id.* § 503(b)(1)–(8).

<sup>58</sup> 11 U.S.C. § 503(b)(9).

<sup>59</sup> U.C.C. § 2-105(1) (2004) ("Goods means all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities . . . [.] and things in action.").

<sup>60</sup> 4 COLLIER, *supra* note 32, ¶ 503.16[1]; see, e.g., *In re Goody's Family Clothing*, 401 B.R. 131, 134 (Bankr. D. Del. 2009) (citing the "near unanimous" adoption of the U.C.C. across the country and concluding that the § 503(b)(9) term "goods" conforms to the U.C.C. definition of "goods").

<sup>61</sup> See *In re Pridgen*, No. 07-04531-8-RDD, 2008 Bankr. LEXIS 1274, at \*4 (Bankr. E.D.N.C. Apr. 22, 2008).

<sup>62</sup> 5 COLLIER, *supra* note 32, ¶ 547.02[2].

<sup>63</sup> *Id.*

“value” may not be given in satisfaction of an antecedent debt or be a substitution of an obligation for an existing obligation.<sup>64</sup>

Section 503(b)(9) also requires that all transactions that a debtor or creditor argues are administrative expenses must have occurred in the “ordinary course of business.”<sup>65</sup> Some courts employ two tests to determine whether the sale of goods occurred in the ordinary course of business.<sup>66</sup> The first test, the horizontal test, compares the business transaction at issue to the type of transactions engaged in by other businesses across the same industry.<sup>67</sup> The second test—the vertical test—compares the business transaction at issue against other transactions undertaken by the same business.<sup>68</sup> Some jurisdictions require the creditor to satisfy both tests for a sale to qualify as made in the ordinary course of business.<sup>69</sup> Other courts only employ the vertical test because the horizontal test violates principles of statutory construction, is redundant, and is difficult to apply.<sup>70</sup>

While the horizontal and vertical tests were used as the standard by which bankruptcy courts measure whether administrative expense claims concerned goods shipped in the “ordinary course of business,” this leads to creditors trying to double dip.

### 3. *Double Dipping*

A new question arose at the start of 2010: can a creditor assert a subsequent new value defense for the same goods for which it wishes to claim postpetition as an administrative expense? The case *In re Commissary Operations* was the first instance of a bankruptcy court dealing with this particular argument.<sup>71</sup>

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<sup>64</sup> *Id.* In other words, a creditor may not agree to forgive a debt in exchange for the debtor agreeing to a new debt in the same amount, just to bring the debt into the preference period for administrative expenses.

<sup>65</sup> 11 U.S.C. § 503(b)(9) (2006).

<sup>66</sup> Burlington N. R.R. v. Dant & Russell, Inc. (*In re Dant & Russell, Inc.*), 853 F.2d 700, 704 (9th Cir. 1988).

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* at 705.

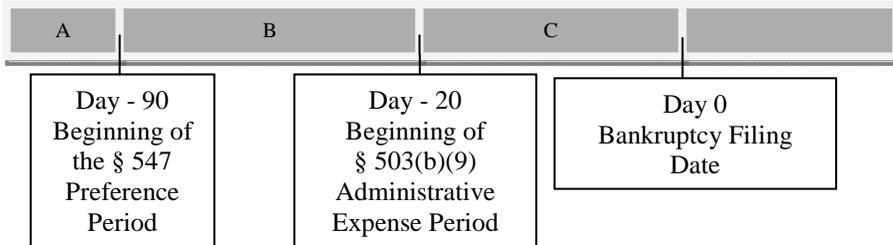
<sup>69</sup> *See id.* (“Because both the vertical and horizontal dimension tests have been met, the postpetition leases were executed in the ordinary course of . . . business for [§] 549(a) purposes and are not avoidable as being outside the ordinary course.”).

<sup>70</sup> *In re Ockerlund Constr. Co.*, 308 B.R. 325, 329 n.1 (Bankr. N.D. Ill. 2004); *In re Husting Land & Dev., Inc.*, 255 B.R. 772, 779–80 (Bankr. D. Utah 2000).

<sup>71</sup> *Commissary Operations, Inc. v. Dot Foods, Inc.* (*In re Commissary Operations, Inc.*), 421 B.R. 873, 876 (Bankr. M.D. Tenn. 2010) (“Whether deliveries entitled to a § 503(b)(9) claim status are disqualified from constituting new value for purposes of 11 U.S.C. §§ 547(a)(2) and 547(c)(4) is a question of first impression.”).

While distinguishing *In re Commissary Operations* from an earlier precedent dealing with reclamation claims,<sup>72</sup> the court determined that creditors could claim an administrative expense for the same goods they wished to use as a subsequent new value defense.<sup>73</sup>

To illustrate how double dipping works, consider the following timeline (Chart 1):



The creditor ships goods to the debtor during period A. The debtor receives the goods and pays the creditor during period B, which falls within the preference period. By receiving payment for the goods in that period, the creditor has received a preference that it will have to disgorge when the debtor declares bankruptcy. Together, periods B and C make up the preference period, whereas only period C makes up the administrative expense period. After being paid in period B, the creditor ships more goods to the debtor during period C, within both the § 547 preference period *and* within the § 503(b)(9) administrative expense period. On day 0, the debtor files for bankruptcy. Pursuant to § 547, the creditor would have to return the preference it received during period B to the debtor's estate but, in this case, the creditor will argue for an exception under § 547(c)(4). The creditor will claim that the goods it shipped in period C offset the preference it received in period B. Normally, that would mean that the creditor does not have to repay the preference to the debtor's estate. However, the goods shipped during period C also fall within the § 503(b)(9) administrative expense period. Section 503(b)(9) allows the creditor to be paid in full from the debtor's estate for the goods shipped twenty days prior to the bankruptcy filing. The creditor will try to double dip by using the goods shipped in period C to offset the preference received during period B *and* will attempt to be paid for the period C goods from the debtor's estate as an

<sup>72</sup> *Id.* at 877–78 (citing *Phx. Rest. Grp. v. Proficient Food Co. (In re Phx. Rest. Grp.)*, 373 B.R. 541, 549 (M.D. Tenn. 2007)).

<sup>73</sup> *Id.* at 879.

administrative expense. The creditor in *In re Commissary Operations* successfully used this argument.<sup>74</sup>

Shortly after *In re Commissary Operations*, the Bankruptcy Court for the Northern District of Georgia visited the same issue in *TI Acquisition II*.<sup>75</sup> The court in *TI Acquisition II* held, contrary to the holding in *In re Commissary Operations*, that a creditor could not use both a subsequent new value defense and an administrative expense claim for the same goods.<sup>76</sup> The *TI Acquisition II* court reasoned, “[I]t would be inequitable and contrary to the statute to allow the [subsequent] new value defense to be used when the creditor has been paid in full, out of the debtor’s estate, for the new value shipments.”<sup>77</sup> In other words, the court concluded that the creditor has to choose whether it wants to be paid under the subsequent new value defense or as an administrative expense claim. A creditor cannot argue both. The *TI Acquisition II* decision from the Bankruptcy Court for the Northern District of Georgia stands in direct contradiction to the *In re Commissary Operations* decision reached by the Bankruptcy Court for the Middle District of Tennessee.

4. *Section 502(d) and the Disallowance of an Administrative Expense Until the Creditor Repays the Transfer It Received from the Debtor*

Section 502(d) allows a court to disallow “any claim of any entity . . . that is a transferee of a transfer avoidable under [§] . . . 547 . . . unless such entity or transferee has paid the amount, or turned over any such property.”<sup>78</sup> Some courts have held, for instance, that § 502(d) disallows a creditor’s prepetition claim (such as an administrative expense claim under § 503(b)(9)) against a debtor until the creditor repays a transfer that would have been avoidable under § 547.<sup>79</sup> Other courts have held that an argument based on § 502(d) is inapplicable to administrative expense claims.<sup>80</sup>

Section 502(d) is meant to be used when “something more than a gentle influence is needed” to persuade the creditor to cooperate with the trustee’s

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<sup>74</sup> *Id.*

<sup>75</sup> See *TI Acquisition, LLC v. S. Polymer, Inc. (In re TI Acquisition, LLC)*, 429 B.R. 377 (Bankr. N.D. Ga. 2010).

<sup>76</sup> *Id.* at 385.

<sup>77</sup> *Id.*

<sup>78</sup> 11 U.S.C. § 502(d) (2006).

<sup>79</sup> See, e.g., *In re Circuit City Stores, Inc.*, 426 B.R. 560, 571 (Bankr. E.D. Va. 2010).

<sup>80</sup> See, e.g., *ASM Capital v. Ames Dep’t Stores (In re Ames Dep’t Stores)*, 582 F.3d 422, 430 (2d. Cir. 2009).

avoidance power.<sup>81</sup> The trustee must establish the liability of the transferee to the estate for whatever property he received in order to trigger § 502(d).<sup>82</sup> Also, § 502(d) speaks only to whether the court will allow the transferee's claim, not to whether there is any evidence to support the claim.<sup>83</sup> The effect is that the transferee faces a choice of whether to receive payment for its § 503(b)(9) claim now and risk liability of losing its preference at a later date or waive its § 503(b)(9) claim in favor of keeping its preference. How a creditor will make this decision depends on the order in which the issues arise in the bankruptcy case. While § 503(b)(9) administrative expense claims, like all administrative expense claims, are paid no later than at the time of plan confirmation,<sup>84</sup> preference actions may take years longer.<sup>85</sup> However, if the debtor is particularly low on funds, it may initiate the preference action much sooner, like the debtor in *TI Acquisition II*.<sup>86</sup>

Because § 502(d) only has coercive effect, it cannot directly force the transferee to turn over a preference to the debtor's estate.<sup>87</sup> The coercive effect derives from the ability of the court to refuse payment from the debtor's estate on any disallowed claim until the creditor has turned over the preference it allegedly owes.<sup>88</sup> It has the result of forcing the creditor to choose whether it would prefer to keep the preference and lose the administrative expense claim, or turn over the preference to the estate for the chance of a favorable ruling on its administrative expense. The trustee's mere assertion that a piece of property held by the transferee is an avoidable transfer is enough to allow the court to temporarily suspend any other claim the transferee may have against the estate until said transferee turns over the property the trustee claims is avoidable.<sup>89</sup>

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<sup>81</sup> See *Campbell v. United States (In re Davis)*, 889 F.2d 658, 662 (5th Cir. 1989).

<sup>82</sup> 4 COLLIER, *supra* note 32, ¶ 502.05[1].

<sup>83</sup> *Id.* ¶ 502.05[2].

<sup>84</sup> *Bankruptcy Creditor 503(b)(9) Administrative Expense*, BURBAGE & WEDDELL LLC (June 18, 2009), <http://www.burbageweddell.com/bankruptcy-creditor-rights-overview/section-503b9-administrative-expense-claims/>.

<sup>85</sup> *Preference Action (Bankruptcy) Law & Legal Definition*, USLEGAL.COM, <http://definitions.uslegal.com/p/preference-action-bankruptcy/> (last visited Mar. 12, 2012) ("Typically, a Trustee has two years from the bankruptcy petition date to bring the preference action.").

<sup>86</sup> *TI Acquisition, LLC v. S. Polymer, Inc. (In re TI Acquisition, LLC)*, 429 B.R. 377, 378–79 (Bankr. N.D. Ga. 2010).

<sup>87</sup> 4 COLLIER, *supra* note 32, ¶ 502.05[1].

<sup>88</sup> *Id.* ¶ 502.05[2].

<sup>89</sup> *Id.* ¶ 502.05[2][a].

Courts are divided in their use of § 502(d) to disallow § 503(b)(9) administrative expense claims to temporarily disallow the claim.<sup>90</sup> For instance, the court in *In re Circuit City* disallowed a creditor's administrative expense claim until that creditor returned the property transferred to it by the debtor that was potentially avoidable under § 547.<sup>91</sup> The court, using arguments derived primarily from theories of statutory construction and noting the conflicting interpretations of § 503(b)(9), concluded that § 503(b)(9) claimants are "creditors" under § 101(10)(A) of the Code and, as per Rule 3002 of the Federal Rules of Bankruptcy Procedure, must file a claim pursuant to § 501(a).<sup>92</sup> The *Circuit City* court noted that Fourth Circuit precedent made § 502(d) disallowance applicable to claims filed under § 501(a).<sup>93</sup>

## II. ANALYSIS

### A. General Analysis of the Law with Regard to §§ 547(c)(4) and 503(b)(9)

Before 2010, there were no reported court decisions addressing whether a transferee may use the same goods to assert both a subsequent new value defense under § 547(c)(4) and an administrative expense claim under § 503(b)(9).<sup>94</sup> A 2007 case, *In re Phoenix Restaurant Group*, dealt with a similar issue but did not directly address the point of subsequent new value and administrative expenses.<sup>95</sup>

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<sup>90</sup> Compare *In re Circuit City Stores, Inc.*, 426 B.R. 560, 579 (Bankr. E.D. Va. 2010) (holding that § 502(d) allows a bankruptcy court to disallow an administrative expense claim until transferred property is returned to the estate), with *S. Polymer, Inc. v. TI Acquisition, LLC (In re TI Acquisition, LLC)*, 410 B.R. 742, 751 (Bankr. N.D. Ga. 2009) (holding that § 502(d) may not disallow an administrative expense claim asserted under § 503(b)(9)).

<sup>91</sup> See *In re Circuit City Stores*, 426 B.R. at 579.

<sup>92</sup> See *id.* at 570; see also 11 U.S.C. § 101(10)(A) (2006) ("The term 'creditor' means [an] entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor."); *id.* § 501(a) ("A creditor or an indenture trustee may file a proof of claim."); FED. R. BANKR. P. 3002 ("An unsecured creditor or an equity security holder *must* file a proof of claim or interest for the claim or interest to be allowed." (emphasis added)).

<sup>93</sup> See *In re Circuit City Stores*, 426 B.R. at 569; see also *Durham v. SMI Indus.*, 882 F.2d 881, 882–83 (4th Cir. 1989) ("Since a court can only disallow a claim after one has been filed under [§ 501(a)], 'claim' in § 502(d) includes only one for which a proof has been filed.").

<sup>94</sup> *Commissary Operations, Inc. v. Dot Foods, Inc. (In re Commissary Operations, Inc.)*, 421 B.R. 873, 876 (Bankr. M.D. Tenn. 2010).

<sup>95</sup> See *Phx. Rest. Grp. v. Proficient Food Co. (In re Phx. Rest. Grp.)*, 373 B.R. 541, 547 (M.D. Tenn. 2007) (holding that a reclamation claim could deplete a creditor's subsequent new value defense because, by virtue of maintaining the power to reclaim the goods at any time, the creditor had not actually provided the debtor's estate with new value). *But see In re ABC-NACO, Inc.*, 483 F.3d 470, 474 (7th Cir. 2007) (holding that because the creditor did not retain the right to revoke licenses it had conveyed to the debtor, it could not

In *In re Phoenix Restaurant*, the Bankruptcy Court for the Middle District of Tennessee examined a subsequent new value defense claimed by a creditor in the amount of \$540,000.<sup>96</sup> The creditor asserted both a reclamation claim on goods it had shipped within the preference period as well as a subsequent new value defense based on the value of those same goods.<sup>97</sup> The court held that the creditor could not use both arguments because if the creditor reclaimed the goods, those goods would not have added new value to the estate.<sup>98</sup> Otherwise, the court feared that the creditor “could count the same amount in its favor twice, and doing so would clearly place [the creditor] ahead of other creditors, defeating the purpose of § 547.”<sup>99</sup>

Three years later, the Bankruptcy Court for the Middle District of Tennessee examined a similar issue in *In re Commissary Operations*. In that case the debtor, a grocer and owner of chain restaurants, initiated a bankruptcy proceeding in which more than 200 creditors asserted administrative expense claims arising under § 503(b)(9).<sup>100</sup> Among those creditors, several sought to double dip by asserting a subsequent new value defense for certain goods and then filing an administrative expense claim to receive priority payment from the debtor’s estate.<sup>101</sup>

The court in *In re Commissary Operations* used the reasoning of *In re Phoenix Restaurant* in deciding that a § 503(b)(9) administrative expense claim was analogous to a critical vendor claim.<sup>102</sup> However, the court distinguished the administrative expense claim in *In re Commissary Operations* from reclamation claims because reclamation claims arise before the bankruptcy petition date while, by the court’s reasoning, § 503(b)(9) claims could arise only after the bankruptcy petition filing.<sup>103</sup> Additionally, the court decided that goods shipped within the twenty-day prepetition window of

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use the value of not revoking those licenses in a subsequent new value defense). The distinction between these two cases may hinge on the difference between the power to “reclaim” and the power to “revoke.”

<sup>96</sup> *In re Phx. Rest. Grp.*, 373 B.R. at 546.

<sup>97</sup> *Id.*

<sup>98</sup> *Id.* at 548.

<sup>99</sup> *Id.*

<sup>100</sup> *Commissary Operations, Inc. v. Dot Foods, Inc. (In re Commissary Operations, Inc.)*, 421 B.R. 873, 875 (Bankr. M.D. Tenn. 2010).

<sup>101</sup> *Id.* at 875–76.

<sup>102</sup> *Id.* at 878. “The critical vendor doctrine applies to vendors that are so vital to the continued business operations of the debtor that their refusal to sell to the debtor could mean the demise of the debtor and its reorganization.” Darren A. Pascarella, *United States: The Critical Vendor Doctrine*, MONDAQ.COM (Feb. 10, 2004), <http://www.mondaq.com/unitedstates/article.asp?articleid=24369>.

<sup>103</sup> *In re Commissary Operations*, 421 B.R. at 876–77.

§ 503(b)(9) were shipped “free of the seller’s strings,” while a creditor using a reclamation claim could reclaim the specific goods it had shipped to the debtor and thus those goods were not shipped “free of the seller’s strings.”<sup>104</sup>

In examining congressional policy choices, the *Commissary Operations* court decided that prohibiting creditors from double dipping would force the creditor to choose between asserting its right to a § 503(b)(9) administrative expense claim and preserving its power to use a subsequent new value defense to defend its preference.<sup>105</sup> To force creditors to make such a decision, the court reasoned, would “chill their willingness to do business with troubled entities.”<sup>106</sup> To support the court’s presumption that Congress did not intend for new value to be reduced by goods for which an administrative expense claim is also asserted, the court noted that Congress added no provision to the Code prohibiting double dipping when it added § 503(b)(9).<sup>107</sup>

Admittedly, Congress did not address double dipping when amending the Code in 2005. However, the court should consider that no creditor tried to argue for double dipping in a published case before 2005 because § 503(b)(9) did not exist until the 2005 amendments.<sup>108</sup> There is no indication from the statute or the legislative history that Congress intended either to permit or prohibit double dipping. The *Commissary Operations* court takes an overly formalistic approach to a matter that likely was not contemplated by Congress. Rather than focusing on what Congress did not communicate in the statute, the court should look to what Congress did communicate by way of its policy goals when it enacted the statute—namely, encouraging equity among all creditors.

The court’s brief policy considerations in *In re Commissary Operations* are also too broad. The court’s fears that prohibiting double dipping will create a strong disincentive to keep doing business with a troubled debtor are unfounded. Permitting double dipping would certainly give the creditor the best of both worlds. But prohibiting it and forcing the creditor to decide between being paid immediately on its administrative expense claim or reducing its preference liability does not encourage that creditor to stop doing

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<sup>104</sup> *Id.* at 878 (quoting *Phx. Rest. Grp. v. Proficient Food Co. (In re Phx. Rest. Grp.)*, 373 B.R. 541, 548 (M.D. Tenn. 2007)).

<sup>105</sup> *Id.* at 879.

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1227(b), 119 Stat. 23, 200.

business with the troubled debtor. When a creditor receives a preference from a troubled debtor, it is indifferent to the decision to ship new value goods as long as those goods can reduce its preference liability. If it ships those goods and claims the subsequent new value defense, its preference liability is reduced by the value of those new value goods.<sup>109</sup> If it ships the goods and claims an administrative expense, it is paid an amount equal to the value of those goods from the debtor's estate<sup>110</sup> and must face preference liability in the future. Either the new value goods are treated as any other goods would be treated in the subsequent new value defense or they are treated as any other goods would be treated under an administrative expense claim. Forcing the creditor to choose merely puts it on the same footing as all other creditors. These creditors may have administrative expense claims or subsequent new value defenses, with no more of a disincentive to deal with the troubled debtor than any of the other creditors.

As demonstrated above, the policy goal of encouraging creditors to continue doing business with troubled debtors is likely unaffected by prohibiting double dipping. Therefore, courts should instead focus on the policy goal of encouraging equal treatment among creditors. *In re Commissary Operations* ignores this goal. Effectively, *In re Commissary Operations* gives creditors with goods who potentially qualify for a subsequent new value defense and an administrative expense claim a privileged position over other creditors. Additionally, the *Commissary Operations* court gives an advantage to certain creditors with no reciprocal benefit to the debtor.

At least one commentator has argued that permitting creditor double dipping is permissible under the language of § 547.<sup>111</sup> The argument relies on the idea that postpetition payments cannot reduce prepetition new value.<sup>112</sup> Section 547(c)(4)(B) says that a new value defense is only allowed if “*the debtor did not make an otherwise unavoidable transfer*” for the benefit of the creditor who wishes to double dip.<sup>113</sup> Because case law has established that only either the debtor in possession (DIP) or the trustee can act on behalf of the estate, this argument asserts that we should only look to the prepetition actions

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<sup>109</sup> 11 U.S.C. § 547(c)(4) (2006).

<sup>110</sup> *Id.* § 503(b)(9).

<sup>111</sup> See Mark I. Duedall, *The (Adverse?) Effect of the New Administrative Claim of Section 503(b)(9) on Preference Actions*, 2 PREFERENCE Q.L.J., Jan. 12, 2006, at 1, 9.

<sup>112</sup> See *id.* at 5 (citing *Grant v. Sun Bank (In re Thurmon Constr., Inc.)*, 189 B.R. 1004, 1014 (Bankr. M.D. Fla. 1995)).

<sup>113</sup> 11 U.S.C. § 547(c)(4)(B) (emphasis added).

of the debtor. Those administrative expense payments that come from the estate postpetition are completely separate from any subsequent new value prepetition. Further, cases have established that postpetition shipments of goods cannot enhance prepetition new value.<sup>114</sup> Thus, a reasonable argument may be made that “a careful reading of § 547(c)(4)(B) shows it has no application to postpetition payments of any kind, which would include postpetition payments by a DIP of a prepetition claim entitled to priority under § 503(b)(9).”<sup>115</sup>

However, upon closer inspection, there is reason to believe that the filing date is not an absolute impediment between prepetition actions of the debtor and the postpetition actions of the DIP or trustee. Section 547(a)(2), in defining new value for the purposes of the section, says that new value “means money or money’s worth in goods, services, or new credit . . . that is neither void nor voidable by the debtor *or the trustee* under any applicable law.”<sup>116</sup> The significance of “or the trustee” is that the trustee of the estate does not exist until after the petition has been filed. Therefore, § 547(a)(2) states that the trustee (which can only exist postpetition) may void prepetition new value. If that is the case, it would suggest that the filing of the petition is not an obstacle preventing interference with the debtor’s prepetition receipt of goods.

Shortly after the decision in *In re Commissary Operations*, the Bankruptcy Court for the Northern District of Georgia decided *TI Acquisition II*.<sup>117</sup> The debtor in *TI Acquisition II* was a textile manufacturer who had received \$302,512 worth of manufacturing supplies from a creditor.<sup>118</sup> In the bankruptcy proceeding, the creditor tried to double dip, and the debtor told the court that it would only allow either the administrative expense claim or the subsequent new value defense.<sup>119</sup>

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<sup>114</sup> See, e.g., *Field v. Md. Motor Truck Ass’n (In re George Transfer, Inc.)*, 259 B.R. 89, 95–96 (Bankr. D. Md. 2001).

<sup>115</sup> See *Duedall*, *supra* note 111, at 7.

<sup>116</sup> 11 U.S.C. § 547(a)(2) (emphasis added).

<sup>117</sup> *TI Acquisition, LLC v. S. Polymer, Inc. (In re TI Acquisition, LLC)*, 429 B.R. 377 (Bankr. N.D. Ga. 2010). This case was the second hearing pertaining to the dispute between Southern Polymer and TI Acquisition, LLC. In the first hearing, the court had disallowed a § 503(b)(9) administrative expense claim by the creditor. See *S. Polymer, Inc. v. TI Acquisition, LLC (In re TI Acquisition, LLC)*, 410 B.R. 742 (Bankr. N.D. Ga. 2009).

<sup>118</sup> *In re TI Acquisition*, 429 B.R. at 378.

<sup>119</sup> *Id.* at 379.

Unlike *In re Commissary Operations*, the court in *TI Acquisition II* determined that administrative expenses were similar to reclamation claims.<sup>120</sup> It accused the *Commissary Operations* court of ignoring key language in *In re Phoenix Restaurant*.<sup>121</sup> *TI Acquisition II* referred to *In re Phoenix Restaurant* for the point that “[the creditor] had the right either to reclaim goods of a value of \$540,000 *or have its reclamation claim enhanced in priority over other creditors to that amount.*”<sup>122</sup> Further, the *Phoenix Restaurant* case stated, “Either way, [the creditor’s] reclamation claim would not add ‘new value’ to the debtor; as the [b]ankruptcy [c]ourt put it, these goods were not ‘shipped free of the seller’s strings.’”<sup>123</sup> The significance of the italicized portion of the above quote is that enhancing a claim in priority over other creditors is exactly what happens with a § 503(b)(9) administrative expense claim.<sup>124</sup>

*In re Phoenix Restaurant*’s reasoning was that goods subject to a reclamation claim are not sold “free of the seller’s strings” because the seller could either reclaim the goods themselves or have a monetary claim enhanced in priority over other creditors in the bankruptcy proceeding.<sup>125</sup> In the same way, goods shipped by a creditor to the debtor twenty days before the bankruptcy filing would also receive an enhanced priority over other creditors in the bankruptcy proceeding. Under that reasoning, *TI Acquisition II* correctly decided that goods subject to an administrative expense claim were not shipped free of the seller’s strings.<sup>126</sup> But is there a significant difference between a § 503(b)(9) administrative expense claim and a reclamation claim?

### *1. An Administrative Expense Claim is Analogous to a Reclamation Claim*

If an administrative expense claim is analogous to a reclamation claim, it will significantly strengthen a party’s argument that the goods were not new value. This was the reasoning of the bankruptcy court in *In re Phoenix Restaurant*.<sup>127</sup> If the creditor may reclaim or receive payment for them after the filing of the bankruptcy petition, the goods have not balanced out the creditor’s

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<sup>120</sup> *Id.* at 381.

<sup>121</sup> *Id.*

<sup>122</sup> *Id.* (quoting *Phx. Rest. Grp. v. Proficient Food Co. (In re Phx. Rest. Grp.)*, 373 B.R. 541, 548 (M.D. Tenn. 2007)) (emphasis added by *TI Acquisition* court).

<sup>123</sup> *In re Phx. Rest. Grp.*, 373 B.R. at 548.

<sup>124</sup> See 11 U.S.C. § 507(a)(2) (2006). Section 507 elevates administrative expense claims to the position of second highest priority, above all other creditors’ claims except domestic support obligations.

<sup>125</sup> *In re Phx. Rest. Grp.*, 373 B.R. at 548.

<sup>126</sup> See *In re TI Acquisition*, 429 B.R. at 381.

<sup>127</sup> *In re Phx. Rest. Grp.*, 373 B.R. at 548.

earlier preference.<sup>128</sup> In the same way, allowing the creditor to receive an administrative expense claim for the same goods it argues added new value to the debtor's estate would not replenish the debtor's estate of the property previously received by the creditor. It does not make sense to grant that the creditor added new value to the debtor's estate and then allow the creditor to deplete the estate by that same amount of new value after the debtor files for bankruptcy protection. The nature of the subsequent new value defense and the § 503(b)(9) administrative expense claim would suggest that the two are mutually exclusive.

In the case of the interaction between the subsequent new value defense and administrative expenses, the reasoning from *In re Phoenix Restaurant* is applicable. In courts that accept the U.C.C. definition of "goods,"<sup>129</sup> a claim for an administrative expense is likely to constitute a reclamation claim because, as *In re Phoenix Restaurant* noted, a reclamation claim may seek either the goods themselves or a prioritized monetary payment for the goods.<sup>130</sup> When claiming an administrative expense, the creditor seeks payment for those goods; it does not seek to reclaim the goods it has shipped to the debtor.<sup>131</sup>

A creditor might be inclined to dismiss the distinction between reclaiming the goods themselves and seeking payment from the estate of the debtor. Whether the creditor receives the goods themselves or the cash for those goods, the debtor's estate is depleted by the same amount. However, the bankruptcy court in *In re Commissary Operations* focused on the fact that a reclamation claim may arise before the debtor files for bankruptcy, while administrative expense claims can only arise after the filing of a bankruptcy petition.<sup>132</sup> In that case, the court focused on the creditor's expectations when shipping the goods.<sup>133</sup> With regard to a reclamation claim, the creditor knows at the time of shipping the goods that it can exercise its reclamation claim and take the goods back. However, with an administrative expense claim, the creditor may not know the debtor is within twenty days of filing for bankruptcy

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<sup>128</sup> *Id.*

<sup>129</sup> U.C.C. § 2-105(1) (2004). See *supra* note 59 for the definition of "goods."

<sup>130</sup> *In re Phx. Rest. Grp.*, 373 B.R. at 548.

<sup>131</sup> The wording of § 503(b)(9) states that an administrative expense claim is allowed only for "the value of any goods received by the debtor" rather than the creditor being able to reclaim the goods themselves. 11 U.S.C. § 503(b)(9) (2006) (emphasis added).

<sup>132</sup> *Commissary Operations, Inc. v. Dot Foods, Inc. (In re Commissary Operations, Inc.)*, 421 B.R. 873, 877 (Bankr. M.D. Tenn. 2010).

<sup>133</sup> *Id.*

and thus, at the time of shipping, has no idea that he will have a cognizable claim against the estate.

Additionally, the court in *In re Commissary Operations* noted that the creditor might not even receive its full claim for an administrative expense the way it would via a reclamation claim because, while administrative expenses receive the second highest priority of unsecured creditors, they still may not recover the full value of its goods after the secured creditors and domestic support obligations are satisfied.<sup>134</sup> Further, the bankruptcy court also might not approve the administrative expense claim.<sup>135</sup>

The court in *In re Commissary Operations* also focused briefly on the policy behind §§ 503(b)(9) and 547(c)(4).<sup>136</sup> The policy considerations made by Congress were to encourage creditors to continue doing business with distressed debtors.<sup>137</sup> The court briefly touched on a formalistic approach to the statute at the end of its opinion, noting:

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 [either section] that indicates any [c]ongressional 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.<sup>138</sup>

While it is true that Congress did not amend § 547(c)(4) to deal with new value reductions as a result of its addition of § 503(b)(9), that is hardly indicative of Congress's intent on this matter. An argument that Congress did not intend § 503(b)(9) to reduce a § 547(c)(4) new value defense because it did not amend § 547(c)(4) with the 2005 amendments might be less convincing, however, when one remembers that the argument presented in *In re Commissary Operations* was an issue of first impression.<sup>139</sup> It is difficult to take Congress's silence on the issue to be tacit approval of an argument that

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<sup>134</sup> *Id.* at 877–78.

<sup>135</sup> *Id.* at 878.

<sup>136</sup> *Id.* at 879; see also *Courts Continue to Strengthen the “New Value” Defense*, NEIGER LLP, <http://www.neigerllp.com/avoidance-action-report/courts-continue-to-strengthen-the-%E2%80%9Cnew-value-%E2%80%9D-defense> (last visited Mar. 12, 2012).

<sup>137</sup> See *In re Commissary Operations*, 421 B.R. at 877 (citing *Phx. Rest. Grp. v. Proficient Food Co. (In re Phx. Rest. Grp.)*, 373 B.R. 541, 547 (M.D. Tenn. 2007); *In re Arts Dairy, LLC*, 414 B.R. 219, 220 (Bankr. N.D. Ohio 2009)).

<sup>138</sup> *In re Commissary Operations*, 421 B.R. at 879.

<sup>139</sup> See *id.* at 876.

had never been used before. The more likely explanation is that Congress simply did not consider the question when enacting the amendments.

The reasoning of *In re Commissary Operations* is, however, completely at odds with that of *TI Acquisition II*. On whether administrative expense claims are comparable to reclamation claims, the court in *TI Acquisition II* held that administrative expense claims are similar to reclamation claims, based largely on a functionalist line of reasoning. Primarily, the court reasoned that the determinative fact was that both reclamation claims and administrative expense claims deprive the debtor of the “uninhibited use of new value.”<sup>140</sup>

*TI Acquisition II* could be limited to its facts. The creditor’s administrative expense was fully protected by a fund set aside by the estate.<sup>141</sup> Thus, the court reasoned, while there is normally a substantial difference between the right to reclamation and the right to an administrative expense, there was no difference in this particular case because of the reserve fund.<sup>142</sup> Under the court’s reasoning, the creditor would be indifferent as to which it got if it had both an administrative expense claim and a reclamation claim on account of the reserve fund.<sup>143</sup> While the opinion seems broad enough to apply to many different factual settings, a creditor might try to distinguish its case from *TI Acquisition II* if no such reserve fund existed and there was a fear of administrative insolvency.

*B. Jurisdictional Obstacles to Double Dipping: The “Remains Unpaid” Approach and the “Subsequent Advance” Approach*

*TI Acquisition II* noted that the timing of a § 503(b)(9) claim affects whether double dipping is an available argument.<sup>144</sup> There are two different approaches that circuit courts have followed when examining whether goods that constitute new value must remain unpaid: (1) the “remains unpaid” approach, and (2) the “subsequent advance” approach.<sup>145</sup> The *TI Acquisition II* court believed that both approaches could be used to prevent double dipping,<sup>146</sup>

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<sup>140</sup> *TI Acquisition, LLC v. S. Polymer, Inc. (In re TI Acquisition, LLC)*, 429 B.R. 377, 384 (Bankr. N.D. Ga. 2010).

<sup>141</sup> *Id.* at 385.

<sup>142</sup> *Id.* at 381.

<sup>143</sup> *Id.*

<sup>144</sup> *See id.* at 383–84.

<sup>145</sup> *See id.* at 382–83.

<sup>146</sup> *See id.* at 383–84. If the Eleventh Circuit were to fully embrace the remains unpaid approach, it is clear that the postpetition payment of SPI’s § 503(b)(9) claim would deplete SPI’s new value defense. Under the

but the argument is less straightforward with the “subsequent advance” approach.

*1. Two Different Approaches to Whether Subsequent New Value May Be Paid and Still Claimed as an Administrative Expense*

A corollary to the jurisdictional arguments between the “remains unpaid” and “subsequent advance” approaches is to argue that §§ 503(b)(9) and 547(c)(4) are inapplicable on the grounds that § 547(c)(4)(B) requires that the “debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.”<sup>147</sup> Timing becomes the main issue because it might make a difference whether the debtor has already paid the administrative expense claim under § 503(b)(9) when the subsequent new value defense of § 547(c)(4) is raised. In other words, does the payment of the administrative expense claim to the creditor count as “an otherwise unavoidable transfer to or for the benefit of such creditor”? If so, it would seem that upon receipt of payment, that creditor would no longer be able to use the subsequent new value defense to keep a preference.

There is a split in the courts as to whether the new value must remain unpaid for the creditor to use it as a defense against disgorging the preference.<sup>148</sup> One side requires that it remain unpaid, and the other focuses on whether the preference was paid by an otherwise unavoidable transfer.<sup>149</sup> The approach of the former jurisdictions is aptly named the “remains unpaid” approach, while the approach of the latter jurisdictions is known as the “subsequent advance” approach.<sup>150</sup>

*a. The “Remains Unpaid” Approach*

The “remains unpaid” approach has three requirements: (1) the creditor must give unsecured new value; (2) the debtor must receive the new value after the preferential transfer at issue; and (3) the debtor must not have repaid the

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“subsequent advance” approach, the reasoning in *In re Phoenix Restaurant* still supports treating fully funded § 503(b)(9) claims like reclamation claims and unlike critical vendor payments because § 503(b)(9) claims deny the debtor and the debtor’s estate the uninhibited use of new value.

<sup>147</sup> 11 U.S.C. § 547(c)(4)(B) (2006).

<sup>148</sup> 4 NORTON, *supra* note 43, § 66:36, at 66-169.

<sup>149</sup> *Id.* § 66:36, at 66-169 to -170.

<sup>150</sup> See Leslie Treff, *Commentary on the Ability of Creditor to Offset Preferential Transfers by New Value*, 2010 LEXISNEXIS EMERGING ISSUES ANALYSIS 4922, at 3-4 (2010).

new value.<sup>151</sup> In these jurisdictions it would seem that the third requirement may prevent a creditor from both using a subsequent new value defense and making a claim for administrative expenses under § 503(b)(9). The creditor, in being paid for its administrative expense claim, would have to forgo keeping its preferential payments through the subsequent new value defense. At least one commentator regards the “remains unpaid” approach as the controlling law in the Third, Seventh, and Eleventh Circuit Courts of Appeals.<sup>152</sup>

In a “remains unpaid” jurisdiction, the argument to ban double dipping is easier.<sup>153</sup> Paying the § 503(b)(9) claim for new value goods would violate the requirement that the payment for those goods remains unpaid. If a creditor receives payment for its new value goods, the debtor has not benefitted from any new value.

*b. The “Subsequent Advance” (TI Acquisition II) Approach*

The “subsequent advance” approach renders certain transfers not preferential even though no goods were exchanged during the preference period. Specifically, the “subsequent advance” approach is as follows:

When, for goods sold and delivered, payments are made on a running or open account between the parties in the regular course of business within the 90-day period, without knowledge on the part of the creditor of the debtor’s insolvency, and the net result of this transaction is to enrich the debtor’s estate by the total sales, less the total payment, such payments or transfers are not preferential, even though no corresponding goods are exchanged for the payments made within the preference period.<sup>154</sup>

The gist of this approach is simply that the new value may not have been secured by or paid for by an unavoidable transfer.<sup>155</sup>

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<sup>151</sup> Kroh Bros. Dev. Co. v. Cont’l Constr. Eng’rs, Inc. (*In re* Kroh Bros. Dev. Co.), 930 F.2d 648, 652 (8th Cir. 1991); *see also* N.Y.C. Shoes, Inc. v. Bentley Int’l, Inc. (*In re* N.Y.C. Shoes, Inc.), 880 F.2d 679, 680 (3d Cir. 1989); Charisma Inv. Co. v. Airport Sys., Inc. (*In re* Jet Fla. Sys., Inc.), 841 F.2d 1082, 1083 (11th Cir. 1988).

<sup>152</sup> *See* Treff, *supra* note 150, at 1.

<sup>153</sup> *See* TI Acquisition, LLC v. S. Polymer, Inc. (*In re* TI Acquisition, LLC), 429 B.R. 377, 384 (Bankr. N.D. Ga. 2010) (“If the Eleventh Circuit were to fully embrace the remains unpaid approach, it is clear that the post-petition payment of [the creditor’s] § 503(b)(9) claim would deplete [the creditor’s] new value defense.”).

<sup>154</sup> 5 COLLIER, *supra* note 32, ¶ 547.04[4][d].

<sup>155</sup> *In re* TI Acquisition, 429 B.R. at 383.

The “subsequent advance” approach opens the door to double dipping and hinges on whether a § 503(b)(9) claim arises prepetition or postpetition.<sup>156</sup> The reasoning is that § 547, governing preferences, closes the window for new value shipments on the date of the bankruptcy filing.<sup>157</sup> Thus, § 503(b)(9) administrative expense claims, which are paid postpetition, arguably could not be used to deplete prepetition new value.

However, as argued earlier in this Comment,<sup>158</sup> the substance of § 503(b)(9) administrative expense claims arise prepetition.<sup>159</sup> They should be treated as prepetition contingent claims. The goods at issue in a § 503(b)(9) claim are shipped twenty days before the filing of the bankruptcy petition and are paid priority with other administrative expenses.<sup>160</sup> Under the “subsequent advance” approach, treating § 503(b)(9) goods as prepetition contingent claims would make them analogous to reclamation claims. Thus, a party challenging double dipping would have a colorable argument that the new value was depleted by the payment of the § 503(b)(9) claim.<sup>161</sup>

The resolution of these two conflicting views may lie in the Code itself.<sup>162</sup> Section 547(c)(4)(B) places emphasis on the avoidability of the debtor’s subsequent payments and not on whether the new value was *actually* unpaid.<sup>163</sup> If the matter does not revolve around whether the new value will eventually be repaid, it would seem that § 503(b)(9) and the existence of an administrative expense claim would have no bearing on whether a creditor may successfully assert a subsequent new value defense.<sup>164</sup>

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<sup>156</sup> See *Phx. Rest. Grp. v. Proficient Food Co. (In re Phx. Rest. Grp.)*, 373 B.R. 541, 547 (M.D. Tenn. 2007) (“The [b]ankruptcy [c]ourt reasoned that the preference window of § 547 closed on the date of the filing of the bankruptcy petition and post-petition payments could not be used to deplete pre-petition ‘new value.’”).

<sup>157</sup> *Id.*

<sup>158</sup> See *supra* text accompanying note 57.

<sup>159</sup> See 11 U.S.C. § 503(b)(9) (2006); *S. Polymer, Inc. v. TI Acquisition, LLC (In re TI Acquisition, LLC)*, 410 B.R. 742, 750 (Bankr. N.D. Ga. 2010).

<sup>160</sup> See 11 U.S.C. § 503(b)(9).

<sup>161</sup> See, e.g., *TI Acquisition, LLC v. S. Polymer, Inc. (In re TI Acquisition, LLC)*, 429 B.R. 377, 384 (Bankr. N.D. Ga. 2010) (“Under the subsequent advance approach, the reasoning in *In re Phoenix Restaurant Group* still supports treating fully funded § 503(b)(9) claims like reclamation claims and unlike critical vendor payments because § 503(b)(9) claims deny the debtor and the debtor’s estate the uninhibited use of new value.”).

<sup>162</sup> 4 NORTON, *supra* note 43, § 66:36, at 66-170.

<sup>163</sup> 11 U.S.C. § 547(c)(4)(B).

<sup>164</sup> 4 NORTON, *supra* note 43, § 66:36, at 66-170 to -171. (citing *Commissary Operations, Inc. v. Dot Foods, Inc. (In re Commissary Operations, Inc.)*, 421 B.R. 873 (Bankr. M.D. Tenn. 2010)). *But see In re TI Acquisition*, 429 B.R. 377.

The *TI Acquisition II* court also questioned the notion that the Eleventh Circuit was a jurisdiction that ascribed to the reasoning that the new value must remain unpaid in order to use the subsequent new value defense.<sup>165</sup> While it did not deny that the previous Eleventh Circuit case of *In re Jet Florida Systems* had listed “the new value must remain unpaid” in its list of requirements to utilize the subsequent new value defense in 1988, it noted that § 547(c)(4)(B) was not directly in dispute in the case and thus treated the statements of the Eleventh Circuit in *In re Jet Florida* as dicta.<sup>166</sup> While the court was correct in noting that § 547(c)(4)(B) never specifically came up in the *Jet Florida* case, the matter at issue does revolve around a legal interpretation of § 547(c)(4).<sup>167</sup> While the facts of the *Jet Florida* case show that the new value at issue in that case remained unpaid and the court listed that new value “remain unpaid” when it listed the requirements, it did not go into any further analysis of the issue.<sup>168</sup>

Nonetheless, contrary to the statement of the bankruptcy court in *TI Acquisition II*, other commentators regard the Eleventh Circuit as a jurisdiction that follows the “remains unpaid” requirement for determining the applicability of the subsequent new value defense.<sup>169</sup> Given the infrequency with which preference actions are litigated, and thus the exceedingly rare occasions on which the federal appellate courts have the opportunity to review that body of case law, it may be some time before it is clear whether *In re Jet Florida* is good precedent for the proposition that the Eleventh Circuit is a “remains unpaid” jurisdiction.

The *TI Acquisition II* court is not the first bankruptcy court to distinguish between a present case and other precedential decisions in the same jurisdiction by appealing to the fact that the earlier court did not specifically address § 547(c)(4)(B). In 2009, the Bankruptcy Court for the District of Delaware made essentially the same argument to distinguish its precedent.<sup>170</sup> In *In re Pillowtex Corp.*, the bankruptcy court addressed the third requirement

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<sup>165</sup> *In re TI Acquisition*, 429 B.R. at 383–84.

<sup>166</sup> *Id.* (quoting *Charisma Inv. Co. v. Airport Sys., Inc. (In re Jet Fla. Sys., Inc.)*, 841 F.2d 1082, 1083 (11th Cir. 1988)).

<sup>167</sup> *In re Jet Fla. Sys.*, 841 F.2d at 1083.

<sup>168</sup> *Id.*

<sup>169</sup> See, e.g., Treff, *supra* note 150, at 1 (“Section 547(c)(4)(B) of the Bankruptcy Code has been interpreted by the Third, Seventh, and Eleventh Circuits to require that ‘new value’ remain unpaid at the end of the preference period to be used by a creditor to offset its preference liability.”).

<sup>170</sup> See *Wahoski v. Am. & Efrid, Inc. (In re Pillowtex Corp.)*, 416 B.R. 123, 128–29 (Bankr. D. Del. 2009).

of the subsequent new value defense. The court determined that it could distinguish between two earlier cases that had placed the District of Delaware within the “remains unpaid” approach.<sup>171</sup> Though neither of the two earlier cases was a circuit court case as in *TI Acquisition II*, one was a district court decision.<sup>172</sup> Similar to the reasoning of the court in *TI Acquisition II*, the *Pillowtex* court concluded that “neither [of the two earlier] court[s] analyzed the third element of the test, but considered only whether the creditor had provided new value *after* receipt of a preferential transfer.”<sup>173</sup> On that basis, the court determined that it could examine § 547(c)(4)(B) independently of *In re Jet Florida*.<sup>174</sup>

If the *TI Acquisition II* court is correct in its reading of Eleventh Circuit precedent and its reasoning stands, the decision could act as a total bar to those wishing to assert the same new value goods for a subsequent new value defense and an administrative expense claim. Both *TI Acquisition II*<sup>175</sup> and *Pillowtex*<sup>176</sup> offer a potential solution to those who wish to bar double dipping. This would give bankruptcy courts substantial power to shape §§ 547(c)(4) and 503(b)(9) jurisprudence. Given the infrequency with which the circuit courts of appeal examine bankruptcy cases, there could be a substantial amount of lower bankruptcy court precedent placing grassroots pressure on the circuit courts when the issue finally reaches them.

## 2. *Perverse Incentives Created by Allowing Double Dipping*

While the bankruptcy court in *In re Commissary Operations* examined the policy considerations of Congress and the incentives that its interpretation would create for creditors, it did not consider any adverse incentives that its ruling might create for debtors.

A debtor may wish to “load up” on goods from its suppliers on the eve of bankruptcy in an effort to keep its business running through a likely chapter 11

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<sup>171</sup> *See id.*

<sup>172</sup> *See* Claybrook v. Pizza Hut, Inc. (*In re* Discovery Zone, Inc.), No. 99-0941 (PJW), 2004 U.S. Dist. LEXIS 20575 (D. Del. Oct. 5, 2004).

<sup>173</sup> *See In re Pillowtex Corp.*, 416 B.R. at 128–29.

<sup>174</sup> *See id.*

<sup>175</sup> *TI Acquisition, LLC v. S. Polymer, Inc. (In re TI Acquisition, LLC)*, 429 B.R. 377 (Bankr. N.D. Ga. 2010).

<sup>176</sup> *In re Pillowtex Corp.*, 416 B.R. 123.

reorganization.<sup>177</sup> But what other motivation could a debtor have for stocking up on inventory just before bankruptcy?

Insight into the buyer-supplier relationship of businesses helps to answer that question. Loyalty to suppliers who are sympathetic to your business can advantage buyers. Experts advise businesses to build “familial ties” with their suppliers and work together on long-term partnerships.<sup>178</sup>

Loyalty, “familial ties,” and long-term partnerships may lead to a debtor favoring its suppliers over its other creditors. The supplier is similar to an equity investor in some respects.<sup>179</sup> It is often owed too small an amount of money to make direct participation in the bankruptcy litigation worthwhile, and thus, like equity holders in a business, the supplier often receives nothing at the end of a bankruptcy.<sup>180</sup> Despite this seemingly precarious position, the supplier is not without the means to induce payment from the debtor. Debtors in possession wishing to continue the business as a going concern understand that a supplier can often ensure that it gets paid by threatening to withhold future deliveries.<sup>181</sup> Thus, a debtor approaching bankruptcy must decide what it is willing to do to keep its suppliers satisfied.<sup>182</sup> In the debtor’s mind, the desire to maintain a favorable business reputation with industry suppliers may trump the desire to be equitable with all of its creditors.

The implication of the *In re Commissary Operations* decision allowing for double dipping creates a new tool for the savvy debtor. For example, if a debtor wants to ensure that a favored supplier will keep any money it has received as a preference, on the eve of bankruptcy, it may order from the supplier an amount of goods equal to the preference. This incentive could be even greater where the debtor is a small business and the favored supplier is a friend or family member. After declaring bankruptcy, the debtor would then inform the creditor that it should make both the §§ 547(c)(4) and 503(b)(9) claims in order to keep both its preference and receive priority payment via an

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<sup>177</sup> Bob Eisenbach, *Reclamation: Can a Vendor “Get the Goods” from an Insolvent Customer?*, IN THE (RED): THE BUSINESS BANKRUPTCY BLOG (Nov. 19, 2006), <http://bankruptcy.cooley.com/2006/11/articles/business-bankruptcy-issues/reclamation-can-a-vendor-get-the-goods-from-an-insolvent-customer>.

<sup>178</sup> See, e.g., Jeffrey K. Liker & Thomas Y. Choi, *Building Deep Supplier Relationships*, HARV. BUS. REV., Dec. 2004, at 104, 106.

<sup>179</sup> Douglas G. Baird, *The Reorganization of Closely Held Firms and the “Opt Out” Problem*, 72 WASH. U. L.Q. 913, 923 (1994).

<sup>180</sup> *Id.*

<sup>181</sup> *Id.*

<sup>182</sup> Risa Lynn Wolf-Smith, *Must Suppliers Continue To Supply on Credit During the Slide into Bankruptcy? Heck No!*, AM. BANKR. INST. J., Apr. 2009, at 26, 26.

administrative expense claim for its goods. Using this strategy, the debtor may ensure that a favored creditor receives full payment of its claims ahead of all other unsecured creditors.

If the *In re Commissary Operations* case stands, the impact of the holding is difficult to predict. Debt owed to a supplier is often very small in relation to debt owed to all other creditors.<sup>183</sup> However, the claim for administrative expenses can sometimes be substantial. For example, in *TI Acquisition I* and *TI Acquisition II*, the creditor's total administrative expense claim amounted to \$302,512.00.<sup>184</sup> Additionally, the debtor would need significant knowledge of the Code in order to manufacture an opportunity to double dip for a creditor. Companies that have been through bankruptcy before or consult a bankruptcy attorney before filing their petition may obtain the knowledge necessary to manage their supplier business relationship by helping double dip under the reasoning of *In re Commissary Operations*. It may seem that debtors only rarely manufacture an opportunity for favored creditors to double dip, but if other bankruptcy courts accept the reasoning of *In re Commissary Operations*, double dipping may become standard business practice.

Feelings of loyalty, charity, and concern for its business reputation might not be the only reasons that a debtor will structure its payments and bankruptcy to protect its suppliers. Firms often enjoy discretionary lines of credit with their suppliers as a cushion against adverse business effects in difficult economic times.<sup>185</sup> For debtors in high risk industries, suppliers can be a source of capital financing.<sup>186</sup> Suppliers extend trade credit to businesses that demonstrate that they are safe credit risks.<sup>187</sup> Once the potential for risk analysis and credit extensions are open for negotiation, suppliers and debtors can begin to bargain over the terms of those credit extensions. Debtors who have low credit scores or operate high-risk business ventures can offer under-the-table agreements to suppliers which include favorable treatment for that supplier on the eve of bankruptcy. Even when a business is not organized between close personal friends and family members, management has incentives to personalize

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<sup>183</sup> Baird, *supra* note 179, at 923.

<sup>184</sup> *S. Polymer, Inc. v. TI Acquisition, LLC (In re TI Acquisition, LLC)*, 410 B.R. 742, 745 (Bankr. N.D. Ga. 2009). It is unclear from the opinion how much of the claim specifically fell under § 503(b)(9).

<sup>185</sup> Baird, *supra* note 179, at 922.

<sup>186</sup> *Capital Sources for Your Business*, UNIV. ME. COOP. EXTENSION PUBL'NS, <http://umaine.edu/publications/3008e> (last visited Mar. 12, 2012).

<sup>187</sup> Trade credit is an agreement between two businesses that one will buy goods from the other on account. *Trade Credit*, ENTREPRENEUR, <http://www.entrepreneur.com/encyclopedia/term/82538.html> (last visited Mar. 12, 2012).

business relationships, especially those with their suppliers.<sup>188</sup> Suppliers, unlike banks that may only provide one-time financing, are creditors that maintain regular contact with the business. Often, businesses will feel a strong sense of commitment to their suppliers.<sup>189</sup>

Businesses will feel a need to keep their suppliers informed of their long-term plans.<sup>190</sup> Some consulting groups encourage businesses to treat their suppliers as partners rather than as just vendors.<sup>191</sup> They encourage businesses to “engage in . . . forward planning” with their suppliers so that both parties will feel comfortable.<sup>192</sup> All of this regular contact and personal interaction will lead businesses to view their relationship with certain suppliers as personal—not just economic.

*In re Commissary Operations* may provide just the legal tool a debtor needs to protect its supplier relationships in bankruptcy.<sup>193</sup> If the reasoning of *In re Commissary Operations* holds, the debtor’s attorney could advise the debtor to order an amount of goods from the supplier’s business equal to the amount of the preference the supplier holds. The supplier will then be capable of arguing that those goods shipped on the eve of bankruptcy constitute both subsequent new value and an administrative expense. The debtor’s estate will be depleted in the amount of the administrative expense to the detriment of its other creditors, but its business reputation and personal relationship with its favored supplier may remain intact.

### 3. *Mitigating Perverse Incentives*

If a creditor suspects that a debtor ordered goods from its supplier on the eve of bankruptcy to protect that supplier’s preference by allowing it to double dip, there is an additional option available to challenge the substance of the administrative expense claim. Section 503(b)(9) requires that any goods for which a creditor seeks an administrative expense claim be sold “in the ordinary

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<sup>188</sup> Bob Reiss, *Build a Good Relationship with Suppliers*, ENTREPRENEUR, <http://www.entrepreneur.com/management/growingyourbusiness/article205868.html> (last visited Mar. 12, 2012) (advising management to “personalize the relationship” with their suppliers by visiting their offices, “invit[ing] them to break bread,” “invit[ing] them to . . . [company] picnics,” and “includ[ing] them in . . . strategy meetings”).

<sup>189</sup> *Supplier Relationships*, EPIQ, [http://www.epiqtech.com/supplier\\_relationship\\_management.htm](http://www.epiqtech.com/supplier_relationship_management.htm) (last visited Mar. 12, 2012).

<sup>190</sup> *Id.*

<sup>191</sup> *See, e.g., id.*

<sup>192</sup> *See, e.g., id.*

<sup>193</sup> *See Commissary Operations, Inc. v. Dot Foods, Inc. (In re Commissary Operations, Inc.)*, 421 B.R. 873 (Bankr. M.D. Tenn. 2010).

course of . . . business.”<sup>194</sup> Under the U.C.C., a “[b]uyer in ordinary course of business” is “a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person, other than a pawnbroker, in the business of selling goods of that kind.”<sup>195</sup> Thus, if a creditor suspects that the debtor is stocking up on goods right before bankruptcy, it may challenge those purchases on the grounds that they were not purchased in the ordinary course of business.

Courts use two tests to determine whether a transaction occurred in the ordinary course of business.<sup>196</sup> The first test is known as the horizontal test and involves comparing the transaction at issue to similar transactions across the industry.<sup>197</sup> If the sale does not comport with what other similarly situated businesses would do in similar situations, the transaction will fail the horizontal test.<sup>198</sup>

The second test is known as the vertical test (also called the “creditor expectation test”) and involves comparing the sale at issue with previous sales made by the debtor.<sup>199</sup> If the sale is too dissimilar to other sales that the business made prior to the preference period, it will fail the vertical test.

Those courts that do not use both tests will employ the vertical test alone.<sup>200</sup> The horizontal test “has been criticized on statutory construction grounds as . . . redundant . . . and difficult to apply.”<sup>201</sup> Nevertheless, some jurisdictions still apply it.<sup>202</sup>

A debtor trying to stock up on goods on the eve of bankruptcy might leave indicia that the sale was not in the ordinary course of business. There is also a possibility that a party wishing to challenge the administrative expense claim of another party could argue that the goods were not sold in good faith because

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<sup>194</sup> 11 U.S.C. § 503(b)(9) (2006).

<sup>195</sup> WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE 3D DICTIONARY OF BANKRUPTCY TERMS O30 (2012) (citing U.C.C. § 2-201(b)(9)).

<sup>196</sup> Burlington N. R.R. v. Dant & Russell, Inc. (*In re Dant & Russell, Inc.*), 853 F.2d 700, 704–06 (9th Cir. 1988). *But see In re Ockerlund Constr. Co.*, 308 B.R. 325, 328–29 (Bankr. N.D. Ill. 2004) (rejecting the need to employ the horizontal test and applying only the vertical test).

<sup>197</sup> *In re Dant & Russell*, 853 F.2d at 704. Note that this definition of “ordinary course of business” came about seventeen years before the 2005 amendments, which created § 503(b)(9).

<sup>198</sup> *Id.*

<sup>199</sup> *Id.* at 705.

<sup>200</sup> *See In re Ockerlund Constr.*, 308 B.R. at 328–29.; *In re Husting Land and Dev., Inc.*, 255 B.R. 772, 779–80 (Bankr. D. Utah 2000).

<sup>201</sup> *In re Husting Land and Dev.*, 255 B.R. at 779.

<sup>202</sup> *See, e.g., In re Dant & Russell*, 853 F.2d at 704.

they were sold with “knowledge that the sale violates the rights of another person.”<sup>203</sup> The debtor ordering significantly larger amounts of a particular good from a supplier than it has in the past, ordering a different or more expensive type of good than it normally does, or significantly changing the shipping terms for the goods may constitute evidence that the sale was not performed in the ordinary course of business.

However, a business on the cusp of filing a bankruptcy petition is not operating in the normal course of business. A criticism of both the vertical and horizontal tests is that a company in financial distress should not have its transactions scrutinized by courts in comparison to other businesses in the industry that might not be in financial distress. Perhaps transactions that do not meet the vertical test should only carry a rebuttable *presumption* that they are not in the ordinary course of business. It might be advantageous to jurisdictions outside the Ninth Circuit to adopt the reasoning of *In re Dant & Russell*<sup>204</sup> with a caveat: to the extent certain transactions might not be in line with industry practices, businesses will have the opportunity to give arguments as to why the transaction really is in good faith and the ordinary course of business, even if other businesses across the industry would not engage in the same transactions.

#### 4. Section 502(d) as a Solution to the Double Dipping Problem

If a creditor is unable to convince the court that the reasoning under *In re Phoenix Restaurants* and *TI Acquisition II* is correct, it should look to § 502(d) of the Code and try to disallow the administrative expense claim until the preference is repaid to the estate.<sup>205</sup> Precedent in a district or an unwillingness to confront the issue of double dipping might prevent a court from adopting the logic of *TI Acquisition II*. Yet when confronted with a creditor who wishes to use the same goods for a subsequent new value defense, as well as for an administrative expense claim, the bankruptcy court can apply this argument as an “out.”

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<sup>203</sup> NORTON, *supra* note 195, at O30.

<sup>204</sup> *In re Dant & Russell*, 853 F.2d at 704. This case focuses on the horizontal and vertical tests and describes the jurisdictional splits in how they are applied. However, this Comment suggests that while the horizontal and vertical tests are good starting points, a distressed business which may need to engage in abnormal business transactions for the purpose of its own economic survival should have the opportunity to explain why its transactions were made in good faith, even if such transactions do not technically pass the horizontal and vertical tests.

<sup>205</sup> See 11 U.S.C. § 502(d) (2006).

Courts are split as to whether § 502(d) can be applied in this way.<sup>206</sup> The bankruptcy court in *In re Circuit City* dealt with the interplay between §§ 501(a), 502(d), and 503(b)(9).<sup>207</sup> The *Circuit City* court held that § 502(d) could disallow an administrative expense claim.<sup>208</sup> On the other hand, the bankruptcy court in *TI Acquisition I* held that § 502(d) did not apply to administrative expense claims.<sup>209</sup>

*a. The TI Acquisition I Approach*

In 2009, the Bankruptcy Court for the Northern District of Georgia decided *TI Acquisition I*, holding that § 502(d) could not disallow administrative expense claims filed pursuant to § 503(b)(9).<sup>210</sup> The debtor in that case sought to disallow a \$302,512 claim filed by its creditors.<sup>211</sup>

In denying the applicability of § 502(d), the court looked at the fact that the statute had not been amended in 2005 when § 503(b)(9) was added to make § 502(d) disallowance applicable.<sup>212</sup> The court reasoned that § 503(b)(9) claims were administrative expenses and not prepetition claims.<sup>213</sup> It held that § 502(d) was applicable only to those claims governed by § 501.<sup>214</sup>

The opinion tries to make sense of an ambiguous section of the Code. Section 503(b)(9) is an anomaly in the sense that all other § 503(b) claims stem

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<sup>206</sup> Compare *In re Circuit City Stores, Inc.*, 426 B.R. 560 (Bankr. E.D. Va. 2010) (determining that § 502(d) may be used to disallow a § 503(b)(9) claim), with *ASM Capital, LP v. Ames Dep't Stores (In re Ames Dep't Stores)*, 582 F.3d 422 (2d Cir. 2009), and *S. Polymer, Inc. v. TI Acquisition, LLC (In re TI Acquisition, LLC)*, 410 B.R. 742 (Bankr. N.D. Ga. 2009) (both holding that § 502(d) may not disallow a § 503(b)(9) claim).

<sup>207</sup> *In re Circuit City Stores*, 426 B.R. at 571. Section 501(a) states simply that “[a] creditor or an indenture trustee may file a proof of claim.” 11 U.S.C. § 501(a). Section 502(d) says, “[T]he court shall disallow any claim of any entity . . . that is a transferee of a transfer avoidable under [§] . . . 547 . . . unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable . . .” *Id.* § 502(d).

<sup>208</sup> *In re Circuit City Stores*, 426 B.R. at 571.

<sup>209</sup> *In re TI Acquisition*, 410 B.R. at 751. Though the court in this case refused to disallow the administrative expense claim, it postponed payment of the claim until the creditor’s actual liability was determined at a later date. *Id.*

<sup>210</sup> *Id.*

<sup>211</sup> *Id.* at 745.

<sup>212</sup> See *id.* at 745–46. “Section 502(d) does not contain any language or reference which would make it applicable to administrative expenses of any kind.” *Id.* at 750.

<sup>213</sup> *Id.* at 749 (“[T]he claim asserted by [the creditor] is an administrative claim, not a pre-petition claim.”).

<sup>214</sup> *Id.* at 750 (“[Section] 502(d) . . . applies only to those pre- and post-petition claims that are governed by § 501.”).

from activities that only arise postpetition.<sup>215</sup> Because § 503(b)(9) was inserted in the 2005 Code amendments without comment from the legislature, the *TI Acquisition I* court, relying on an earlier case,<sup>216</sup> reasoned that § 502(d) applies only to those claims governed by §§ 501 and 502.<sup>217</sup> Section 502(a) begins, “A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest . . . objects.”<sup>218</sup> The language of § 502(a) seems to suggest that all claims filed pursuant to § 501 are immediately allowed, without any other preconditions, unless a party objects. Section 503(b), however, says, “*After notice and a hearing*, there shall be allowed administrative expenses . . . .”<sup>219</sup> Thus, §§ 502(a) and 503(b) seem to have different requirements that must be met before any claims filed pursuant to either are allowed. But does that mean that the two sections are mutually exclusive?

The *Circuit City* court determined that nothing in the Code suggests that §§ 501, 502, and 503 are mutually exclusive.<sup>220</sup> The applicability of § 502(d) to § 503(b)(9) claimants can be understood in six pieces: (1) as § 503(b)(9) claimants are creditors,<sup>221</sup> (2) they must follow the Federal Rules of Bankruptcy Procedure 3002<sup>222</sup> and (3) file their claims pursuant to § 501(a);<sup>223</sup> (4) they thereby comply with Rule 3002(a) and, in doing so, simultaneously comply with § 501(a), (5) making those claims governed by § 502(a) and (d), and (6) allowing § 502(d) to disallow those § 503(b)(9) claims. Contrary to the reasoning of *TI Acquisition I*, methodical contemplation of the sections at hand suggests that § 502(d) can be used to disallow a § 503(b)(9) administrative expense claim.

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<sup>215</sup> Compare 11 U.S.C. § 503(b)(1)–(8) (2006), with *id.* § 503(b)(9).

<sup>216</sup> See *In re Plastech Engineered Prods., Inc.*, 394 B.R. 147, 161 (Bankr. E.D. Mich. 2008) (“[Section] 502(d) does apply to post-petition claims, but *only* to those post-petition claims that are governed by § 501 and § 502.”)

<sup>217</sup> *In re TI Acquisition*, 410 B.R. at 750 (citing *In re Plastech Engineered Prods.*, 394 B.R. at 161).

<sup>218</sup> 11 U.S.C. § 502(a).

<sup>219</sup> *Id.* § 503(b) (emphasis added).

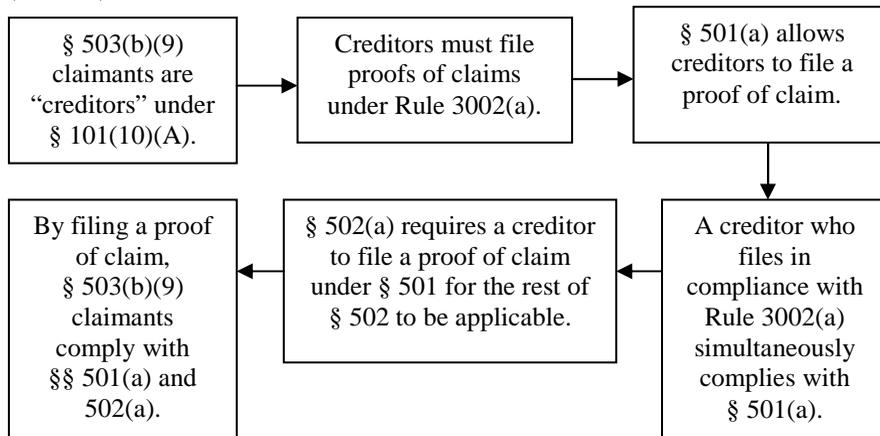
<sup>220</sup> *In re Circuit City Stores, Inc.*, 426 B.R. 560, 571 (Bankr. E.D. Va. 2010).

<sup>221</sup> 11 U.S.C. § 101(10)(A).

<sup>222</sup> FED. R. BANKR. P. 3002.

<sup>223</sup> 11 U.S.C. § 501(a) (“A creditor . . . may file a proof of claim.”).

To simplify this complicated reasoning, consider the following diagram (Chart 2):



The *TI Acquisition I* court should have focused on the substance of the § 503(b)(9) claim rather than its classification as an administrative expense. In fact, focusing solely on its classification led the court to awkward treatment of § 503(b)(9) claims. For example, the court noted that “the claim asserted by [the creditor] is an administrative claim, not a prepetition claim.”<sup>224</sup> One page later, however, the court says, “Although an administrative expense under § 503(b)(9) is for a prepetition debt, its prepetition nature does not dictate that § 503(b)(9) expenses should be treated differently than other § 503(b) expenses.”<sup>225</sup> In other words, even though the substance of a § 503(b)(9) claim arises prepetition, it should be treated as if it arose postpetition to ensure uniformity within § 503(b).<sup>226</sup> While uniformity is an important goal, the *TI Acquisition I* court discourages the uniformity of prepetition claim treatment throughout the Code by insisting that § 503(b)(9), though substantively prepetition, should be treated as if it arose postpetition.

<sup>224</sup> S. Polymer, Inc. v. TI Acquisition, LLC (*In re* TI Acquisition, LLC), 410 B.R. 742, 749 (Bankr. N.D. Ga. 2009).

<sup>225</sup> *Id.* at 750.

<sup>226</sup> With the exception of § 503(b)(9), all other § 503(b) administrative expense claims arise from activity that occurs postpetition.

*b. The Circuit City Approach (An In-Depth Look at Chart 2)*

In *In re Circuit City*, the debtor filed objections to the creditors' § 503(b)(9) administrative expense claims on the grounds that those claims should be disallowed pursuant to § 502(d) until the creditors repaid all of their preferences.<sup>227</sup> The court noted that at least one treatise says that “[the § 503 caption] ‘allowance of administrative expenses’ . . . appears to suggest that § 503 is a separate allowance section, apart from § 502, devoted exclusively to administrative expenses. If so, then § 502 would not apply to the allowance of administrative expenses.”<sup>228</sup> However, the court rejected that reasoning and determined that § 502(d) could disallow an administrative expense claim.<sup>229</sup>

The *Circuit City* court reasoned *in pari materia*<sup>230</sup> and looked to Rules 3002<sup>231</sup> and 3003<sup>232</sup> of the Federal Rules of Bankruptcy Procedure to determine that both rules require creditors to file proof of claims pursuant to § 501(a).<sup>233</sup>

Because § 502(d) permits disallowance of a claim by a creditor unless it gives any transfer it has received back to the estate, and a “creditor” is defined under § 101(10)(A) as an “entity that has a claim against the debtor *that arose at the time of or before the order for relief* concerning the debtor,” the matter hinges on whether § 503(b)(9) claimants are creditors.<sup>234</sup> In the entire list of administrative expense claims, only § 503(b)(9) is a claim that arises before or

<sup>227</sup> *In re Circuit City Stores, Inc.*, 426 B.R. 560, 564–65 (Bankr. E.D. Va. 2010). It should be noted that this case deals with temporary disallowance under § 502(d) and not permanent disallowance. The creditors do not lose their § 503(b)(9) claims if the court disallows them; the claims are merely suspended until the creditors repay preferences to the debtor's estate.

<sup>228</sup> *Id.* at 576 (quoting 2 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE 2D § 42:16, at 42-91 (2007)).

<sup>229</sup> *Id.* at 579.

<sup>230</sup> “[A] canon of construction that statutes that [relate to the same matter] may be construed together, so that inconsistencies in one statute may be resolved by looking at another statute on the same subject.” BLACK'S LAW DICTIONARY, *supra* note 2, at 807.

<sup>231</sup> FED. R. BANKR. P. 3002(a) (“An unsecured creditor or an equity security holder must file a proof of claim or interest for the claim or interest to be allowed . . .”).

<sup>232</sup> *Id.* 3003(c)(2) (“*Who must file.* Any creditor or equity security holder whose claim or interest is not scheduled or scheduled as disputed, contingent, or unliquidated shall file a proof of claim or interest within the time prescribed by subdivision (c)(3) of this rule; any creditor who fails to do so shall not be treated as a creditor with respect to such claim for the purposes of voting and distribution.”).

<sup>233</sup> *In re Circuit City Stores*, 426 B.R. at 574. The court reasoned that a § 503(b)(9) claimant constituted was a “creditor” under § 101(10)(A). *See* 11 U.S.C. § 101(10)(A) (2006).

<sup>234</sup> 11 U.S.C. § 101(10)(A) (emphasis added).

at the time of the bankruptcy petition filing.<sup>235</sup> Because § 503(b)(9) creates a claim for prepetition goods shipped to the debtor within twenty days prior to filing of the bankruptcy petition, it is unclear as to when an administrative expense claim actually becomes a claim.

The conflict as to the timing of when § 503(b)(9) creditors actually have claims should be decided by looking at the substance of a § 503(b)(9) claim. The substance of a § 503(b)(9) claim is based on goods that are shipped prepetition.<sup>236</sup> Because the goods that make up the claims arise prepetition and the claims are contingent upon when the debtor files for bankruptcy, this Comment argues<sup>237</sup> that courts should treat them as prepetition contingent claims. Treated as prepetition, the issue of whether a § 503(b)(9) administrative expense claimant is a creditor for purposes of § 101(10)(A) disappears.<sup>238</sup> As prepetition claims, the claimant would meet § 101(10)(A)'s definition of "creditor": "[an] entity that has a claim against the debtor *that arose at the time of or before the order for relief* concerning the debtor."<sup>239</sup>

Even after the *Circuit City* court reasoned that § 503(b)(9) claimants meet the definition of a "creditor,"<sup>240</sup> the court still had to determine whether § 502(d) could be used to disallow the administrative expense in an effort to coerce the creditor into disgorging a preference under § 547.<sup>241</sup>

The connection between §§ 502(d) and 547(c)(4) made by the *Circuit City* court may draw criticism. A potential weakness in the applicability of the *Circuit City* court's reasoning to future cases is that the precise legal issue in *In re Circuit City* was "whether § 502(d) can be applied as a matter of law to temporarily disallow § 503(b)(9) claims in the amount *potentially recoverable* as a preferential transfer under § 547."<sup>242</sup> The court also noted that "a [c]laimant will be both seeking an administrative expense payment for goods . . . and using the delivery of those same goods as a basis for the new

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<sup>235</sup> See, e.g., *id.* § 503(b)(4) (allowing as an administrative expense claim "reasonable compensation for professional services rendered by an attorney or an accountant").

<sup>236</sup> See *id.* § 503(b)(9).

<sup>237</sup> See *supra* Section II.B.1.b.

<sup>238</sup> See 11 U.S.C. § 101(10)(A).

<sup>239</sup> *Id.* (emphasis added).

<sup>240</sup> *In re Circuit City Stores, Inc.*, 426 B.R. 560, 571 (Bankr. E.D. Va. 2010). The *Circuit City* court also looked to § 101(5)(A) to determine if § 503(b)(9) claims met the definition of "claim" in the Code. The *Circuit City* court made short work of the issue, noting that the words "claim" and "expense" are used interchangeably throughout the Code. *Id.* at 568–69.

<sup>241</sup> See 11 U.S.C. § 547.

<sup>242</sup> *In re Circuit City Stores*, 426 B.R. at 566 (emphasis added).

value defense.”<sup>243</sup> This dual use of § 503(b)(9) goods by claimants leads to confusion regarding the applicability § 502(d): if a creditor claims that it does not have to disgorge a preference under § 547(b) because it can use the subsequent new value defense under § 547(c)(4), is that preference “potentially recoverable”? The subsequent new value defense is listed in § 547(c)(4) as a transfer that the trustee *may not* recover.<sup>244</sup> The court employs the modifier “potentially,”<sup>245</sup> perhaps suggesting that the recoverability of the preference must be in dispute between the parties in order for the reasoning of *In re Circuit City* to apply. While the holding of *In re Circuit City* may be interpreted as limited to those situations where there is pending litigation regarding the preferences paid to the creditor using the subsequent new value defense, the *Circuit City* court itself drew no particular emphasis to the word “potentially” in its opinion.<sup>246</sup>

Another weakness in the *Circuit City* court’s reasoning lies in a potential conflict between the plain language of § 503 and Rule 3002.<sup>247</sup> The creditor in *In re Circuit City* argued that requiring administrative expenses to be filed in accordance with § 501(a) and then disallowing those administrative expenses with § 502(d) would violate the plain language of § 503.<sup>248</sup> Section 503(b) states, “After notice and a hearing, there *shall* be allowed administrative expenses.”<sup>249</sup> The mandatory language of § 503(b) requires that administrative expenses be allowed. Unlike Rule 3002,<sup>250</sup> § 503(b) does not require that the creditor file a claim under § 501(a).<sup>251</sup> The creditors in *In re Circuit City* argued that to require that they file such a claim and make it susceptible to disallowance by § 502(d) would bring the Federal Rules of Bankruptcy Procedure and the Code into conflict.<sup>252</sup> When the Federal Rules of Bankruptcy Procedure come into conflict with the Code, the matter must be settled in favor of the Code.<sup>253</sup> The court in *In re Circuit City*, while agreeing that the Code trumps the Federal Rules, found no conflict between the Code

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<sup>243</sup> *Id.* at 571.

<sup>244</sup> *See* 11 U.S.C. § 547(c).

<sup>245</sup> *In re Circuit City Stores*, 426 B.R. at 566.

<sup>246</sup> *See id.*

<sup>247</sup> *Id.* at 574–75.

<sup>248</sup> *Id.*

<sup>249</sup> 11 U.S.C. § 503(b) (emphasis added).

<sup>250</sup> FED. R. BANKR. P. 3002(a).

<sup>251</sup> *See* 11 U.S.C. § 503(b).

<sup>252</sup> *In re Circuit City Stores*, 426 B.R. at 574–75.

<sup>253</sup> *Id.* at 575 (citing *In re Pac. Atl. Trading Co.*, 33 F.3d 1064, 1066 (9th Cir. 1994)).

and the Rules.<sup>254</sup> The court reasoned that requiring creditors to abide by the Rules and file their claims according to § 501(a) would not “abridge, enlarge, or modify any substantive right.”<sup>255</sup> The *Circuit City* court determined that whether the creditors had to follow Rule 3002 and file their claims under § 501(a) was merely a procedural matter and did not impose an excessive burden on § 503(b)(9) claimants.<sup>256</sup>

A creditor arguing against the applicability of Rule 3002(a) in this circumstance would try to argue that requiring compliance with § 501(a) in filing an administrative expense claim would “modify [a] substantive right.”<sup>257</sup> It is unlikely that such an argument would work, however, given that the Federal Rules of Bankruptcy Procedure are propagated by the Supreme Court and are largely viewed as dealing with merely procedural matters such as notice and rules of evidence.<sup>258</sup> A creditor might also argue that the filing of his claim could “have a profound impact on other substantive rights, including the right to demand a jury trial.”<sup>259</sup> The issue would be resolved by examining whether a requirement to file the claim under § 501(a) would have an impact on the substantive rights of the creditor or whether it would have merely a procedural impact. As such, courts should examine the matter on a case-by-case basis rather than issue a blanket rule. In general, filing requirements seem to fall in the category of procedure rather than substance.

When considering the question of whether disallowance is proper, it is important to keep in mind the unique nature of § 503(b)(9) administrative expense claims and how § 502(d) applies to them. Section 503(b)(9) claims are unique in that they are administrative expense claims that arise prepetition but are paid postpetition.<sup>260</sup> The general rule is that when Congress passes a statute

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<sup>254</sup> *Id.*

<sup>255</sup> *Id.* (citing 28 U.S.C. § 2075 (2006)).

<sup>256</sup> *Id.*

<sup>257</sup> *See id.* (citing 28 U.S.C. § 2075).

<sup>258</sup> 1 NORTON, *supra* note 43, § 5:9, at 5-21 (“In general, matters left to the rules concern giving notice; setting time limits; designating places to file documents; specifying the form, content and number of documents; indicating the method of conducting trials or hearings, including rules of evidence; regulating conduct of parties appearing before the court; organizing court dockets and calendars; issuing orders, process or judgments; processing appeals; and liquidating property of the estate. Certain other matters are left to the rules prescribed by the Judicial Conference such as determination of filing fees.”).

<sup>259</sup> 3 *id.* § 48:15, at 48-37 to -38.

<sup>260</sup> 11 U.S.C. § 503(b) (2006).

to supersede judicially created common law, it will make that intent explicit.<sup>261</sup> Neither in the Code itself nor in the legislative history does Congress make clear an intent to change the common law method for handling administrative expense claims. If there was no congressional intent to carve out a special exception for § 503(b)(9), the reasoning of the pre-2005 administrative expense jurisprudence is fully applicable.<sup>262</sup> It seems unlikely that Congress intended §§ 502(d) and 503(b)(9) to be independent sections that are inapplicable to each other. The applicability of the sections to each other removes the last textual barrier for use of § 502(d) to disallow § 503(b)(9) and prevent double dipping.

### CONCLUSION

*In re Commissary Operations* has brought a fascinating new angle for creditors in a bankruptcy dispute over preferences and new value.<sup>263</sup> By allowing creditors to double dip and claim both subsequent new value and an administrative expense for the same goods, it allows creditors to reduce their preference liability by potentially large sums of money.<sup>264</sup> Such an outcome, however, flies in the face of the legislative policy considerations behind the Code—namely, the goal of encouraging equity among creditors.<sup>265</sup>

Perverse incentives for the debtor should also be considered. Though it might be rare to find a sophisticated debtor able to manipulate the Code in such a way as to protect its business reputation by creating a situation in which favored creditors can manipulate double dipping, the idea may become more widespread if the reasoning of *In re Commissary Operations* is widely followed. Such a situation would work against disfavored creditors with no such opportunity. There may also be more than just business relationships and

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<sup>261</sup> See, e.g., *Midlantic Nat'l Bank v. N.J. Dep't of Env'tl. Prot.*, 474 U.S. 494, 501 (1986) (“The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific.”).

<sup>262</sup> See, e.g., *MicroAge, Inc. v. Viewsonic Corp.* (*In re MicroAge, Inc.*), 291 B.R. 503, 509 (B.A.P. 9th Cir. 2002) (reasoning that § 502(d) disallowance arguments are fully applicable to all administrative expense claims by virtue of the fact that Congress expressed no explicit intent to bar § 502(d) from applying to administrative expenses when it passed the statute). *In re MicroAge*, however, was decided with regard to reclamation claims three years before the 2005 Code amendments were passed.

<sup>263</sup> See *Commissary Operations, Inc. v. Dot Foods, Inc.* (*In re Commissary Operations, Inc.*), 421 B.R. 873 (Bankr. M.D. Tenn. 2010).

<sup>264</sup> See, e.g., *S. Polymer, Inc. v. TI Acquisition, LLC* (*In re TI Acquisition, LLC*), 410 B.R. 742, 744–45 (Bankr. N.D. Ga. 2009). The administrative expense claim in that case totaled \$302,512. *Id.*

<sup>265</sup> See generally H.R. REP. NO. 95-595, at 177–79 (1978), reprinted in 1978 U.S.C.C.A.N. 5785, 6138–40.

reputation involved. The double dipping argument provides an opportunity for the debtor to protect friends and family with whom he may again do business if he can make a reasonable argument that those individuals provide him with goods as formal suppliers. Savvy prebankruptcy planning will allow the debtor to defeat the policy purpose of equitable treatment of all creditors that underlies every section of the Code.<sup>266</sup>

Thus, the bankruptcy court in *TI Acquisition II* was correct in denying double dipping outright.<sup>267</sup> To allow a creditor to claim that it advanced new value to the debtor's estate and then demand payment for that very same new value would undermine the bankruptcy goal of equity among all creditors. Analogizing § 503(b)(9) administrative expenses to reclamation claims<sup>268</sup> ensured that all substantively prepetition claims could receive the same treatment in that bankruptcy case.

Some ambiguity remains, however, with regard to how this sort of case should be decided in jurisdictions that follow the "subsequent advance" approach<sup>269</sup> to the subsequent new value defense. By viewing a § 503(b)(9) administrative expense as a substantively prepetition contingent claim, a strong argument may be made that it *can* be used to reduce prepetition new value, barring the subsequent new value defense.

If a court in a "subsequent advance" jurisdiction refuses to recognize § 503(b)(9) as a prepetition claim, all is not lost. Under the reasoning of *In re Circuit City*, a party can look to § 502(d) to argue that the administrative expense claim should be disallowed until the creditor disgorges the preference.<sup>270</sup> Though the court in *TI Acquisition I* determined that § 502(d) was inapplicable to § 503(b)(9),<sup>271</sup> the content of the Code and the requirements of Federal Rule of Bankruptcy Procedure 3002(a) demonstrate

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<sup>266</sup> See generally *id.* at 177–79, 372–74.

<sup>267</sup> *TI Acquisition, LLC v. S. Polymer, Inc. (In re TI Acquisition, LLC)*, 429 B.R. 377, 385–86 (Bankr. N.D. Ga. 2010).

<sup>268</sup> *Id.* at 385.

<sup>269</sup> Recall that the "subsequent advance" approach prohibits any postpetition claims from diminishing the amount a creditor may use as new value in a subsequent new value defense. *Id.* at 383–84. The court argued that § 503(b)(9) administrative expense claims *are* substantively prepetition claims and thus may be used to reduce prepetition new value. *Id.*

<sup>270</sup> See *In re Circuit City Stores, Inc.*, 426 B.R. 560, 579 (Bankr. E.D. Va. 2010).

<sup>271</sup> See *S. Polymer, Inc. v. TI Acquisition, LLC (In re TI Acquisition, LLC)*, 410 B.R. 742, 750 (Bankr. N.D. Ga. 2010).

that § 502(d) is, in fact, applicable to § 503(b)(9) claims (see Chart 2, *supra* Section II.B.4.a).<sup>272</sup>

Because the argument has only been examined in two bankruptcy courts, it remains to be seen whether others will follow their lead. It is unlikely that there will be a definitive statement from higher courts in the near future given the alleged tendency of district courts to either “rubber stamp” a bankruptcy court’s conclusions or to outright neglect them.<sup>273</sup> The time sensitivity of bankruptcies also suggests that it is simply not worth it for the losing party in a bankruptcy case to appeal higher than the district court because, even if the appellant wins, the issue may be rendered moot at that point.

The bankruptcy court in *In re Commissary Operations* was incorrect in allowing creditors to double dip and put themselves in a prioritized position over all other creditors. *TI Acquisition II* correctly identified this issue and, in denying the creditor the opportunity to double dip, set an example that future bankruptcy courts will hopefully follow. For those courts that do not, *In re Circuit City* has provided a tool for parties challenging a double dipping argument to use § 502(d) to disallow payment of the administrative expense claim until the creditor disgorges its preference. *In re Circuit City* demonstrated that the logic behind holding § 502(d) inapplicable to § 503(b)(9) claims in *TI Acquisition I* was flawed.

Double dipping allows certain creditors to defeat the preference system of the Code. Allowing a creditor to count the same goods in a subsequent new value defense as were claimed for an administrative expense would vitiate

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<sup>272</sup> See 11 U.S.C. §§ 501(a), 502(a), 502(d) (2006).

<sup>273</sup> *Commission Considers Venue, Jurisdiction, Appellate Changes at February Meeting*, *supra* note 12, at 13; see also D’Angelo, *supra* note 12, at 610.

§ 547 and undermine the foundational policy goal of the Code—encouraging equity among all creditors.

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