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Unpaid Administrative Expenses May Shield Preference Liability

In a recent decision, *In re Quantum Foods, LLC*,[1] the bankruptcy court in the District of Delaware confronted the issue of whether a creditor holding an unpaid administrative claim can assert that claim as a defense to the recovery of an avoidable preference. In *Quantum,* the Unsecured Creditors Committee (the "Committee") asserted that Tyson Fresh Meats, Inc. and Tyson Foods, Inc. (collectively "Tyson") received avoidable preferences in excess of $13.7 million. Post petition, Tyson sought and received an order allowing an administrative expense claim of $2.6 million, which remained unpaid.

The Committee filed a complaint seeking to recover the pre petition transfers under sections 547, 548 and 550 of the United States Bankruptcy Code,[2] and seeking to have Tyson's administrative claim disallowed unless the preferences were returned pursuant to Code section 502(d). Tyson denied that the transfers were avoidable, asserted that the Committee's preference claims were post petition causes of action, that it was entitled to set off any transfers found to be avoidable and, finally, that the provisions of Code section 502(d) did not apply to post petition administrative claims.

Judge Kevin J. Carey began his decision by noting that the question of whether an allowed administrative claim could be used to set off preference liability was one of first impression in Delaware. He said that the Third Circuit's decision in *In re Friedman's**[3]* was relevant to the analysis. The *Friedman's* court held that, for the purposes of preference analyses, because the preference period ends with the filing of the petition, goods or services provided to the debtor post petition could not be used as subsequent new value. The Committee asserted that Tyson's asserted set off was a "disguised" or "renamed" post petition new value defense because, like the new value defense, it had the effect of reducing the total amount of preferential transfers returned to the estate, thereby disrupting the Code's objective of equality of distribution.[4] The court stated that if Tysons claim constituted a new value defense, it was not allowable because post petition activity cannot factor into the preference calculation. However, said the court, if the claim was an ordinary set off claim, set off may be allowable.[5]

Judge Carey noted that some courts have held that the new value defense need not be cut off at the petition date. However, none of these decisions offered a

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convincing contextual basis for doing so. Instead, he concluded, the law and reason suggested that the preference calculations should be confined to the preference period, citing *Friedman's'* persuasive rationale for doing so.[6] Because Tyson's administrative claim related to the post petition period, the new value defense found in Code section 547(c)(4) simply did not apply.[7] Moreover, the court was not persuaded by the Committee's argument that Tyson's asserting its right of set off was really a disguised new value defense. The set off claim did not affect the bottom line of the preference calculation. Rather, the set off claim merely affected the amounts paid to the estate. This means that the set off claim affected the preference claim externally rather than internally, taking it outside of the new value defense.[8]

Analyzing the appropriateness of the Tyson's attempt to set off its claim, Judge Carey began by addressing the requirement of mutuality; that is, that both transactions of the set off occur on the same side of the bankruptcy petition. It is axiomatic, he said, that a preference cause of action concerns only pre petition facts, and just as obvious that only a preference claim can be asserted, and therefore only arises post petition.[9]

The court next addressed the Committee's argument that Code section 502(d) (which provides for the disallowance of any claim until the claim holder satisfies its preference liability) prohibits Tyson from exercising the right of set off. Code section 502(d) by its terms, said the court, does not apply to administrative claims. Conversely, Code section 503, providing for administrative expenses, has no analogous provision to Code section 502(d).[10] Citing the 2001 Delaware bankruptcy court decision of *In re Lids Corp.,*[11] Judge Carey noted that Judge Walwrath denied the application of Code section 502(d) to post petition claims and approved Judge Walrath's reasoning that if trade creditors felt that a potential preference would be used to prevent payment of their administrative claims, the trade creditors would be unwilling to extend post petition trade credit to a Chapter 11 debtor.[12]

Finally, the court disposed of the Committee's assertion that allowing Tyson's the right of set off would frustrate the Code's objective of equality of distribution among creditors. If there is a rule of equality of distribution, Judge Carey observed, there are so many exceptions that they surely swallow the rule. Courts balancing the interests of various creditors, such as the holders of wage claims, often justify unequal treatment. As the Third Circuit ruled in *Friedman's,* "Inequality per se is not to be avoided; indeed, reasoned and justified inequality sometimes prevails, usually based on what is in the best interest of the

estate."[13] Those courts which require the application the new value defense of Code section 547(c)(4) resulting in absolute equal treatment of all unsecured claims are misguided.[14]

The case correctly found that the Code section 547(c)(4) new value defense is cut off as of the petition date. Additionally, the court recognized that preference liability arises only at the time of the petition and not before, making it a post petition claim. As such, any unpaid administrative expense is the proper subject of a set off against a preference claim. Additionally, the court confirmed that Code section 502(d) does not apply to administrative expenses governed by Code section 503, and is no bar to asserting a post petition right of set off. Having this protection may make it more likely that trade creditors would be willing to do business with the debtor after the filing, as they are assured that they will receive a benefit for the goods or services they provide even if the debtor becomes administratively insolvent.

While the case does not acknowledge that the right of set off is dependent upon applicable law, it appears that—in this instance—the right of set off arises under federal common law, as both obligations arise under the Code.[15]

[1] *In re Quantum Foods, LLC,* 554 B.R. 729 (Bankr. D. Del. 2016).

[2] 11 U.S.C. §§ 101 1532 (the "Code").

[3] *Friedman's Liquidating Tr. v. Roth Staffing Co., LP (In re Friedman's),*738 F.3d 547 (3d Cir. 2013).

[4] *In re Quantum Foods, LLC,* 554 B.R at 732.

[5] *Id.* at 733.

[6][6] The *Friedman's* court enumerated five reasons for limiting the new value analysis to the preference period: (1) It would be otherwise perpetually open ended; (2) The title of Code section 547 is "Preferences" suggesting that relevant activity must occur during the preference period; (3) The "hypothetical liquidation" test must be performed as of the petition date; (4) The statute of limitations begins to run on the petition date; and (5) Extending the preference analysis beyond the petition date would be inconsistent with the "improvement in positon" test articulated in Code section 547(c)(5). *Friedman's* at 554 57.

[7] *In re Quantum Foods, LLC,* at 733.

[8] *Id,* at 734.

[9] *Id.* at 734 735.

[10] *Id.* at 735

[11] *In re Lid Corp.,* 260 B.R. 68 (Bankr. D. Del. 2001)

[12] *In re Quantum Foods, LLC,* at 735.

[13] *Friedman's,* 738 F.3d 560.

[14] *Id.*

[15] *See* 5 Collier on Bankruptcy § 553.04[3] (Alan J. Resnick & Henry J. Sommer eds., 16th ed.).