

**THE INTERPLAY BETWEEN SECTION 503(B)(9) CLAIMS  
AND SECTION 547 PREFERENCE ACTIONS**

*Anne Marie P. Kelley, Scott J. Freedman and Brody C. Stevens<sup>1</sup>  
Dilworth Paxson LLP*

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 established a new administrative priority claim for creditors providing goods to a debtor within 20 days of the petition date. Section 503(b)(9) of the Bankruptcy Code<sup>2</sup> provides:

(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—

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(9) 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.

11 U.S.C. § 503(b)(9) (2008). “The legislative history surrounding this section is scant, but presumably Congress was concerned about providing a vehicle to enhance payment to creditors that shipped goods to a debtor in the ordinary course of business on the eve of bankruptcy.” Judith Greenstone Miller & Jay L. Welford, *503(b)(9) Claimants – The New Constituent, a/k/a “The 500 Pound Gorilla,” At The Table*, 5 DEPAUL BUS. & COM. L.J. 487 (2007). Further, because section 503(b)(9) is a relatively new section of the Code, “there is little case law construing the scope of the provision.” In re WETCO Restaurant Group, LLC, Slip Copy, 2008 WL 1848779, \*1 (W.D.La. April 23, 2008). However, despite the lack of case law specifically addressing section 503(b)(9), case law developed with respect to other section 503 administrative

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<sup>1</sup> Ms. Kelley is a partner and Messrs. Freedman and Stevens are associates with Dilworth Paxson LLP. Ms. Kelley is the Co-Chairperson of Dilworth's Bankruptcy Group and is a member of its Litigation Department. Mr. Freedman and Mr. Stevens are members of Dilworth's Bankruptcy Group/Litigation Department and Corporate Department, respectively. Dilworth is headquartered in Philadelphia, Pa. and has offices in Cherry Hill, N.J., Harrisburg, Pa., Wilmington, Del., Neptune, N.J., and Washington, DC. Ms. Kelley can be reached at AKelley@Dilworthlaw.com; Mr. Freedman can be reached at SFreedman@Dilworthlaw.com; and Mr. Stevens can be reached at BStevens@Dilworthlaw.com.

<sup>2</sup> References to the Bankruptcy Code mean Title 11 of the United States Code, §101, et seq.

claims may provide guidance on issues that are anticipated to arise when section 503(b)(9) claims clash with section 547 preference claims. This article will briefly address the interplay of section 503(b)(9) with the sections 502(d), 547(c)(4), and 547(b)(5) of the Bankruptcy Code.<sup>3</sup>

**I. Can section 502(d) be utilized to prevent a distribution on a section 503(b)(9) claim as a result of potential preference liability?**

Section 502 of the Bankruptcy Code contains various provisions that dictate the claims allowance process. Section 502(d) requires the court to disallow a claim of any party from which property is recoverable under the various avoidance provisions of Chapter 5 of the Bankruptcy Code unless the party returns such property to the bankruptcy estate.<sup>4</sup> Thus, in accordance with section 502(d), a claim filed under section 501 of the Bankruptcy Code is subject to disallowance if and to the extent the claimholder received an avoidable transfer including a transfer that is preferential pursuant to section 547 of the Bankruptcy Code.

Not surprisingly, some debtors have already indicated that they intend to rely on section 502(d) to attack asserted section 503(b)(9) claims if and to the extent the claimholder received a

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<sup>3</sup> This article does not address non-preference issues often raised in connection with the interpretation of section 503(b)(9), such as:

- Who bears the burden of proof as to the amount and validity of a section 503(b)(9) claim?
- How is the twenty-day period calculated?
- What are goods, and how are they valued for purposes of this section?
- When are goods deemed received, and does the passage of title constitute receipt?
- What does “the ordinary course of such debtor’s business” mean?
- How is a section 503(b)(9) claim asserted?
- When must the estate satisfy allowed section 503(b)(9) claims?
- Can an unpaid section 503(b)(9) claimant require disgorgement of other paid administrative claims (such as, professional fees) in an administratively insolvent case?

<sup>4</sup> The text of section 502(d) reads, in its entirety, as follows:

Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.

11 U.S.C. § 502(d) (2008).

preferential transfer. Although courts have not yet addressed whether a section 503(b)(9) claim is subject to disallowance under section 502(d), courts grappling with the issue of whether other administrative expense claims are subject to section 502(d) have reached conflicting conclusions.<sup>5</sup> In In re USA Labs, Inc., 2006 Bankr. LEXIS 2394, \*4 (Bankr. S.D. Fla. April 13, 2006), upon review of the cases on each side of the issue, the Bankruptcy Code “strongly agree[d] with the courts which concluded that section 502(d) does not apply to administrative expense claims allowable under section 503 of the Bankruptcy Code.” The USA Labs court justified its finding as follows:

The structure of section 502 indicates that the only claims to which subsection (d) applies to are prepetition claims or those post-petition claims, such as rejection claims or contribution claims, which are treated like prepetition claims in section 502(e) through (i) and are expressly subject to section 502(d). Durango, 247 B.R. at 330. Moreover, the policy considerations underlying the reason for administrative expenses and their corresponding priority in the context of a bankruptcy case, further compel a finding that section 502(d) does not act as a bar. See Lids, 260 B.R. at 684 (stating that “extension of [502(d)] to administrative claims could have devastating effects on a debtor’s ability to reorganize.”).

In re USA Labs, Inc., 2006 Bankr. LEXIS 2394 at \*4 (citations as in original).

Similarly, with regard to the intersection of sections 502(d) and 503, the court in In re Phoenix Restaurant Group, Inc., 2004 WL 3113719, \*19 (Bankr. M.D.Tenn. Dec. 16, 2004), explained in a memorandum opinion:

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<sup>5</sup> See, e.g., In re MicroAge, Inc., 291 B.R. 503 (9<sup>th</sup> Cir. B.A.P. 2002) (section 502(d) applies to administrative expense claims not yet allowed by the court); In re Triple Star Welding, Inc., 324 B.R. 778, 794 (9<sup>th</sup> Cir. B.A.P. 2005) (restating the holding of MicroAge); In re Georgia Steel, Inc., 38 B.R. 829, 839-40 (Bankr. M.D. Ga. 1984) (administrative expense claims are subject to section 502(d)); In re Roberds, Inc., 315 B.R. 443 (Bankr. S.D. Ohio 2004) (section 502(d) is not a barrier to an administrative expense claim); In re Durango Georgia Paper Co., 297 B.R. 326, 331 (Bankr. S.D. Ga. 2003) (section 502(d) does not apply to administrative expense claims allowable under section 503 of the Code); In re Lids Corp., 260 B.R. 680 (Bankr. D. Del. 2001) (administrative expense claims are not subject to section 502(d)); In re CM Holdings, Inc., 264 B.R. 141 (Bankr. D. Del. 2000) (administrative expenses are not subject to section 502(d)).

Section 503 concerns administrative expenses, which are distinct from claims under section 501, and [which] need not be requested by a “creditor.” Administrative expenses are pursued by filing “a request for payment” under § 503(a), not by filing a proof of claim under section 501 ... There is no provision in section 503 analogous to section 502(d) disallowing administrative expenses held by an entity that received an avoidable transfer. Section 502(d) does not cross-reference or obviously affect the allowance or payment of administrative expenses under section 503.

The court applied a literal reading of sections 502(d) and 503 of the Bankruptcy Code in reaching its conclusion focusing on the distinction between section 502(d), which pertains to the disallowance of “any claim,” and section 503, which applies to the allowance of only “administrative expenses.”

Further evidence of this distinction is that, unlike filing proofs of claim, the Bankruptcy Code does not explicitly set forth a process or procedure for filing requests for payment of administrative expenses. 4 COLLIER ON BANKRUPTCY, ¶ 503.02[1] at 4-503 (15<sup>th</sup> ed. 2008). Moreover, there is no official form with respect to a request for payment of an administrative expense in the Federal Rules of Bankruptcy Procedure. In fact, an application for payment of administrative expense is not properly asserted in a proof of claim, and the filing of proof of claim is unnecessary to request payment of an administrative expense. Rather, an application for payment filed under section 503(a) is all that is required. *Id.*

The counterview is that, because an “allowed administrative expense” is “a right to payment,” it constitutes a “claim” for purposes of section 101(5) of the Code.<sup>6</sup> See *MicroAge*, 291 B.R. at 508 (“Section 502(d) by its terms applies to ‘any claim’ of an entity that received an avoidable transfer, and the definition of a ‘claim’ in section 101(5) is sufficiently broad to

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<sup>6</sup> Section 101(5) of the Bankruptcy Code defines a “claim” as a “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.”

include requests for payment of expenses of administration.”)

Of the courts split as to whether section 502(d) applies to section 503 claims, the Bankruptcy Appellate Panel for the Ninth Circuit seems primed to hold that section 502(d) is applicable to section 503(b)(9) claims. In In re Brown & Cole Stores, LLC, 375 B.R. 873 (B.A.P. 9<sup>th</sup> Cir. 2007), the court, as part of its consideration as to whether the debtor is permitted to setoff its pre-petition claim against the creditor’s administrative priority claim, explained that section 503(b)(9) is “unlike all other subsections of section 503” in that it applies to pre-petition debt. Id. at 879.<sup>7</sup> “All of the other subsections of section 503 create administrative priority for postpetition debt, [which] is a crucial difference when applying the setoff provisions of the Bankruptcy Code.” Id. “Thus, the provisions of section 553(a), which provide for setoff of mutual debts which arise before bankruptcy, do not apply to most administrative priority claims but do apply to twenty-day sales claims, which by definition arise prepetition.” Id.

Brown & Cole Stores provides a rationale for courts to distinguish the application of section 502(d), in the context of section 503(b)(9) claims, that might not be inconsistent with the cases finding section 502(d) inapplicable to section 503(b) claims generally. For example, the Phoenix Restaurant court, which found that “section 502(d) was not a barrier to the allowance of an administrative expense,” noted that “[a]dministrative expenses are postpetition charges entitled to statutory priority.” Phoenix Restaurant, 2004 WL 3113719 at \*20. As such, “they cannot be set off against prepetition claims.” Id. (citing 11 U.S.C. §553). As per the Brown & Cole Stores decision, section 503(b)(9) claims, which are based on amounts owed as of the

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<sup>7</sup> Courts have, however, allowed creditors to setoff administrative claims against preference liability alleged by a debtor. “[A] likely use of a setoff defense would be one in which the creditor has postpetition administrative expense claims or some other claim that arose postpetition; in this instance, the obligations of the debtor and creditor are mutual.” Byron C. Starcher & Mark Duedall, *Preference Actions and Kitchen Sink Affirmative Defenses*, 1 PREFERENCE QUARTERLY L.J. 1, 6 (June 1, 2005) (citing In re Doctors Hospital of Hyde Park, Inc., 337 F.3d 951, 955 (7<sup>th</sup> Cir. 2003); In re Davidson Lumber Sales, Inc., 66 F.3d 1560, 1569 (10<sup>th</sup> Cir. 1995)).

petition date, are dissimilar to other post-petition 503(b) claims. This reasoning suggests that section 502(d) could be utilized to prevent a distribution on a section 503(b)(9) claim.

In summary, research revealed no published opinions squarely addressing the section 502(d) disallowance of section 503(b)(9) claims as of the date of this article, and courts have reached conflicting conclusions as to the applicability of section 502(d) to other administrative expense claims. This issue will undoubtedly continue to be the subject of litigation.

## **II. What is the impact of section 503(b)(9) claims on the subsequent new value defense?**

The new value defense is codified in section 547(c)(4) of the Bankruptcy Code and, in essence, provides that a preferential transfer may not be avoided:

[T]o the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor –

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of such new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor ...

11 U.S.C. §547(c)(4).

The new value defense is one of the most frequently raised defenses to a preference action. It is a non-fact sensitive, simple, mathematical defense of which the scope and extent are easily determinable. Practitioners should be cautioned, however, that payment of section 503(b)(9) claims may represent an obstacle to asserting a new value defense under section 547(c)(4) of the Bankruptcy Code. Indeed, although courts have not formally considered whether payment of section 503(b)(9) claims impact the assertion of a successful new value defense, there are arguments on both sides of this recent debate. The following arguments

support the conclusion that the payment of a section 503(b)(9) claim should not adversely affect the creditor's new value defense.<sup>8</sup>

First, allowing a post-petition payment on a section 503(b)(9) claim based on pre-petition invoices would be inconsistent with the legal precept law that post-petition invoices are not eligible for use in a new value defense. As explained by the court in In re Jolly "N", Inc., 122 B.R. 897, 909-10 (D.N.J. 1991):

To allow a creditor to offset post-petition advances against preferential transfers would be contrary to other provisions of the Code dealing with post-petition advances, would possibly prejudice the interests of other creditors, and would ignore the orderly mechanisms established by Congress to protect all interested parties concerned. Moreover, there is a lack of mutuality for such offsets because post-petition advances are made to the debtor's estate, and not to the debtor.

It follows that "[t]o allow post-petition payments to reduce a creditor's new value defense, while at the same time holding that post-petition provision of new value has no effect on the defense, is internally inconsistent and unfair." Mark I. Duedall, *The (Adverse?) Effect of the New Administrative Claim of Section 503(b)(9) on Preference Actions*, 2 PREFERENCE QUARTERLY L.J. 1, 6 (Jan. 12, 2006) (hereinafter "PREFERENCE QUARTERLY"). Stated differently, it would be inequitable to find that a new value defense would be unavailable if and to the extent a claimant receives a post-petition payment on its pre-petition claim afforded administrative priority under section 503(b)(9).

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<sup>8</sup> These arguments assume that the section 503(b)(9) claim was paid before the preference claim was raised. However, it is becoming increasingly more likely that an effort will be made to temporarily disallow a section 503(b)(9) claim until there is a resolution of the creditor's potential preference exposure (pursuant to section 502(d)). This temporary disallowance may actually benefit the creditor from a preference perspective in that, at the time of the preference claim, its section 503(b)(9) claim will be unpaid and, thus, any dispute as to its use is eliminated. Then, once the preference claim is resolved (with the creditor being able to use its section 503(b)(9) goods as new value), the section 503(b)(9) claim should be allowed and paid.

Second, this conclusion is further supported by the distinction between a “debtor” and a “debtor-in-possession” under the Bankruptcy Code, which remains critical to the analysis under section 547(c)(4). Applying a plain reading to section 547(c)(4)(B), the new value defense is not available unless the new value is provided “to or for the benefit of the debtor” and on account of which “the debtor did not make an otherwise unavoidable transfer to or for the benefit of [the] creditor.” 11 U.S.C. §547(c)(4)(B) (emphasis added). It follows that the use of the term “debtor” and the absence of the phrase “debtor-in-possession” in section 547(c)(4) arguably requires the conclusion that new value given to or transfers made by a debtor-in-possession should be disregarded for purposes of the new value defense.

Sections 101(13) and (41) of the Bankruptcy Code (when read together) define a “debtor” as the person (that is, an individual, partnership or corporation) or municipality concerning which a case has been commenced. Yet, section 1101 of the Bankruptcy Code provides that, for purposes of Chapter 11 only, a “debtor-in-possession” means a “debtor.” Indeed, the entity operating after the filing of a Chapter 11 petition is generally considered a separate and distinct entity from the entity that filed the bankruptcy petition. For example, section 1107(b) of the Bankruptcy Code provides that a professional is not disqualified for employment by a “debtor-in-possession” under section 327 of the Bankruptcy Code only because such professional was employed by the “debtor” before the commencement of the case. An argument can easily be made that, if it had been the drafters’ intent to have the terms debtor and debtor-in-possession represent the same entity in Chapter 5 (and in other Chapters) of the Bankruptcy Code, they would not have limited the applicability of section 1101 to Chapter 11 only.

Several courts have relied on the distinction between the pre-petition “debtor” and the post-petition “debtor-in-possession” to prohibit creditors from using post-petition new value (that is, new value provided to a debtor-in-possession after the petition date) as part of a new value

defense. For example, in In re D.J. Management Group, 161 B.R. 5 (Bankr. W.D.N.Y 1993), the court held that a supplier was not entitled to a new value credit for supplies provided to the debtor-in-possession post-petition, concluding that new value is appropriate only if such new value is extended for the benefit of the “pre-petition” debtor as opposed to the “post-petition” bankruptcy estate. The court stated that the “phrase ‘the debtor’ is systematically used throughout the Bankruptcy Code to connote an entity different from ‘the estate,’ ... or ‘the debtor-in-possession.’ If Congress had intended to recognize a ‘new value’ exception for credit extended to the ‘estate’ ... it would not have used the word ‘debtor.’” Id. at 6. See also, In re TennOhio Transportation Co., 255 B.R. 307, 310 (Bankr. S.D. Oh. 2000) (same); In re Sharoff Food Serv., Inc., 179 B.R. 669, 678 (Bankr. D. Colo. 1995) (same); Jolly “N”, Inc., 122 B.R. at 909 (same).

Similarly, at least one court has held that post-petition transfers on account of pre-petition new value rendered by a creditor did not disqualify such new value. In In re Phoenix Restaurant Group Inc., 317 B.R. 491 (Bankr. M.D. Tenn. 2004), the debtor made seven transfers to the creditor during the preference period after which the creditor provided new value to the debtor that remained unpaid as of the petition date. The debtor-in-possession did, however, pay for such new value after the petition date in accordance with a court-approved critical vendor program. Id. at 493. In holding that the debtor’s post-petition payment to the creditor on account of pre-petition services did not negate the creditor’s new value defense to the extent of such payment, the court opined that the term “debtor” referenced in section 547(c)(4)(B) refers to transfers by the pre-petition debtor and not the post-petition debtor-in-possession:

Had Congress intended §547(c)(4)(B) to account for payments made post-petition, the section would have included something like ‘an otherwise unavoidable transfer of an interest of the estate in property to or for the benefit of such creditor.’ Instead, Congress disqualified only new value paid for by ‘the debtor’ with an otherwise unavoidable transfer.

Id. at 497. The court concluded that the reference to “debtor” effectively ends the analysis as to the eligibility for inclusion in the new value defense under section 547(c)(4) at the petition date.

It should be noted, however, that other courts have observed that post-petition payments made by a debtor-in-possession eliminate the pre-petition new value paid thereby. For example, in In re NETtel Corp., Inc., 323 B.R. 1, 6 (Bankr. D.D.C. 2005), the court (in dicta) stated that invoices paid by a debtor-in-possession post-petition pursuant to a critical vendor program would be ineligible for use as new value under section 547(c)(4) if such payments were immune from avoidance. Such an interpretation essentially rewrites section 547(c)(4)’s “the debtor did not make an otherwise unavoidable transfer” to include the debtor and the debtor-in-possession.

Similarly, in In re Login Bros. Book Co., 294 B.R. 297 (Bankr. N.D. Ill. 2003), the court held that a creditor’s new value defense was reduced to the extent of pre-petition new value returned to the creditor post-petition pursuant to an order of the court. Because the post-petition return was made pursuant to a court order, the court reasoned that the “an otherwise unavoidable transfer” under subsection 547(c)(4)(B) necessitated a finding that the creditor’s new value defense must be reduced by the amount of that transfer:

[B]oth the plain language and policy behind the statute indicate that the timing of a repayment of new value is irrelevant. The statutory requirement that new value not be repaid – set out at §547(c)(4)(B) – contains no limitation on the time that the repayment or return of new value (the ‘otherwise unavoidable transfer to or for the benefit of such creditor’) must occur . . . And the policy behind the new value exception – that the estate be replenished by the new value – would be defeated if a creditor were allowed to keep a preferential payment of its debt on account of a new value contribution to the estate and also receive repayment of that contribution, regardless of whether the repayment occurred before or after the commencement of the bankruptcy case.

Id. at 300. See also, In re MMR Holding Corp., 203 B.R. 605, 609 (Bankr. M.D. La. 1996) (“[a]n unavoidable post-petition transfer on account of new value extended subsequent to a

preference *should* limit the use of §547(c)(4) by the amount of the unavoidable transfer, as without a reduction in the new value offset, the transferee would be receiving double use of the new value ...”) (emphasis in original); In re JKJ Chevrolet, Inc., 412 F.3d 545, 553 n.6 (4<sup>th</sup> Cir. 2005) (citing Login Bros. for the proposition that post-petition transfers may be considered under section 547(c)(4)(B) though not deciding issue); In re Arizona Fast Foods, LLC, 299 B.R. 589 (Bankr. D. Ariz. 2003) (reaching a similar conclusion without citation to authority and with little analysis).<sup>9</sup>

Third, a post-petition payment on a section 503(b)(9) claim should not preclude the use of new value that remained unpaid as of the petition date. Indeed, as referenced in the second argument, it is generally accepted that the determinative date as to whether new value is eligible for use under section 547(c)(4) (and for purposes of preference liability and defenses thereto) is the petition date. In fact, “[m]ost cases are in accord with the view that the petition date fixes the preference claim and any preference defenses.” PREFERENCE QUARTERLY, at 5 (citations omitted). See In re New York City Shoes, Inc., 880 F.2d 679, 680 (3d Cir. 1989) (If, among other things, the debtor did not fully compensate the creditor for the “new value” as of the date that it filed its bankruptcy petition, the creditor “is entitled to set off the amount of ‘new value’ which remains unpaid on the date of the petition against the amount which the creditor is required to return to the trustee on account of the preferential transfer it received”); Jolly “N”, Inc., 122 B.R. at 907-08 (A creditor is entitled to set off the amount of “new value” which remains unpaid on the date of the petition against the amount which the creditor is required to

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<sup>9</sup> One commentator has argued that a section 503(b)(9) claim could be construed to be the equivalent of a properly perfected and enforceable reclamation claim. In that circumstance, as long as administrative claims are paid in full, the section 503(b)(9) invoices would no longer qualify as allowed new value. Joseph L. Steinfeld & Gregory S. Abrams (principals of A.S.K. Financial), *New Value and Reclamation Post-BAPCPA*, 26-1 AMER. BANKR. INSTIT. J. 8 (Feb. 2007) (citing Arizona Fast Foods in support).

return under a preference action, if the debtor has not fully compensated the creditor for the “new value” as of the date that it filed its bankruptcy petition); but see Login Bros., 294 B.R. at 298.

The fourth argument supporting the conclusion that payment of section 503(b)(9) claims should not impact the new value defense also focuses on the plain language of section 547(c)(4)(B), which makes only new value on account of which the debtor “did not make” an otherwise unavoidable transfer thereafter to the creditor eligible for the defense. 11 U.S.C. §547(c)(4)(B). “‘Did not make’ is past tense, i.e., referring to payments that must have been made pre-petition.” PREFERENCE QUARTERLY, at 5. If section 547(c)(4)(B) is applied to allow future payments to eliminate the new value defense, then the statute could easily have been revised to read “did not or does not make” an otherwise unavoidable transfer thereafter to the creditor. Id.

The final argument focuses on the inequity of the resultant slippery slope if post-petition payment of section 503(b)(9) claims based on pre-petition invoices could negate a new value defense. Specifically, if post-petition transfers could invalidate pre-petition new value, it follows that a distribution under a Chapter 11 plan or in a Chapter 7 liquidation would also invalidate the defense. Following the holding of a case such as Login Bros. to its logical conclusion shows that the result of such cases makes, at least, the holding questionable.

**III. Is the pre-petition payment of what would otherwise be a section 503(b)(9) claim not recoverable as a preference because such payment did not allow the creditor to get more than it otherwise would have received in a liquidation?**

Section 547(b) sets forth the requirements to establish a *prima facie* case for avoidance of a transfer as preferential. Under subsection (b)(5), a “trustee must establish that the transfer yielded the creditor a greater return on its debt than it would have received if the transfer had not taken place and it had received a distribution under a Chapter 7 liquidation.” In re Kiwi Int’l Air Lines, Inc., 344 F.3d 311, 317 (3d Cir. 2003). “In other words, when a trustee commences a

section 547 preference action, the court is to compare what the creditor actually received and what it would have received under the Chapter 7 distribution provisions of the Code in order to determine whether the creditor received more than its fair share.” Id. (citations omitted).

It is certainly arguable that payments by a debtor-in-position of section 503(b)(9) claims may satisfy the section 547(b)(5) requirement. Although courts have not addressed this issue in any published opinion, analogous issues have been considered with respect to the assumption of executory contracts and the payment of the pre-petition claims of critical vendors – with different results. In assumption cases, courts have held that preference-period payments for goods sold pursuant to a subsequently assumed executory contract are not avoidable as preferential transfers because they fail to satisfy section 547(b). See, e.g., Kiwi; In re LCO Enterprises, 12 F.3d 938 (9<sup>th</sup> Cir. 1993); In the Matter of Superior Toy and Mfg. Co., Inc., 78 F.3d 1169 (7<sup>th</sup> Cir. 1996); In re Seidle, 778 F.2d 659 (11<sup>th</sup> Cir. 1985); MMR Holding Corp., 203 B.R. at 612-13; In re Teligent, Inc., 324 B.R. 479 (S.D.N.Y. 2005) (noting “well-settled doctrine that a preference action may not be maintained for payments made in connection with an assumed executory contract”).

In Kiwi, the debtor made payments within 90 days of its bankruptcy filing to various creditors who were parties to executory contracts that were assumed and assigned under section 365 of the Bankruptcy Code as part of the court-approved sale of substantially all of the debtor’s assets. Pursuant to section 365, the debtor was required to cure all pre-petition unpaid amounts owed under the contracts. Upon the trustee initiating preference actions against the parties to the executory contracts subject to cure, the defendants successfully moved to dismiss the actions. The Trustee appealed the decision of the Bankruptcy Court, which was affirmed by both the District Court and the Third Circuit Court of Appeals.

The trustee in Kiwi unsuccessfully sought to characterize the defendant-creditors as being similarly situated to general unsecured creditors for purposes of section 547(b)(5). The Third Circuit found that “the trustee’s analysis disregards the unique set of rights provided to the defendants by section 365.” Kiwi, 344 F.3d at 317. Further analyzing these “unique rights” under section 365, which requires a debtor-in-possession to cure the debtor’s defaults in payment to assume an executory contract of the debtor, the Kiwi court explained that “because assumption acts as a renewed acceptance of the terms of the executory bargain, the Bankruptcy Code provides that the cost of performing the debtor’s obligations is an administrative expense of the estate, which will be paid first out of the assets of the estate.” Id. at 318 (citing In re Columbia Gas System Inc., 50 F.3d 233, 238-39 (3d Cir. 1995)) (emphasis added). The court held that such pre-petition, administrative payments to the creditors are “not recoverable as preferences because, had the creditors not received the payments pre-petition, they would have received amounts reflecting those sums, in any event, when the Bankruptcy Court approved the cures of the assumed agreements.” Kiwi, 344 F.3d at 321.

Courts have, however, rejected the Kiwi analysis when raised in the context of preference actions initiated against creditors who were eligible to participate in, or actually participated in, a court-approved critical vendor program. For example, in In re Zenith Industrial Corp., 319 B.R. 810, 814-15 (Bankr. D. Del. 2005), the court rejected an affirmative defense to a preference action that section 547(b)(5) was not satisfied in that the creditor might have otherwise been paid under a court-approved critical vendor order program. Because a critical vendor program is discretionary based upon the facts and circumstances vis-à-vis the debtor-creditor relationship, whereas section 365 mandates that all pre-petition obligations be paid before a contract is assumed, the court rejected the argument that a critical vendor program was analogous to the “unique rights” afforded by section 365 identified in Kiwi. In other words, the Zenith creditor’s

affirmative defense was too speculative - mere eligibility for critical vendor status is not a sufficient defense to a preference action. Significantly, the Zenith court was not faced with the situation in which the creditor's claim had, in fact, been paid pursuant to the court-approved critical vendor program. See also, In re Bridge Info. Sys., Inc., 321 B.R. 247 (Bankr. E.D. Mo. 2005) (the authority to pay certain pre-petition claims is not the equivalent of the court requiring the payment of such claims in connection with the assumption of a contract); In re Tropical Sportswear Intern. Corp., 320 B.R. 15 (Bankr. M.D. Fla. 2005) (a critical vendor order expressly waiving avoidance actions will be subject to strict scrutiny); In re Fultonville Metal Prods. Co., 330 B.R. 305 (Bankr. M.D. Fla. 2005) (court-approved payment of the "critical" vendor's pre-petition claim did not insulate the vendor from preference risk); In re Hayes Lemmerz International, Inc., 313 B.R. 189 (Bankr. D. Del. 2004) (preference claims were not waived in that there was no consideration or analysis of whether any potential critical vendor received a preferential payment).

Based on these divergent conclusions reached by the courts, there is a strong argument that payments on claims that would otherwise qualify as section 503(b)(9) administrative expense claims should not be recoverable as preferences because (a) section 503(b)(9) claimants are granted a statutory set of rights unique from general unsecured creditors elevating otherwise pre-petition unsecured claims to administrative creditor status, (b) the allowance and payment of section 503(b)(9) claims are not discretionary based on the facts and circumstances of a particular case, and (c) regardless of when the payments are received by a creditor for goods received by the debtor within 20 days before the petition date, they are not more than what such creditor would otherwise be entitled to receive upon allowance of its section 503(b)(9) claim.<sup>10</sup>

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<sup>10</sup> Similarly, the "benefit to the estate" test in section 547(b) could arguably prohibit the recovery of a payment of what would otherwise be a section 503(b)(9) claim in that such recovery would, in turn, only result in an

#### **IV. Summary**

As the allowance and payment of section 503(b)(9) claims are becoming critical issues in recently filed bankruptcy cases, it is anticipated that courts will consider the impact section 503(b)(9) claims have on preference exposure and the defenses thereto (only some of which issues are discussed herein). Thus, practitioners should be cognizant that there are various issues presented by section 503(b)(9) ripe for litigation or, more likely, the threat of litigation.

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administrative claim and not give rise to any additional recovery for unsecured creditors. In fact, a bankruptcy judge in Texas recently ordered a Chapter 7 trustee not to sue any vendor for any payment relating to goods shipped within 20 days prior to the filing that would give rise to section 503(b)(9) claim in that such actions did not make “economic sense” and would not benefit the unsecured creditors. See In re Brook Mays Music Co., 2007 Bankr. LEXIS 2902 (Bankr. N.D. Tex. Aug. 1, 2007).