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## Problems in the Code

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### Law and (Sparrer) Sausages

*"Remains Unpaid" Continues to Confound in Preference Cases*



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In the recent case of *Unsecured Creditors Committee of Sparrer Sausage Co. v. Jason's Foods Inc.* ("Sausage"),<sup>1</sup> the U.S. Court of Appeals for the Seventh Circuit repeated an erroneous statement of law regarding the "new value" affirmative defense to preference claims found in § 547(c)(4) of the Bankruptcy Code. A curious thing, to be sure, considering that the Seventh Circuit devoted less than one page of its opinion to defendant Jason's Foods Inc.'s new value defense. The first 12 pages of the opinion largely addressed Jason's "ordinary-course" defense, found in § 547(c)(2), and clarified the law following cases like *In re Milwaukee Cheese Wisconsin Inc.*<sup>2</sup> and *In re Tolona Pizza Products Corp.*<sup>3</sup> In contrast to the detailed analysis of Jason's ordinary-course defense, the Seventh Circuit said little about why Jason's liability was entirely offset by new value, and in the process, it misstated the law.

#### The Law

Section 547(c)(4) of the Bankruptcy Code provides: (c) The trustee may not avoid under this section a transfer — ...

(4) 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 —

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

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.<sup>4</sup>

#### Sparrer

During the 90-day period immediately preceding its bankruptcy filing, Sparrer Sausage Co. Inc. ("Sparrer") paid Jason's more than \$500,000 for unprocessed meat products. During that same period, Jason's delivered to Sparrer more than \$63,000 of additional meat products for which Sparrer never paid. When the creditors' committee sued Jason's to recover preferential transfers, Jason's argued that all of the transfers were protected by the ordinary course and new value defenses. The Seventh Circuit concluded that Jason's had a valid ordinary course defense for all but approximately \$60,000 of the transfers. Since there was no dispute about the new value that Jason's provided, Jason's had a complete defense after offsetting the \$63,000 of new value against the balance of potential liability.<sup>5</sup>

In affirming the validity of Jason's new value defense, the Seventh Circuit made the following statement of law: "A creditor may avail itself of ... [new value] defense if, after receiving a preferential transfer from the debtor, it advanced additional, unsecured credit that remains unpaid."<sup>6</sup> The Third, Eighth and Eleventh Circuits have also used the "remains unpaid" standard.<sup>7</sup> What is this "remains unpaid" rule, and where does it come from?

#### Understanding the Remains-Unpaid Standard

Consider the following example: A debtor pays its creditor \$50,000 on day 45 before the debtor files a voluntary chapter 11 case. Ten days later, on day

<sup>5</sup> *Sausage*, 2016 WL 3213096 at \* 5.

<sup>6</sup> *Id.* (citing *In re Prescott*, 805 F.2d 719, 727 (7th Cir. 1986)).

<sup>7</sup> See, e.g., *In re New York City Shoes Inc.*, 880 F.2d 679, 680 (3d Cir. 1989); *In re Kroh Bros. Dev. Co.*, 930 F.2d 648, 653 (8th Cir. 1991); *In re Jet Fla. Sys. Inc.*, 841 F.2d 1082, 1083 (11th Cir. 1988). But see, e.g., *In re Pillowtex Corp.*, 416 B.R. 123, 126-28 (Bankr. D. Del. 2009) (rejecting "remains unpaid" standard and noting that it was not before court in *City Shoes*); *In re Jones Truck Lines Inc.*, 130 F.3d 323, 329 (8th Cir. 1997) (rejecting *Kroh Brothers's* "remains-unpaid" standard and labeling it "shorthand").

<sup>1</sup> No. 15-2356, -- F.3d --, 2016 WL 3213096 (7th Cir. June 10, 2016).

<sup>2</sup> 112 F.3d 845 (7th Cir. 1997).

<sup>3</sup> 11 U.S.C. § 547(c)(4).

<sup>4</sup> 3 F.3d 1029 (7th Cir. 1993).

35 before the bankruptcy filing, the creditor provides the debtor with \$15,000 of widgets. Thirty days later still, on day five before the bankruptcy, the debtor pays for the \$15,000 of widgets. Then, on the eve of the chapter 11 filing, the creditor delivers to the debtor another \$25,000 of widgets. Neither payment was made in the ordinary course of business (or according to ordinary business terms), so the debtor sues the creditor to recover both the \$50,000 payment and the \$15,000 payment. Upon proof, the debtor acknowledges that the creditor is not obligated to return the \$15,000 payment because the creditor's eve-of-bankruptcy new value offsets the payment fully and that the balance of such new value can be carried back to the \$50,000 payment to reduce liability for that transfer by \$10,000, leaving a liability of \$40,000 ( $\$15,000 - \$25,000 + \$50,000 = \$40,000$ ). The debtor does not recognize the earlier \$15,000 of new value because it did not "remain unpaid."

If this debtor is correct, the liability is \$40,000. But if the new value does not have to "remain unpaid," the creditor's liability would be \$25,000, not \$40,000 ( $\$15,000 - \$25,000 - \$15,000 + \$50,000 = \$25,000$ ). This is where the remains-unpaid standard makes a significant difference.

## Origin of the Remains-Unpaid Standard

One would have a difficult time finding the remains-unpaid standard in § 547(c)(4) of the Bankruptcy Code, yet the Seventh Circuit has repeated this "test" at least three times over the last 30 years.<sup>8</sup> Both *Sausage* and *P.A. Bergner* rely on *Prescott*, a 1986 opinion that appears to have introduced the concept as something bordering on *dicta*, rather as part of any clear holding in the case.

In *Prescott*, the Seventh Circuit affirmed the district court's holding that rejected Marine Bank's new value defense because Marine Bank "never showed that" the debtors' account overdrafts (new value advanced by Marine Bank) "went unpaid." The Seventh Circuit started from the premise that there are three requirements for a § 547(c)(4) defense: (1) the creditor must extend new value after the preferential transfer; (2) the new value must be unsecured; and (3) the new value must remain unpaid.<sup>9</sup> As support for this test, the Seventh Circuit ignored the Bankruptcy Code and instead cited three 1980s bankruptcy decisions from Maine, Michigan and Georgia.<sup>10</sup>

*Prescott* appears to be the first time that the Seventh Circuit made the remains-unpaid standard part of the local lexicon, at least since the Bankruptcy Code's enactment in 1979. This has had a dramatic impact on preference litigation in the years since. Bankruptcy courts in the Seventh Circuit are relying on *Prescott*'s "remains unpaid" rule, even when they seemingly disagree with it.<sup>11</sup> In *GGSI*, the preference defendant argued that the remains-unpaid statement in *Prescott* was *dicta*, not a holding. Judge **A. Benjamin Goldgar** disagreed, stating, "Since that was *Prescott*'s holding, not just a set of extra-

neous remarks, it cannot be dismissed as mere *dicta*."<sup>12</sup> Almost verbatim, Judge **Margaret Dee McGarity** reached the same conclusion about the binding effect of *Prescott* a year later in *Schabel*.<sup>13</sup>

**The remains-unpaid standard should be directly considered and rejected by the Seventh Circuit. Hopefully, this issue will be presented in the near future, though ... it may take some time.**

What Judges Goldgar and McGarity said is more or less true. When the Seventh Circuit made the statement that the bankruptcy judges attributed to it, the full sentence read, "*The district court determined that Marine [Bank] failed to meet this burden because it never showed that any overdrafts went unpaid.*"<sup>14</sup> The Seventh Circuit said nothing more about it, but ultimately affirmed the district court's rulings as to Marine Bank.<sup>15</sup>

This is far from a ringing endorsement of a dispositive rule, but it is nevertheless the link that binds the remains-unpaid standard to Seventh Circuit new value jurisprudence, however weak it might be. In any event, whether or not *Prescott* is truly binding authority on this subject, it can hardly be argued that the Seventh Circuit fully considered *the statute* when it adopted the remains-unpaid standard. To the contrary, the Seventh Circuit adopted the rule without giving it full consideration. *P.A. Bergner* and *Sausage* repeat the error without analysis, leaving something of a dead-end in a search for the origin of the remains-unpaid standard.

Dig a little deeper, however, and you will find the true origin of the rule: the Bankruptcy Act of 1898. The relevant language has been part of the Bankruptcy Act since the beginning. In 1898, § 60(c) of the Bankruptcy Act read:

If a creditor has been preferred, and afterwards in good faith gives the debtor further credit without security of any kind for property [that] becomes a part of the debtor's estates, *the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy* may be set off against the amount which would otherwise be recoverable from him.<sup>16</sup>

## In the Bankruptcy Code, "Remains Unpaid" Remains Unsaid

When the remains-unpaid rule is given proper consideration by reading the 1978 Bankruptcy Code (and not the now-repealed Bankruptcy Act), it fails. Indeed, § 547(c)(4) demonstrates that Congress considered the issue of "paid" new value and chose to permit it in one important circumstance. The statute states that new value cannot be paid with an "otherwise unavoidable transfer." The Seventh Circuit should presume that Congress intended to change the law when, in 1978, it removed the remains-unpaid standard

<sup>8</sup> *Sausage*, 2016 WL 3213096 at \*5; *In re P.A. Bergner & Co.*, 140 F.3d 1111, 1121 (7th Cir. 1998); *Prescott*, 805 F.2d at 728.

<sup>9</sup> *Prescott*, 805 F.2d at 728.

<sup>10</sup> *Id.* (citing *In re Saco Local Dev. Corp.*, 30 B.R. 859, 867 (Bankr. D. Me. 1983); *In re Formed Tubes Inc.*, 46 B.R. 645, 646 (Bankr. E.D. Mich. 1985); and *In re Bishop*, 17 B.R. 180, 183 (Bankr. N.D. Ga. 1982)). None of these decisions addresses the remains-unpaid standard in significant detail.

<sup>11</sup> *See, e.g., In re Schabel*, 338 B.R. 376, 380-81 (Bankr. E.D. Wis. 2005) (citing *Prescott*); *In re GGSI Liquidation Inc.*, 313 B.R. 770, 777-79 (Bankr. N.D. Ill. 2004) (citing *Prescott*).

<sup>12</sup> *GGSI*, 313 B.R. at 778.

<sup>13</sup> *Schabel*, 338 B.R. at 380-81.

<sup>14</sup> *Prescott*, 805 F.2d at 728 (emphasis added).

<sup>15</sup> *Id.*

<sup>16</sup> Bankruptcy Act of 1898, ch. 541, § 60(c), 30 Stat. 544 (repealed 1978) (emphasis added).

that was present in the Bankruptcy Act.<sup>17</sup> If Congress had intended to preserve that standard, it would have said in § 547(c)(4), “on account of which new value the debtor did not make a transfer to or for the benefit of such creditor.” Instead, Congress only referenced an “otherwise unavoidable transfer.”

What is an otherwise-unavoidable transfer? In short, “an otherwise unavoidable transfer” is a transfer that is protected from avoidance in some “other” way. “Other” must mean an alternative to § 547(c)(4), such as § 547(c)(2), the ordinary-course defense. So if the transfer that pays for the new value meets the requirements of § 547(c)(2), it is “otherwise” unavoidable by the debtor, meaning that the new value that it satisfied cannot be offset against any prior transfers. This is the holding of the many courts that have analyzed the statute’s wording.<sup>18</sup> In the previous example above, the \$15,000 of new value could not be offset against the initial \$50,000 transfer if the subsequent payment of \$15,000 were made in the ordinary course, but you were asked to assume that both payments were *unordinary*. What happens then?

The \$15,000 of new value becomes unavoidable, but only because additional new value was provided on the eve of bankruptcy. In other words, an unavoidable transfer was made on account of the initial new value, but it was not “otherwise” unavoidable. If Congress wanted to encourage creditors to continue doing business with financially stressed debtors (as the evidence seems to suggest<sup>19</sup>), should not the creditor be entitled to offset both examples of new value?

We are reluctant to answer that question (even though we believe the correct answer is a resounding “yes”) because we believe that the search for congressional intent has led the courts to err in the past. For example, many courts ask whether the estate was “diminished” or “replenished” by the transactions in question before they analyze the statute’s language.<sup>20</sup> This is not the typical Seventh Circuit approach to statutory interpretation, nor is there any reason to think that it is the correct approach here.<sup>21</sup> It looks more like the “equitable” bankruptcy arguments of old, which have been rejected by the Seventh Circuit in recent years.<sup>22</sup> But even if it were Congress’s goal to ensure that the estate is replenished, what is new value if not “replenishment”?

If policy should be considered at all, both debtors and creditors can find something to appreciate in Congress’s choice to give the creditor the benefit of its “paid” new value, but only when the creditor protects itself (and the debtor) by providing even more new value. The message? Keep the new value coming, because it is usually better for the debtor and may be better even for the creditor.

## Conclusion

The remains-unpaid standard should be directly considered and rejected by the Seventh Circuit. Hopefully, this issue will be presented in the near future, though the rarity of preference appeals suggests that it may take some time. In the interim, unfortunately, *Sausage* repeats the errors of the new value decisions that came before it and tethers itself to a statute that was repealed some 38 years ago. Somewhere in this controversy there is surely a joke about watching laws and sausages being made, but we are not taking the bait. **abi**

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<sup>17</sup> See, e.g., *Stone v. I.N.S.*, 514 U.S. 386, 397 (1995) (“When Congress acts to amend a statute, we presume [that] it intends [for] its amendment to have real and substantial effect.”).

<sup>18</sup> See, e.g., *Jones Truck*, 130 F.3d at 328-29; *In re IRFM Inc.*, 52 F.3d 228, 231-32 (9th Cir. 1995); *In re Toyota of Jefferson Inc.*, 14 F.3d 1088, 1092-93 (5th Cir. 1994).

<sup>19</sup> See, e.g., *Barnhill v. Johnson*, 503 U.S. 393, 402 (1992); *In re Net Pay Sols. Inc.*, 822 F.3d 144, 150 (3d Cir. 2016).

<sup>20</sup> See, e.g., *In re Globe Bldg. Materials Inc.*, 484 F.3d 946, 950 (7th Cir. 2007) (recognizing that “courts sometimes ask” whether new value “replenishes the [debtor’s] estate”); *Kroh Bros.*, 930 F.2d at 652-56; *In re Renew Energy LLC*, 436 B.R. 112, 116 (Bankr. W.D. Wis. 2010).

<sup>21</sup> See, e.g., *In re Qualitech Steel Corp.*, 327 F.3d 537, 543-44 (7th Cir. 2003). See also *In re Schabel*, 338 B.R. 376, 382 (Bankr. E.D. Wis. 2005) (“[T]he words of the statute do not compel consideration of the size of the distributable estate in determining whether the defense applies, that is, whether the estate was in fact ‘replenished.’”).

<sup>22</sup> See, e.g., *In re Milwaukee Cheese Wisconsin Inc.*, 112 F.3d 845, 848 (7th Cir. 1997) (noting that the argument “a bankruptcy court is a court of equity” is not a mantra that makes the Bankruptcy Code dissolve”).