abiLIVE Faculty: A Case Study on Hot Topics in Preference Litigation

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A Little More You Need to Know About the "Ordinary Course of Business" and "New Value" Preference Defenses

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Abstract:

This article discusses recent court decisions that have further developed the law regarding the application of the ordinary course of business and new value preference defenses. The article is intended to update two previously published articles: Everything You Need To Know About The "Ordinary Course of Business" Preference Defense, And More! published in Volume 19, Number 1, 1st Quarter 2013 and Everything You Need to Know About New Value as a Preference Defense, and More published in Volume 17, Number 2, 2nd Quarter 2011.

What is a Preference?

According to section 547(b) of the Bankruptcy Code, a trustee can avoid and recover a transfer as a preference by proving all of the following elements of a preference claim:

i. The debtor transferred its property (usually by tendering payment) to or for the benefit of a creditor. [section 547(b)(1)];

ii. The transfer was made on account of antecedent or existing indebtedness that the debtor owed the creditor. [section 547(b)(2)];

iii. The transfer was made when the debtor was insolvent based on a balance sheet definition of insolvency - liabilities exceeding assets [section 547(b)(3)]. The debtor's insolvency within the 90-day period prior to its bankruptcy filing is presumed, making it easier for a trustee to prove. The creditor has the burden to present some evidence of the debtor's solvency to rebut this presumption. Once rebutted, the burden shifts back to the trustee to prove the debtor's insolvency;

iv. The transfer was made within 90 days of the debtor's bankruptcy filing, in the case of a transfer to a non-insider creditor, and within one year of the bankruptcy filing for a transfer to an insider of the debtor, such as the debtor's officers, directors, controlling shareholders and affiliated companies. [section 547(b)(4)]; and

v. The transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor. [section 547(b)(5)]. This requirement is easy to satisfy unless the recipient of the alleged preference can prove that it was fully secured by the debtor's assets, was paid from the proceeds of its collateral, or all creditors' claims were (or will be) paid in full.

Once a trustee proves all of the elements of a preference claim under section 547(b), the creditor has the burden of proving one or more of the affirmative defenses to a preference claim contained in section 547(c) of the Bankruptcy Code to reduce or eliminate its preference exposure. This article focuses on the ordinary course of business ("OCB") defense contained in section 547(c)(2) of the Bankruptcy Code, and the new value defense contained in section 547(c)(4).

I. THE ORDINARY COURSE OF BUSINESS DEFENSE

The OCB defense requires proof, by a preponderance of the evidence that (1) the alleged preferential transfer paid a debt that was *incurred* in the ordinary course of the debtor's and creditor's business or financial affairs—which merely requires proof of a trade creditor's extension of credit terms to the debtor—and (2) that the transfer was *either* (a) made in the ordinary course of the debtor's and creditor's business or financial affairs (the "subjective" part of the OCB defense), or (b) made according to ordinary business terms (the "objective" part of the OCB defense).

The OCB defense is intended to encourage the continuation of business with (and the extension of credit to) an entity that is sliding into, but seeking to avoid, a bankruptcy filing. The OCB defense is supposed to protect from preference risk a debtor's payment to a creditor during the 90-day period prior to the debtor's bankruptcy filing (the "preference period") that was made in a consistent manner with either the parties' history or how payments are made in the applicable industry. Nevertheless, the courts have been inconsistent and unpredictable in the manner in which they have applied the OCB defense, resulting in expensive litigation over this defense.

A. The Subjective Element of the Ordinary Course of Business Defense

A creditor relying on the subjective prong of the OCB defense must first demonstrate a pre-preference period payment history or "baseline of dealing" between the debtor and the creditor and then compare that to the alleged preferential transfers. As part of this analysis, the court usually considers the following factors: (i) the length of time the parties were engaged in the type of dealing at issue; (ii) whether the amounts of the alleged preferential transfers were larger than prior payments; (iii) whether the payments were tendered in a manner different from previous payments; (iv) whether there was any unusual action by either the debtor or the creditor to collect or pay the debt; and (v) whether the creditor did anything to gain an advantage in light of the debtor's deteriorating financial condition.

There are frequently two components of a court's determination of whether the subjective part of the OCB defense protects the alleged preferential transfers: (i) a statistical analysis primarily focused on comparing the timing of the historical and alleged preferential transfers, and (ii) a determination of whether the factual circumstances surrounding the alleged preferential transfers were unusual. The latter determination considers the extent of any collection efforts and other pressure the creditor had exerted to obtain payment of the alleged preferential transfers. These components of the court's analysis do not carry equal weight as the OCB defense may be inapplicable where an otherwise preferential transfer was made in response to payment and other collection pressure, even where there is a consistency in the timing of the payment based on a statistical analysis.

The Statistical Analysis

Many courts considering the applicability of the subjective prong of the OCB defense have considered whether the alleged preferential transfers, based on timing of the transfers or otherwise, were consistent with the parties' prior course of dealing. The courts have undertaken various forms of statistical analyses and approaches in considering the applicability of the subjective OCB defense. For example, the courts have compared the timing of the payments made during and prior to the preference period based on (i) average (straight or weighted), (ii) median, (iii) deviation off of an average or median, (iv) range (or ranges), (v) regularity of payments based on percentages, or (vi) a combination of one or more of the above methodologies.

Pre-preference Period – How Long is Long Enough?

A bankruptcy court considering a historical baseline of dealings between the parties usually first considers the parties' payment history prior to the preference period. As discussed in the 2013 article, the courts have disagreed on the length of time to be considered in determining the historical baseline course of dealing between the parties. Recent decisions have approved a two year historical period.

In *Davis v. R.A. Brooks Trucking, Co., Inc. (In re Quebecor World (USA))*, the United States Bankruptcy Court for the Southern District of New York relied on a two-year historical period asserted by the plaintiff, rather than a one-year historical period asserted by the defendant. The

court held that the longer two year historical period more accurately reflected the parties' ordinary course of dealings because it included the period when the debtor was in better financial health. This contrasted with the one year period the defendant had asserted when the debtor was financially distressed.

Similarly, in *Cox v. Momar Inc.* (*In re Affiliated Foods Sw. Inc.)*, the bankruptcy trustee argued that a one year period prior to the preference period was appropriate when comparing the timing of payment prior to and during the preference period. The United States Court of Appeals for the Seventh Circuit disagreed, holding that a two year historical baseline provided a more accurate picture of the parties' ordinary course of dealing. The court explained that in order to properly evaluate payments made during the preference period, the payment history should be based on a timeframe when the debtor was financially healthy. The court also justified the use of a two year payment history by the fact that there were only nine transactions during the two years prior to the bankruptcy filing, and only three transactions during the one year prior to the preference period when the debtor was in financial distress. This court suggested that a one year payment history might have been appropriate if there were hundreds of payments during the year prior to the preference period.

May the Court Exclude Portions of the Pre-preference Period When the Debtor was in Distress?

Recently, several courts have limited the historical baseline to when the debtor was financially healthy. There was ample precedent for this based on *Siegel v. Russellville Steel Company, Inc. (In re Circuit City Stores, Inc.)*, where the United States Bankruptcy Court for the Eastern District of Virginia excluded from the payment history the approximately nine month period immediately prior to the preference period, when the debtor was in financial distress. The court instead relied solely on the prior history when the debtor was healthy.

More recently, in *The Unsecured Creditors Committee of Sparrer Sausage Company, Inc. v. Jason's Foods, Inc. (In re Sparrer Sausage Co.)*, the relationship between the debtor, Sparer, and the defendant began on February 2, 2010 and continued until Sparrer's bankruptcy filing on February 7, 2012. The United States Court of Appeals for the Seventh Circuit upheld the bankruptcy court's finding that only payments made during the portion of the parties' historical relationship when Sparrer was financially healthy—February 2, 2010 to April 15, 2011—were the appropriate historical baseline to compare to the alleged preference payments. The court considered the period when Sparer was financially healthy, instead of when Sparer was in financial distress, as a better reflection of the parties' typical payment practices.

Similarly, in *Goodman v. Candy Fleet, LLC (In re Gulf Fleet Holdings, Inc.)*, the United States Bankruptcy Court for the Western District of Louisiana also limited the historical baseline period to when Gulf Fleet, the debtor, was adequately capitalized. The court rejected the defendant's proposed historical baseline—January 1, 2008 through April 30, 2009—as an appropriate baseline. First, the defendant's proposed historical baseline ignored the fact that Gulf Fleet's financial condition began deteriorating in 2009, which was reflected in the parties' payment history. Second, the defendant's proposed historical baseline ignored the impact of a cash infusion that Gulf Fleet's owner had provided in February 2010, which allowed Gulf Fleet to pay

invoices more quickly during the preference period. Accordingly, the court held that the parties' payment history in 2008—when Gulf Fleet was financially healthy—was a sound historical baseline against which to compare the payments made during the preference period.

No Pre-preference Period Payment History

The courts have reached conflicting holdings over whether the subjective OCB defense can protect a payment made during the preference period if there was no pre-preference period history between the parties; *i.e.* the alleged preferential payment was the debtor's first payment to the defendant, or there was a very limited history of dealings between the parties.

In *Jubber v. SMC Electrical Products, Inc., et al. (In re C.W. Mining Co.)*, the United States Court of Appeals for the Tenth Circuit applied the subjective OCB defense to a first time transaction between the debtor and a defendant during the preference period. The debtor, C.W. Mining, a coal-mining company, entered into a contract with the defendant to purchase certain equipment in order to convert its mining method to a "longwall system," with payments under the contract due in installments. The parties did not do business prior to this contract. During the 90-day preference period, the debtor made an installment payment of $200,000 that was received two days prior to the invoice due date. When sued for the return of the payment as a preference, the defendant asserted the subjective OCB defense, even though the defendant had no prior dealings with the debtor.

The Tenth Circuit held that a first-time transaction would be protected by the subjective OCB defense as long as it is "ordinary in relation to this debtor's and this creditor's past practices when dealing with other, similarly situated parties." The court concluded that C.W. Mining both incurred the debt and made the $200,000 payment to the defendant in the ordinary course of business and was, thus, protected by the subjective prong of the OCB defense. The purchase was an arms-length transaction between the parties and the purpose of the purchase was to assist in mining operations. In addition, C.W. Mining had paid the defendant from its own bank account just two days prior to the invoice due date, and there was no evidence of any collection activity by the defendant.

Consistency of, and Method to Determine, Timing of Payments During the Historical Period and the Preference Period

Most court decisions dealing with the applicability of the subjective prong of the OCB defense have relied on the consistency in the timing of the alleged preference payments compared with the timing of payments during the parties' prior course of dealing before the preference period. The courts have compared the timing of the payments made during and prior to the preference period based on a variety of methodologies that have sometimes led to conflicting decisions.

In *Quebecor*, nearly all of the payments made during the preference period were not protected by the subjective OCB defense. The court relied on two methodologies: the average lateness method which considered the average time of payment after issuance of an invoice prior to and during the preference period and plaintiff's "bucketing analysis" which grouped the debtor's historical payments by age. The court relied on the significant disparity of 29.6 days between the

average days to pay of 27.56 prior to the preference period and 57.16 during the preference period. The court also relied on the fact that 88% of the debtor's payments prior to the preference period, paid invoices between 11 and 40 days after receipt of the invoice, compared to only 22% of the payments during the preference period.

The court rejected the "total range method" that defendant asserted as the appropriate methodology, which considers as ordinary any preference payment falling within the minimum and maximum days to pay during the historical period. The court found that this method improperly captured outlying payments and skewed the analysis of what is ordinary.

Bottom line: the court concluded only payments up to 45 days after invoice date were sufficiently consistent with a historical baseline of 93% of the debtor's payments to the defendants prior to the preference period to be considered subjectively ordinary. That excluded nearly all of the alleged preference payments which were, therefore, not protected by the subjective OCB defense.

In *In re Sparrer Sausage Co.*, the bankruptcy court relied on an OCB range of 16 to 28 days after invoice date in evaluating whether the alleged preference payments satisfied the subjective element of the OCB. The court determined the average invoice age of 22 days to pay during the historical period, then added 6 days on both sides of that average and concluded that only payments of invoices 16 to 28 days after invoice date satisfied the subjective OCB defense. Of the 23 invoices paid during the preference period, 12 were paid within the 16 to 28 day range and 11 others were paid outside that range. The debtor's payment of 11 invoices paid 14, 29, 31, 37, and 38 days after invoice date did not satisfy the subjective OCB defense and were avoidable as preferences. The defendant then appealed to the United States District Court, which affirmed the bankruptcy court's ruling.

On appeal, the Seventh Circuit held that the bankruptcy court should not have used a historical baseline range of 16 to 28 days after the invoice date to analyze the subjective prong of the OCB defense. The court found that range to be excessively narrow and arbitrary because it encompassed only 64% of the payments Sparrer had made to the defendant during the historical period. If the range were expanded by just two days on each end to 14 to 30 days to encompass 88% of the payments made during the historical period, all but two payments, made 37 and 38 days after the invoice date, would have been protected by the defense. Defendant ended up having no preference liability because the two payments were fully offset by the new-value defense.

In *In re Affiliated Foods Sw. Inc*., the Eighth Circuit appeared to be applying the total range and average methodologies in evaluating the applicability of the subjective OCB defense. The court relied on a historical average days to pay of approximately 35 days between invoice and payment date, resulting in a range of 13 to 49 days between invoice and payment date. The court ruled that the alleged preferential payment at issue, which was made 26 days after the invoice date, fell within the historical baseline and, therefore, was protected by the subjective prong of the OCB defense.

In *Burtch v. Revchem Composites, Inc. (In re Sierra Concrete Design, Inc.)*, the bankruptcy court held that the subjective OCB defense applied even though the alleged preference payments were made much faster than prior payments. The parties had operated under an agreement that included payment terms and a credit limit for the debtors. When the debtors were at or near the credit limit, Revchem required the debtors to pay previously issued invoices before Revchem shipped new product.

Prior to the 90-day preference period, from February 2004 through April 2008, the debtors' average days-to-pay from the invoice date was 55.22 days, with a range of 0 to 116 days. During the preference period, the debtors' average days-to-pay was 27.3 days, with a range of 13 to 61 days. The court recognized the significance of the debtors' faster payments during the preference period in light of the 27.9 day difference between the 55.22 average days-to-pay prior to the preference period and the 27.3 average days-to-pay during the preference period. According to Revchem, the payments accelerated because the debtors needed product faster for a construction project with tight deadlines.

As a result, the court rejected the trustee's argument that the debtors' faster payments during the preference period precluded Revchem from satisfying the subjective OCB defense. The court also rejected the trustee's argument that the debtors' faster payment to Revchem during the preference period amounted to a material change in practice between the parties.[1] Revchem did not pressure the Debtors to pay outstanding invoices faster than usual during the preference period. Revchem was not aware of the debtors' financial problems and deteriorating financial condition. There was also no proof that the amounts paid during the preference period were larger than the payments prior to the preference period or that the debtors were paying in a different manner. Finally, although Revchem had imposed a credit limit on the debtors, that was the only way Revchem could make sure that the debtors were paying invoices in a timely manner. Moreover, the same credit limit was in effect during the year prior to the preference period and the parties had a history of working under a credit limit. Indeed, Revchem had not placed any credit holds with respect to shipments to the Debtors either prior to or during the preference period. As a result, the court found that the debtors' faster payments during the preference period to remain within the credit limit were consistent with the parties' prior business dealings and, therefore, should be shielded from preference liability by the subjective OCB defense.

In *Stanziale v. Industrial Specialists Inc., a/k/a Industrial Specialists, LLC* (*In re Conex Holdings, LLC)*, the United States Bankruptcy Court for the District of Delaware granted summary judgment (without a trial) in favor of the defendant based on the subjective OCB defense on the grounds that the timing of seven payments made during the preference period was consistent with the parties' pre-preference period history, despite small differences in timing during the pre-preference period. Prior to the preference period, the average days to pay was 61 days when including two outlier payments and 56 days when excluding the outliers. During the preference period, the average days to pay was 54 days. The court held that the differences in

[1]The inconsistent outcomes in *Sierra Concrete* and *Quebecor* clearly demonstrate the difficulty in predicting whether a court will apply the subjective OCB defense. In *Sierra Concrete*, the court applied the subjective OCB defense despite a 27.9 day disparity between the historical and preference period averages, whereas the *Quebecor* court refused to apply the subjective OCB defense in light of a similar 29.6 day disparity.

timing between the historical and preference periods—either a two day difference in average days to pay when excluding outlier payments prior to the preference period or a seven day difference in average days to pay when including the outlier payments—were not sufficiently problematic to take the alleged preferential payments outside of the parties' normal course of dealings.

The court also rejected the plaintiff's argument that certain payments should be omitted from the analysis because they were made to a different entity. The court concluded that the defendant had submitted undisputed proof that both the defendant and the other entity were the same. The court also took into account the consistency in the amount of the payments, the manner in which they were tendered prior to and during the preference period and the absence of unusual collection or other action by the defendant in response to the debtor's deteriorating financial condition.

Finally, in *In re AFA Investment Inc., et al., v. Dale T. Smith & Sons Meat Packing Company (In re AFA Investment Inc.)*, the United States Bankruptcy Court for the District of Delaware held that certain payments were not protected by the subjective OCB defense because of an inconsistency in the timing of payment of invoices prior to and during the preference period. During the approximately one year period prior to the preference period, 97% of all invoices were paid between 16–30 days after the invoice date. By contrast, during the preference period, 96% of the payments were made after 30 days. In addition, of the approximately $13 million in payments prior to the preference period, none were paid later than 35 days after the invoice date, while during the preference period, 71.7% of all invoices were paid after 35 days. Moreover, the weighted average days to pay nearly doubled from 22.43 days prior to the preference period to 43.95 days during the preference period. The court found these differences too significant, and therefore refused to apply the subjective OCB defense.

Change in Ownership

In *Satija v. C-T Plaster, Inc., aka Cen-Tex Plaster, Inc., et al. (In re Sterry Industries, Inc.)*, the United States Bankruptcy Court for the Western District of Texas court analyzed the subjective OCB defense by a defendant whose ownership, and course of dealing, had changed prior to the preference period. Sterry and the defendant had a business relationship for some time prior to Sterry's bankruptcy filing. Up until six months before Sterry's bankruptcy, each invoice was on "Net 30" terms. Sterry would generally mail a check to the defendant but sometimes a representative of the defendant picked up the check.

Then, about six months prior to Sterry's bankruptcy filing, the defendant's business was sold to a new owner. From then on, the invoices stated that payment was "Due Upon Receipt," but witnesses testified that payments were really still due within 30 days. Also, the defendant's representative began picking up each check.

The bankruptcy court recognized that these changes altered the course of business between the parties, when compared to their course of dealings before the company was sold. Indeed, prior to the defendant's change in ownership, with few exceptions, Sterry had made payments between 53 and 112 days after the invoice date. After the ownership change, during the three months prior to the preference period, Sterry began paying faster, making timely payments (i.e. within 30 days) to the defendant.

Although Sterry and the new owners had only a three-month relationship with the defendant prior to the preference period, the court found that period was the relevant baseline to compare to the preference period because "with that [ownership] change came an agreed change in the business relationship between the two entities . . ." The court held that the subjective OCB defense protected the payments during the preference period because the timing and manner of payment (picking up the checks in person within 30 days) between Sterry and the defendant during the three months prior to the preference period was substantially the same as during the preference period. The court rejected the trustee's argument that the change on the invoices to read "Due Upon Receipt" instead of "Net 30" took the payments out of the ordinary course because witnesses had testified that the parties' payment terms remained the same—invoices were due within 30 days. The court also found that the defendant's practice of having a representative pick up the checks was not a coercive practice that took the payments out of the ordinary course of business because that practice began with the ownership change three months prior to the preference period and continued through the preference period. More tellingly for the court, the defendant did not act in a coercive manner where collections had actually slowed down slightly during the preference period (though defendant's invoices were still paid within 30 days).

The court was quite liberal in applying the subjective OCB defense to these facts. Another court might have reached the opposite conclusion and refused to apply the defense.

B. The Objective Element of the Ordinary Course of Business Defense

Even where a creditor cannot satisfy the subjective part of the OCB defense to shield a transfer from preference risk, the creditor would still be protected by satisfying the objective prong of the defense. A creditor seeking to invoke the protection of the objective OCB defense must prove that the payment or other transfer was made according to "ordinary business terms." The Bankruptcy Code does not define the phrase "ordinary business terms". The courts have determined that a creditor satisfies this requirement by proving that the transfer was consistent with payments made in the creditor's industry, the debtor's industry or some combination of both industries.

After determining the proper industry, creditors have relied upon numerous sources of data to establish a baseline against which transfers should be measured when determining if they were made according to "ordinary business terms." The sources of data include, among others, statistics from the Credit Research Foundation ("CRF"), Standard & Poors (Capital IQ) ("Capital IQ"), Dun & Bradstreet ("D&B"), the Risk Management Association ("RMA"), CreditRiskMonitor ("CRM"), and BizMiner. These sources aggregate data reported by companies in numerous industries during specific time periods, including data concerning the

timing of the collection of receivables – oftentimes referred to as days sales outstanding ("DSO"). In addition, creditors have sought to prove ordinary business terms with varying degrees of success by relying on testimony from individuals with significant experience in the applicable industry.

Whose Industry Should be Relied Upon to Prove Ordinary Business Terms?

There have not been many published decisions addressing the industry a creditor can rely on in attempting to prove the alleged preference payments were made according to ordinary business terms. Nonetheless, this issue has been consistently raised by both plaintiffs and defendants over the last few years and has introduced another layer of complexity into determining the applicability of the objective OCB defense.

The United States Sixth Circuit Court of Appeals, in *First Federal of Michigan v. Barrow*, was one of the first Courts of Appeals to address this question. The court held that the ordinary business terms analysis was based on the debtor's industry. A few years later, the Sixth Circuit reiterated this view in *Logan v. Basic Distribution Co. (In re Fred Hawes Organization, Inc.)*, rejecting the argument that a creditor's interactions with its own customers could be relied upon in proving ordinary business terms. Instead, relying in part on *First Federal*, the court considered the debtor's industry as a whole. The Bankruptcy Appellate Panel of the Eighth Circuit in *Shodeen v. Airline Software, Inc. (In re Accessair, Inc.)* also held that only the debtor's industry was relevant in determining ordinary business terms.

By contrast, the Seventh Circuit, in the seminal decision addressing the meaning of "ordinary business terms", *In re Tolona Pizza Products Co.*, held that the courts should focus on the creditor's industry. However, the court recognized the difficulties in identifying the industry, as follows:

> Not only is it difficult to identify the industry whose norm shall govern (is it, here, the sale of sausages to makers of pizza? The sale of sausages to anyone? The sale of anything to makers of pizza?), but there can be great variance in billing practices within an industry. Apparently there is in this industry, whatever exactly "this industry" is; for while it is plain that neither [creditor] nor its competitors enforce payment within seven days, it is unclear that there is a standard outer limit of forbearance. …. The law should not push businessmen to agree upon a single set of billing practices; antitrust objections to one side, the relevant business and financial considerations vary widely among firms on both the buying and the selling side of the market.

Accordingly, the Court in *Tolona Pizza* held:

> "[O]rdinary business terms" refers to the range of terms that encompasses the practices in which firms similar in some general way to the creditor in question engage, and that only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope of subsection C. … There is no single set of terms on which the members of the industry have coalesced; instead there is a broad range and the district judge plausibly situated the dealings between [creditor] and [debtor] within it."

Relying on *Tolona Pizza*, the United States Court of Appeals for the Third Circuit, in *Fiber Lite Corp. v Molded Acoustical Products, Inc. (In re Molded Acoustical Products, Inc.)* also held that "ordinary business terms" should be analyzed with reference to the creditor's industry.[2] The Third Circuit used the same description of "ordinary business terms" that the court used in *Tolona Pizza* but added that the longer the creditor's pre-bankruptcy relationship with the debtor, the more the creditor could vary its credit terms from the industry norm and yet still satisfy the objective OCB defense. Likewise, the Fourth Circuit in *Advo-System, Inc. v. Maxway Corp*. held that "ordinary business terms" refers to the creditor's industry.

The Fifth Circuit in *Gulf City Seafoods, Inc. v. Ludwig Shrimp Co. (In re Gulf City Seafoods, Inc.)*, took a slightly different approach and held that a combination of the debtor's and creditor's industries should be considered in proving ordinary business terms. The Fifth Circuit observed:

> Defining the industry whose standard should be used for comparison is not always a simple task…. In our view, for an industry standard to be useful as a rough benchmark, the creditor should provide evidence of credit arrangements of other debtors and creditors in a similar market, preferably both geographic and product. We think that the industry benchmark inquiry is best illustrated by application: In this case, [creditor] might provide evidence, to the extent that it is reasonably available, of credit practices between suppliers to whom [debtor] might reasonably turn for its seafood supply and firms with whom [debtor] competes for consumers, from which a bankruptcy judge can determine whether there is some basis to find that the [creditor-debtor] arrangement is not a virtual stranger in the industry.

More recently, the United States Bankruptcy Court for the Eastern District of North Carolina, in *Hutson v. Branch Banking & Trust Company (In re National Gas Distributors, LLC)*, articulated a more stringent standard for satisfying the objective prong of the OCB defense. The court held that a creditor seeking to prove the objective OCB defense must show that the transfers in question conformed with the ordinary business terms of both the debtor's and creditor's industries, and to "general business standards that are common to all business transactions in all industries."

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[2] Relying on the Third Circuit's decision in *Molded Acoustical*, the Bankruptcy Court for the District of Delaware in *AFA Investment Inc.* also recently held that the creditor's industry is the appropriate industry for proving ordinary business terms.

Do "Ordinary Business Terms" Include Only Payment Terms or Other Creditor Conduct?

Another issue that has recently been raised is whether "ordinary business terms" refer to only payment terms, or also encompass the entirety of a creditor's collection practices, including terms changes, pressure, shipping holds, threats or other similar conduct. While it is uncontroverted that pressure in collecting a creditor's claim can negate the applicability of the subjective prong of the OCB defense, it is unsettled, whether creditor pressure has the same negative impact on the applicability of the objective OCB defense.

There is nothing in the text of the Section 547(c) objective OCB defense that limits the "industry" test to a creditor's course of dealing with the debtor. Plaintiffs have argued that "ordinary business terms" encompasses all aspects of a vendor's collection practices. According to this argument, creditors should not be rewarded for the pressure they have exerted in collecting their claims just because the payments happened to have been made within the relevant industry OCB range.

There is limited case law addressing this issue. In *Simon v. Gerdau MacSteel, Inc. (In re American Camshaft Specialties, Inc.)*, the United States Bankruptcy Court for the Eastern District of Michigan held that the alleged preferential transfer at issue satisfied the subjective OCB defense despite the fact that there was a change in the method of payment (check to wire), the debtor's line of credit was reduced, and the defendant refused to ship product. In addressing the objective OCB prong, the court also noted that the applicability of the objective OCB defense is not affected by a creditor pressuring the debtor into making the payments by wire transfer.

Similarly, the United States Bankruptcy Court for the Southern District of New York in *Pereira v. United Parcel Service of America, Inc. a/k/a UPS, et al. (In re Waterford Wedgwood, USA, Inc.)* held that a significant deviation in the average days-to-pay during the pre-preference period did not impact a creditor's ability to invoke the objective OCB defense. United Parcel Service of America Inc. ("UPS") had provided shipping and other related services to the Waterford Wedgwood USA, Inc. and Royal Doulton USA, Inc. (collectively, the "Waterford Debtors"). The Waterford Debtors consistently paid UPS's invoices later than the "net 32 day" payment terms both prior to and during the preference period.

The plaintiff, a trustee appointed to wind down the Waterford Debtors' estates, argued that a deviation from the parties' pre-preference payment history precluded UPS from asserting the objective OCB defense. The plaintiff identified three distinct periods, beginning six months before the Waterford Debtors' bankruptcy filings, and observed that the average days-to-pay in the second period (72 days) was significantly higher than the average days-to-pay in the first and third periods (49 and 44 days, respectively). The plaintiff then argued that this discrepancy between the periods is evidence that the Waterford Debtors had accelerated payments to UPS and, therefore, the payments could not be shielded by the objective prong of the OCB defense.

The court rejected the plaintiff's argument that the deviation from the parties' past practices precluded UPS from asserting an objective OCB defense because the plaintiff was conflating the objective and subjective elements. The *Waterford Wedgwood*, court relying on an earlier Second Circuit decision, *Lawson v. Ford Motor Co. (In re Roblin Indus., Inc.)*, concluded that the

historical experience between the Debtor and UPS is irrelevant to the applicability of the objective element of the OCB defense because its focus should be on the practices in the relevant industry.

On the other hand, the *National Gas* court took a more fact-specific approach to the ordinary business terms defense in holding that the objective OCB defense did not protect the alleged preference payments. The court noted that the objective part of the OCB defense requires an examination of more than just the standards of the creditor's industry. The court considered the industry standards of both the creditor and the debtor, as well as the general business standards that are common to all business transactions in all industries in determining whether a transfer satisfies the objective OCB defense. Although the defendant submitted an affidavit stating that the transfers at issue were made in a manner typical of the banking industry, the court concluded that the transfers were non-ordinary because the debtor's conduct did not conform to the standards of the debtor's industry or with general sound business practices. Despite the lack of unusual collection activities by the defendant, the court determined that the debtor was in financial distress when the debtor made the alleged preference payments to the defendant and was trying to pay off those debts for which the debtor's owners had personal liability.

How do Courts Analyze Whether a Transfer is Made Pursuant to "Ordinary Business Terms"?

In *Waterford Wedgwood*, the court applied the trustee's proposed objective OCB industry range of one standard deviation off of the shipping industry mean of 42 days and held that payments made 30 to 54 days (+/- 12 days from the mean) after invoice date were made within ordinary industry terms. The court rejected as too broad UPS' objective ordinary course analysis that had relied on CRM DSO data in the shipping industry from 2008 and 2009, and then eliminated the top 5% and bottom 5% of the DSO for both years. This resulted in industry OCB ranges of 14 to 70 days-to-pay in 2008 and 16 to 72 days-to-pay in 2009.

While the *Waterford Wedgewood* court determined that an objective OCB range covering 90% of the reporting companies' DSO was too broad, the United States Bankruptcy Court for the District of Delaware, in *HLI Creditor Trust v. Metal Technologies Woodstock Corporation f/k/a Metal Technologies Woodstock, Ltd. (In re Hayes Lemmerz International, Inc.)*, held that relying on an objective OCB range covering only 50% of the surveyed companies' receivables collection information was too narrow. In *Hayes Lemmerz*, the defendant, Metal Technologies, relied on expert testimony concerning the timing of the collection of receivables. Metal Technologies' expert relied on industry data from D&B (Standard Industrial Classification Code 3321, the gray and ductile iron foundry category) ("SIC 3321"). The expert also relied on industry data from two reports compiled by Capital IQ. One report covered 203 automotive component companies and the other report covered 66 companies that produced a variety of different automotive parts. With respect to the report covering 203 companies, Metal Technologies' expert divided the payment data from the 52.4 day median days-to-pay into upper and lower quartiles, such that the OCB range of the middle 50% was 41.1 to 64.6 days-to-pay. The expert also reviewed different sub-groupings of the data, which produced the middle 60% ranging from 39 to 67.6 days and the middle 75% from 30.4 to 79 days-to-pay. With respect to companies in the report covering 66 companies, the middle 50%, 60% and 75% ranged between 45.4 to 67.6 days-to-pay, 42.8 to

69.7 days and 40.6 to 84.5 days-to-pay, respectively. This compared to payments by the debtors to Metal Technologies averaging 63.8 days during the preference period. The expert also testified that Metal Technologies was a tier 2 supplier while the debtors were tier 1 suppliers, and that the appropriate industry was the broad automotive supply industry. The expert also testified that the payment terms utilized by the Metal Technologies, "net 60, prox. weekly", were consistent with industry practices and the alleged preference payments were ordinary in the industry.

To the contrary, plaintiff's expert only relied on the SIC 3321 D&B data and apparently disregarded the Capital IQ data. This data reflected collection periods ranging between 40 and 55 days with a 48 day mean. The expert also testified that transfers paying invoices more than 65 days after invoice date were not paid according to "ordinary industry terms." By only relying on data from SIC 3321, the plaintiff's expert tried to pigeonhole Metal Technologies into a "very narrow industry". In support of the narrow industry, the expert also testified that the SIC 3321 data was more representative of Metal Technologies' industry than the Capital IQ data provided by Metal Technologies. The Capital IQ data included both tier 1 and tier 2 companies, many of which, unlike Metal Technologies, were large and publically held.

The court held in favor of Metal Technologies and determined that all of the alleged preference payments were shielded from preference risk by the objective OCB defense. The court relied on the fact that payments of invoices from 50 to 75 days after invoice date fell within the range of payments in the debtor's industry and rejected the data relied upon by plaintiff's expert as too narrow and strict under the *Molded Acoustical* and *Tolona Pizza* tests. The approach permitted virtually no deviation from the collection results of the middle 50% of SIC 3321 surveyed companies. In addition, the court determined that plaintiff's expert did not provide any evidence as to whether the middle 50% of the SIC 3321 companies were actually comparable to Metal Technologies.

The *AFA Investment* court also recently addressed conflicting arguments over the appropriate use of industry data when applying the objective prong of the OCB defense. AFA Investment Inc. and certain affiliates (collectively, the "AFA Debtors") had a relationship with the defendant, Smith & Sons Meat Packing Company ("Smith") that started several years prior to the preference period. In 2012, during the preference period, Smith had received payments totaling $2,273,500.00 from the AFA Debtors. Smith's preference exposure was reduced to $215,664.61 (the "Remaining Preference Claim") after the application of the new value defense. Smith invoked the subjective (discussed earlier) and objective parts of the OCB defense as a full defense to the Remaining Preference Claim.

Smith's expert concluded that the invoices paid related to the Remaining Preference Claim, which payments ranged from 27 to 59 days after invoice date, satisfied the objective part of the OCB defense. The expert relied on two categories of data from BizMiner, a service which provides information for various industries. The first did not distinguish between the actual annual sales of the companies that were surveyed, while the second only included companies with comparable annual sales to Smith.

The BizMiner data showed that the average DSO in Smith's industry (notwithstanding annual sales amount) was 51.18 days in 2010, 46.25 days in 2011 and 22.25 days in 2012. Smith's expert also relied upon BizMiner data that only included companies with comparable annual sales to Smith and observed that the DSO for 2010, 2011 and 2012 was 41.96 days, 43.16 days and 17.46 days, respectively. The expert attributed the improvement in DSO from 2010 through 2012 to the improvement in the timing of collections in Smith's industry. The expert also reviewed data from RMA. The RMA data was comprised of information pulled from financial statements between April 1, 2010 and March 31, 2011, and included a median DSO of 27 days, with most firms reporting a DSO of between 17 and 30 days.

The AFA Debtors' expert, relying on the same sources of data as Smith's expert, concluded that the objective OCB defense did not apply to shield Smith from preference liability. The AFA Debtors' expert rejected Smith's expert's reliance on industry data from 2010 and 2011 because the preference payments were all made in 2012 when payments in Smith's industry were considerably faster.

The court rejected the applicability of the objective OCB defense. The court criticized Smith's expert's reliance on BizMiner industry data (not broken out by annual sales) for Smith's industry from 2010, a period where industrywide DSO (45 days) was more than double that of 2012 (22 days). The court also questioned Smith's expert's reliance on BizMiner data broken out by annual sales from 2010 where the average DSO in 2012 for companies in Smith's same sales class was even shorter, averaging just 17.46 days. It was clear to the court that in 2012 industry members that were surveyed were not facing similar conditions as the members surveyed in the 2010 BizMiner report.

Similarly, the court did not understand why Smith's expert relied on the RMA report, which covered only April 1, 2010 through March 30, 2011, and not 2012. Significantly, there was an available RMA report (not relied upon by Smith's expert) that covered the preference period and included an average DSO of 20 days, which supported the AFA Debtors' position that the objective OCB defense did not apply.

II. THE NEW VALUE DEFENSE

The new value defense, contained in section 547(c)(4) of the Bankruptcy Code, states as follows:

> The trustee [or debtor-in-possession] may not avoid under [section 547(b)] a transfer [as a preference] –
>
> > . . . 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.

A creditor satisfies the new value defense to reduce its preference liability by proving that the creditor had sold goods or provided services to the debtor on credit terms after an alleged preference. Bottom line: after applying this defense, the debtor's unsecured creditors should be no worse off by the alleged preference payment to the extent of the new value the creditor subsequently provided to the debtor. This defense, like other preference defenses, encourages creditors to continue selling and extending credit to troubled companies.

Must New Value Remain Unpaid?

New value that remains unpaid on the bankruptcy filing date always reduces preference liability. However, courts have reached conflicting holdings on whether new value that was ultimately paid during the preference period should reduce preference liability.

Those courts that have allowed paid new value to reduce preference liability have relied on the language of section 547(a)(4)—a transfer may not be avoided as a preference to the extent that after such transfer, such creditor gave new value to the debtor "on account of which new value the debtor did not make an otherwise unavoidable transfer to…such creditor." Section 547(c)(4) clearly states that paid new value must be allowed where the payment for the new value is avoidable as a preference. If, on the other hand, the payment for the new value is protected by another preference defense (such as the OCB or other defenses), the paid invoices cannot be counted as part of the creditor's new value defense. These courts have also noted that the potential preference recovery on account of the paid new value replenishes the bankruptcy estate.

Those courts that have not allowed paid new value as part of a creditor's new value defense have reasoned that there is no benefit to the estate where the new value was paid. Creditors asserting paid new value as part of their new value defense would receive a double benefit because they received payment for the new value and then were also able to use the new value to reduce their preference liability.

In *Miller v. JNJ Logistics LLC (In re Proliance Int'l, Inc.)*, the United States Bankruptcy Court for the District of Delaware affirmed the applicability of the paid new value defense. This was the third decision in a row by a bankruptcy judge in the Third Circuit, which includes the Delaware Bankruptcy Court, that has allowed paid new value. In *Proliance* the trustee sued the defendant, JNJ Logistics LLC ("JNJ") for recovery of a preference claim that included 12 payments totaling $548,035.66. JNJ had an undisputed unpaid new value defense of approximately $49,368.28 based on unpaid invoices owing on the filing date. JNJ also asserted a paid new value defense in the amount of $222,045.11 based on invoices that were paid during the preference period, which the trustee contested.

The *Proliance* court held that JNJ could assert both paid and unpaid new value as part of its new value defense, reducing JNJ's preference exposure by $271,411.38. Of note, while the court allowed the paid new value because the transfers that paid the new value were "otherwise avoidable" as preferential transfers, the court did not condition its holding on the trustee's recovery of the payments for the new value. This suggests a potential expansion of the paid new value defense to allow new value that was paid by a transfer protected by another preference defense.

New Value that is Paid or Returned, Post-Petition Pursuant to Court Order

The paid new value defense has been further complicated where the new value was paid for or the creditor otherwise recovered the new value after the bankruptcy filing. This occurs where (1) a creditor received payment of the new value post-petition pursuant to court order, such as a critical vendor order, or (2) the creditor reclaimed the goods that were part of its new value defense, or (3) the debtor returned the new value to the creditor. The few courts that have addressed this issue have reached conflicting holdings over whether a creditor's new value defense would be reduced by the debtor's post-petition repayment or return of new value pursuant to a court order.

When making this determination, the courts have had to consider the relevant point in time for determining whether new value is paid or remains unpaid. Some courts have made this determination as of the bankruptcy filing date, meaning that new value will be treated as unpaid if the goods or services were not paid for or returned by the bankruptcy filing date (regardless of what happened after the filing). Other courts have held that new value ultimately paid or returned after the bankruptcy filing did not qualify as a preference defense because it would amount to a double-dip. Put another way, where the payment of the new value is itself not avoidable as a preference, the new value that it paid cannot then be counted.

Two more recent cases have addressed this issue. The Bankruptcy Court for the District of New Mexico, in *Gonzales v. Food Marketing Group (In re Furr's Supermarkets, Inc.)*, held that new value could not be used to offset preference liability where the new value was paid pursuant to a court order after the bankruptcy filing. The Third Circuit, in *Friedman's Liquidating Trust v. Roth Staffing Companies LP (In re Friedman's Inc)*, reached the opposite conclusion, ruling that a creditor could assert new value paid after the bankruptcy filing pursuant to a court order to reduce preference liability.

In *In re Furr's Supermarkets, Inc.*, the New Mexico Bankruptcy Court held that new value paid after the bankruptcy filing could not be invoked as part of the creditor's new value defense because the bankruptcy filing date is not relevant for computing the new value defense. *Furr's* involved the debtors' payment of $180,000 of employees' insurance premiums to Sun Life Insurance during the preference period. As of the bankruptcy filing date, Sun was owed $125,000 on account of insurance that was provided after Sun had received the $180,000 in alleged preferences. After the bankruptcy filing, the debtor paid Sun $60,000 of the unpaid premiums pursuant to bankruptcy court orders. Furr's Chapter 7 trustee sued Sun for the return of the $180,000 Sun had received during the 90-day preference period. Sun claimed that it was entitled to a new value offset for the entire $125,000, reducing its preference liability to $55,000. The trustee countered that the $125,000 of new value that Sun had provided must be reduced by the $60,000 Sun had received after the bankruptcy filing pursuant to the court orders approving the debtor's post-petition payment of pre-petition employee benefits, allowing Sun to claim only $65,000 of new value, and only reducing its preference exposure to $115,000.

The bankruptcy court sided with the trustee and ruled that the court must determine whether the new value had ultimately been paid, regardless of whether it was paid before or after the bankruptcy filing. The debtor's payment of the new value, whether before or after the filing, depleted the estate and diminished the return to creditors. It made no economic sense to count such new value just because it was paid after the bankruptcy filing.

By contrast, in *In re Friedman's Inc.*, the United States Court of Appeals for the Third Circuit, held that new value paid after the bankruptcy filing did not negate the applicability of the new value defense. In *Friedman's*, the debtor had made payments totaling $82,000 to Roth Staffing for personnel. Following these preferential payments, but before the bankruptcy was filed, Roth Staffing had provided additional services valued at $100,000 to the debtor. These services remained unpaid as of the bankruptcy filing date. After filing bankruptcy, the debtor moved in the bankruptcy court for authority to pay its employees' and independent contractors' pre-petition wages, compensation, and related benefits in order to avoid an employee exodus. The bankruptcy court granted the debtor's motion by entry of a "wage order," akin to a critical vendor order. Pursuant to the wage order, after the bankruptcy filing, the debtor paid $72,000 to Roth Staffing on account of pre-petition staffing services. Thereafter, the liquidating trustee, who at the time of the lawsuit had stepped into the debtor's shoes, sued Roth Staffing to avoid and recover the pre-petition payments as preferences. The amount of Roth Staffing's preference exposure depended on whether the new value it had provided should have been reduced by the $72,000 of payments Roth Staffing had received pursuant to the wage order after the bankruptcy filing. If the new value was not reduced, Roth Staffing would have no preference liability because the preference payment of $82,000 was less than the $100,000 in services Roth Staffing had provided after receiving the preference payment. Roth Staffing's preference liability would have been $54,000 if the new value was reduced by the $72,000 of payments Roth Staffing had received after the bankruptcy filing because the $100,000 of services Roth had provided would have been reduced to $28,000.

The Third Circuit court held, contrary to the ruling of New Mexico Bankruptcy Court in *Furr's*, that preference exposure and the computation of new value should be determined on the bankruptcy filing date, regardless of whether that new value was paid by the wage order. The *Friedman's* court disagreed with the holding of the *Furr's* court that the debtor had depleted the estate and diminished the return to creditors by paying for the new value post-petition (and, therefore, the defendant should not be entitled to then count the new value). The *Friedman's* court noted that *Furr's* and the other courts that had focused on "replenishment" and "equality" had lost sight of the real bankruptcy policy objectives, which is for creditors to continue to provide goods and services to a debtor during the debtor's decline and to deter a race to the courthouse.

Post-Petition New Value and Set-Off

The courts have also grappled with whether a creditor can include unpaid post-petition shipments or services as part of its new value defense. A majority of the courts do not allow post-petition new value. Both the Delaware bankruptcy and district courts in *Burtch v. Prudential Real Estate and Relocation Services, Inc., et al. (In re AE Liquidation, Inc.)*, recently held that only new value extended prior to a bankruptcy filing should reduce preference liability. The district court relied on the Third Circuit's holding in *Friedman's* (discussed above) that the bankruptcy filing date is the cutoff date for determining new value.

The United States Bankruptcy Court in Delaware, *In re Quantum Foods, LLC*, recently allowed a preference defendant to assert its setoff rights with respect to its allowed unpaid post-petition administrative priority claim as a counterclaim to reduce the defendant's preference liability. The court noted that it was not relying on a post-petition new value defense, accepting the generally accepted rule that new value must be provided prior to the bankruptcy filing. The court also found that the defendant had satisfied the mutuality requirement for setoff where both the preference claim (which could only have been brought after the bankruptcy filing) and the creditor's administrative claim were post-petition claims.

Conclusion

While a vigilant debtor or trustee will seek to invalidate a creditor's OCB or new value defenses, a creditor should arm itself to support these defenses. That is the key to providing a creditor with increased leverage to resolve its preference exposure on the most favorable terms.

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Mediation Matters

By Leslie A. Berkoff and Nicole Case

The Multiple Roles of a Mediator

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Being an effective mediator requires an individual to wear many hats during the process. They need to serve as a guide, facilitator, listener, confidant, empath, evaluator, educator, problem-solver, flexible strategist and expert. At times, some of these hats are worn simultaneously, but they are often exchanged/interchanged throughout the process; thus, an effective mediator knows when to put them on and take them off. Parties to a mediation, having selected a mediator to assist in resolving their dispute, are entrusting the mediator to know how to change hats/roles, and manage the parties and the process, then guide all of this to a resolution.

The Guide

At the outset, the mediator is a guide to, and an organizer of, the mediation process and should be initially connecting with counsel for the parties to the following: (1) advising how he/she intends to coordinate and manage the mediation process; (2) understanding the parties' expectations for the mediation and a potential outcome; and (3) providing insight and instruction as to how counsel should approach the process and to assist counsel in subsequently guiding their clients. In this regard, the mediator should be establishing a schedule and setting deadlines, advising what information and submissions he/she requires, and asking for input from the parties on who should attend the mediation and whether a joint session at least at the outset would be a value add or a value detractor.

Further, the mediator should be reminding the parties that all submissions that are prepared and exchanged should be settlement-focused, and that these are not litigation pleadings and should be crafted in a far different manner than what would be submitted to a court in preparation for argument and/or ruling.

The Facilitator

Throughout the process, the mediator must facilitate the exchange of communications between the parties and ensure that it is being handled effectively. In this regard, he/she may even need to repackage and/or interpret the information and positions being advanced and exchanged to ensure that the parties are not talking past each other and/or being too argumentative or aggressive as to prevent a breakdown of communication and the process. At times, he/she may choose to withhold certain positions and/or information for a period of time to avoid the process imploding based on hastily advanced positions or statements made in anger or frustration.

In addition, the mediator may need to encourage the parties to be more forthright at times to advance the process and facilitate clarity. It is important to keep in mind when listening to a mediator that he/she is the only person who knows what is going on in both rooms. The suggestion that more information could be helpful to resolution should be seriously reviewed and considered by the parties, as the mediator often knows what will move the proverbial needle.

The Listener

At all times, the mediator must be a good listener, and at the outset of the mediation, he/she must still gather as much information as possible to adequately understand the dispute, the parties' positions and their willingness to come to a resolution.

Parties at this stage may express anger and resentment toward the other side, or the fact that they are confronted with claims and a litigation that they did not bargain for or anticipate. As a neutral listener, the mediator has a unique opportunity to cut through the heated emotions underlying a dispute and focus on the facts supporting and elements underlying the legal causes of action, affirmative defenses and/or counterclaims, thus setting the stage for a successful resolution process.

The Confidant

After establishing his/her role as a neutral listener, the mediator is hopefully working toward gaining the parties' trust, as trust in the mediator is a key element to advancing any resolution. As a result, once trust has been garnered, the parties may feel comfortable sharing information with the mediator that they would otherwise not feel comfortable sharing with the opposing side. Further, being new to the dispute, the mediator is someone a party can turn to and vent.

While many mediators are not or were not judges, they stand in a place of respect and are imbued with a bit more formal authority — even though they are not decision-makers. This can be helpful to a party who simply needs to have someone else hear them and provide guidance and advice. If you can establish trust as a mediator with the party, you are on your way to hopefully having them hear you differently than — but not in place of — their own lawyer and as providing another perspective. At times, lawyers may even turn to the mediator to make headway with a client who needs that third-party perspective to start on a path toward resolution.

The Empath

A good mediator has emotional intelligence, but it is not enough for him/her to simply understand the facts and law; he/she must be able to read the parties and have good interpersonal skills. Having the right kind of personality is a key part of a successful process. The mediator needs to be able to get along with the parties, build trust and foster confidence, as without these building blocks, reaching a resolution is very difficult.

The mediator needs to know how to be patient through this process, as parties may move at their own pace in each case to get to resolution. Every mediation has its own pace and speed limit, and recognizing that is truly important. It might also be necessary to address the facts and claims, tackle various issues in stages, and work through resolution. A good mediator also recognizes that each case is different than a prior case and does not have just one set path for his/her process in attempting to resolve disputes.

At times, getting a sense of the players from the outset of a matter (early-stage process) can be truly helpful. Advise counsel for the parties to help guide the mediator on this. Who can or should be in a room? Where does the party in question sit in the hierarchy of the company? How much authority does the party have to get to a decision? What else does the party have to cope with in terms of ensuring that a result can be achieved? In addition, are there external factors impacting or impeding resolution of which the mediator needs to be aware?

The Evaluator

Upon receipt of the submissions from the parties, the mediator should start engaging with the parties to evaluate the information provided and speak to them separately concerning the information and issues contained in the statements. At this juncture, he/she should be flagging concerns and key points with the parties and may even ask the parties to consider sharing informal information and discovery (depending on the procedural posture of the matter) to assist the parties in evaluating claims and defenses.

In this regard, certain mediations are conducted at an early stage (pre-discovery), and as such, the request for an exchange of some information can be useful to the parties in making decisions on the resolution of claims and defenses, as well as analyzing the strength or weakness of the same. This applies equally to allowing the mediator to obtain access to this information to assist in evaluating the same and provide guidance to the parties.

The Educator

At no time can/should a mediator give legal advice to the parties, but he/she should educate the parties on potential claims that they may face. To be clear, this is different than being an evaluator. A mediator should never advise a party to advance a claim or defense, or take a position that they have not independently thought of on their own, as that is not a mediator's role. However, he/she can (and should) identify for an opposing party a potential claim or defense that the other side has not yet thought of, but could in terms of risk assessment. As long as it is being identified for the party who would be adverse to this position (and not the one to raise it), this is part of the mediator's job of seeing the entire picture.

Noting that someone may have a defense to a claim that has not yet been advanced, but with time and information-gathering could be advanced, is a good way to let a party see potential risk in a case that they otherwise thought was solid. It is part of the process to guide in the evaluation of a claim and consider resolution at a certain stage of the process; the risk analysis is what is being shared, and the potential for additional claims or defenses being raised down the road are considerations for why a party should reflect on resolving a case at this point in time.

The Problem-Solver

The mediator also must be a problem-solver who should be able to bring creativity into the process and work toward a resolution by hearing what the parties want and the issues (facts and law included) at hand, and, upon evaluation, must work to find a way to solve for X. Some of the most successful mediations often involve trading "ice in winter" (something of value to one side that has no or little value to the other), or finding a way to build a path toward resolution.

In the end, creativity and ingenuity can solve a problem/dispute in a way that a court never could, because courts are constrained (and appropriately so) to rule on the facts and law in very clearly defined ways. Utilizing mediation as a process is a way to build a resolution that works for the parties based on the unique facts at hand and the desires of the parties to the dispute.

The Flexible Strategist

A mediator must also be prepared to pivot and be adaptable to the parties, counsel and the needs of the case at hand. The notion that "one size does not fit all" applies across the board. A good mediator can discern when to change gears, modes and/or tactics, as each case is truly different and must be approached with that in mind.

Of course, a mediator then needs to have the ability to be persistent in trying to achieve a resolution. He/she must remember that they are not there to take sides, but rather to assist the parties in considering and evaluating their position, as well as the strengths and weaknesses of their case, and to encourage the parties to consider all aspects of a case: the risks, the upsides and anything in between.

The Expert

A mediator is often selected based not just on experience in the mediation process, but also his/her expertise in a particular area. In this role, he/she is there to provide an additional perspective. The mediator may have experience with a specific area of law or claims/defenses and, at times, even the underlying base facts (*i.e.*, multiple actions brought in the context of a bankruptcy mega-case), as well as a perspective on the nature/type of the dispute in question.

Further, the mediator may know or have experience with the players in the room, and any trust built in prior matters can be useful in getting a deal done. Most commonly, the parties often look to the mediator to provide a knowledgeable third-party view on the dispute, with an eye toward resolution, differently than a party's counsel can — almost like early neutral case evaluation.

Conclusion

A mediator often switches among many of these identified roles depending on the point in time, the case in question or even the nature of the parties. Knowing when and how to do this — all while not undermining or infringing in any way on the client's own relationship with their counsel, not tipping into confidential information gleaned from the other side, and not telegraphing anything more than necessary at that moment in the process — is not a simple feat. It is a skill set built over many years of practice.

In the end, mediation is a complex process that requires a deft hand and a lot of competing skill sets to be employed at the same time (or in tandem). It is not something that people can just jump into without training, and the best mediators have often been doing this for years and have honed their skill sets. It may seem like there is nothing to it, but that is simply not the case.

Each time there is a mediation, the mediator needs to not only be up to speed on the law and facts of the dispute in question, but carefully consider how he/she wants to "set the table" to try to position the parties for a successful resolution. In preparing, he/she must be aware of the many hats that must be worn, and will choose carefully — and for this, the mediator looks to the counsel in the case to help choose from the collection. abi

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Mediation Matters

By Leslie A. Berkoff, Candice L. Kline and Turner N. Falk

The Use of Mediation in Large Chapter 11 Cases: Useful, Voluntary and Mandatory (Part I)

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Bankruptcy is a world of balance, compromise and economics, and is often a perfect venue to foster and encourage the use of mediation in various stages of the reorganization process. Good bankruptcy lawyers are likewise skilled dealmakers who bring together diverse factions, achieve consensus, secure votes or buy-in, and emerge with a consensual plan or approach to a process.

Mediation is highly prevalent in chapter 11 practice. In a 1998 survey, only 9 percent of mediators reported that their chapter 11 mediations involved negotiating a confirmable plan.[1] In a 2009 survey, 81 percent of judges reported using mediation in their chapter 11 cases in some capacity.[2] Strikingly, 51 of 158 judges surveyed in 2009 reported that plan negotiation was the *most common* reason for mediation.[3] Several responding judges employed plan-related mediation, fueling an increase of at least 300 percent in plan-mediation use from 1998-2009.

Since 2009, mediation use has only grown. However, without personal familiarity with the cases, the prevalence of mediation is sometimes hard to track. Of the 15 large chapter 11 cases filed in the Southern District of Texas,[4] only two involved docketed mediation orders. (These docketed mediations show the diversity of issues being mediated.) Even in the same case, mediations may address traditional issues, such as claims-estimation,[5] and nontraditional mediation issues, such as franchisor consent to assignment.[6] Mediations might also include parties somewhat tangentially related to the disputes, such as the representatives of a class whose tax status might be affected by a plan.[7]

An analysis of mediation that begins with the docket will inevitably fall short, as mediation often takes place in informal ways, and plan negotiations may begin long before the formal filing even occurs. Thus, mediation (formal or informal) often starts before the petition has even been filed — an underappreciated part of plan negotiations.

This article is the first of a two-part series about the various stages where mediation occurs and has been useful in cases. Part II will address more traditional and well-covered uses of mediation and how mediation is raised by the parties, highlighting nuances and lesser-studied issues.

Pre-Filing Mediation: Prenegotiated Chapter 11 Plans

In prenegotiated chapter 11 cases, parties can begin negotiating a plan pre-petition, but the actual solicitation occurs post-petition. Before filing, the initial goal is to get a group of stakeholders on board with an agreement to facilitate a smooth transition into bankruptcy. This approach is also intended to encourage a more immediate exit from bankruptcy through a restructuring-support agreement (RSA), also called plan-support agreements.

1 Ralph Peeples, "The Uses of Mediation in Chapter 11 Cases," 17 *Am. Bankr. Inst. L. Rev.* 401, 406 (2009), *available at* abi.org/members/member-resources/law-review (unless otherwise specified, all links in this article were last visited on June 30, 2023).
2 *Id.* at 417.
3 *Id.* at 418.
4 The Southern District of Texas had 15 families of jointly administered cases with more than $100 million in liabilities since January 2020, as shown in a Lex Machina search performed on June 16, 2023.
5 Agreed Mediation Order for Estimation of Driver Claimant's Claims, *In re NPC Int'l Inc.*, Case No. 20-33353 (DRJ) (Bankr. S.D. Tex.), Docket No. 1113.
6 Agreed Mediation Order, *In re NPC Int'l Inc.*, Case No. 20-33353 (DRJ) (Bankr. S.D. Tex.) Docket No. 1195.
7 Response to Motion to Appoint Mediator, *In re GWG Holdings Inc.*, Case No. 22-90032 (MI) (Bankr. S.D. Tex.), Docket No. 1248.

Mediation is an option to get remaining key parties on board with an RSA-backed plan.

Parties may attempt to engage in negotiations on their own; after all, bankruptcy lawyers are deal-makers. However, depending on the number of constituents involved and divergent interests, a neutral without skin in the game could do better by bringing interests to the forefront. Sometimes, even the best professionals get entrenched in their client's position after months or years of advocacy and need the help of a third party to counterbalance their perspective. A mediator can help the parties reset and cross the final bridge to a negotiated solution.

Pre-filing negotiations are private-party mediations where no court order yet governs the mediation conduct and process.[8] First, the parties should ensure that they have a robust agreement on confidentiality and treatment in litigation when the case files.[9] Second, parties should consult applicable statutes and rules, both those governing the mediation agreement and those of the target bankruptcy court. For example, Delaware Bankruptcy Court Local Rule 9019-5(d) provides a detailed guide on what can be mediated, how costs are allocated and the extent of confidentiality over mediation communications. In contrast, the Local Rules for the U.S. Bankruptcy Court for the Southern District of Texas do not mention mediation or alternative dispute resolution.

Post-Filing Mediation: In It to Win It

Once a case has been filed, where debtors have partial buy-in to a process or a plan from a significant constituent group but still need more buy-in, they may immediately ask the bankruptcy court to appoint a mediator to help garner consensus. It is possible to deploy parallel tracks under an aggressive plan process if timelines are important to moving the case along. One critical advantage of mediation is that most mediators will address disputes quickly. This is true whether the mediator is a local judge sitting as a favor to another judge, or a panel mediator: They all recognize that bankruptcy moves quickly.

It is fairly common to face opposition to a fast-moving plan process. Where a debtor seeks a quick restructuring or sale, delay can be a friend to those who want a better deal. Parties may turn to a mediator to promote consensus among strong adverse factions. For example, this may include an unsecured creditors' committee that stridently opposes the plan or is holding out for significant dollars or specific pieces of the pie; a lender looking for something in confirmation; or other well-organized claimants. These headwinds could prove most challenging in mass tort cases.

To mitigate delay tactics, mediations with these factions often progress in parallel with major case events (*e.g.*, approval of a disclosure statement or plan confirmation). This way, despite the "hold up," the upcoming trial or potential rulings may keep the parties engaged in a substantive result in the mediation, thereby avoiding pushing the envelope too far. In LTL Management LLC's first bankruptcy, the court used parallel tracks by setting estimation hearings with mediation moving along at the same time.[10]

Some mediations may involve the court for briefing and trials teed up at the same time. However, the best economics seem to exist when mediation comes first to save on the estate costs and resources of all parties concerned. Even if mediation fails or is unsuccessful in that moment, all the work put into mediation statements, analysis and related pleadings might morph into briefings for the next stage of the litigation process. Thus, anyone who truly and properly prepares for mediation has not "wasted time." (An optimistic mediator would even say they have laid the groundwork for a later settlement). Merely the pressure of a pending trial, deposition or court ruling may force holdout constituencies to resolve matters.

Mallinckrodt: Mediation Wins the Day

Mallinckrodt's bankruptcy involved many mediations with varying dynamics. It is not the only recent chapter 11 case to emphasize mediation, but it serves as a good example. Pre-petition, the debtors negotiated an RSA with secured noteholders and certain governmental entities regarding opioid liability. On filing, private opioid claimants were not decisively onboard with the RSA, and neither were general unsecured creditors. Separate official committees were formed for opioid (OCC) and nonopioid unsecured creditors (UCC), and both expressed serious reservations about the initial proposed plan.

The OCC engaged in mediation with the debtors to address the amount that opioid creditors would be paid and how those funds would be divided among the different opioid constituencies: the federal government, states, individuals, companies and future claimants. This mediation resulted in a modest increase in funding for opioid trusts and an allocation of how that funding would be divided among the constituencies. The OCC later supported plan confirmation.[11]

The UCC engaged in mediation with a different starting posture: Many large claims were subject to the debtors' objections, and the plan only allocated approximately 8 percent of the distributions to UCCs. Mediating before Hon. **Christopher S. Sontchi** (ret.), the UCC obtained a 40 percent increase in funding for the eventual UCC liquidating trust, deferral of the claims objections not already adjudicated, and an allocation of the trust corpus among different types of nonopioid general unsecureds based on a complex debtor-by-debtor valuation waterfall. The UCC also supported the plan.[12]

The confirmed plan featured separate trusts for opioid creditors and nonopioid general unsecureds. The trust documents governing these entities also require mediation, within certain limits. For example, mediation could resolve disputes between different opioid creditors within defined constituency groups, without creditor-on-creditor violence in

8 For example, after dismissal of its first bankruptcy case, LTL used mediation to accomplish plan-support agreements that form the core of its second chapter 11 filing. *See* First-Day Declaration of John K. Kim, *In re LTL Mgmt. LLC*, Case No. 23-12825 (MBK) (Bankr. D.N.J.), Docket No. 4 at ¶¶ 72-74. Here, although private, the parties leveraged the mediation orders from the first bankruptcy case.

9 Leslie A. Berkoff & John G. Loughnane, "Limitations on Confidentiality," XLI *ABI Journal* 9, 26-27, 47, September 2022, *available at* abi.org/abi-journal.

10 Order Appointing Estimation Expert, *In re LTL Mgmt.*, Case No. 21-30589 (MBK) (Bankr. D.N.J.), Docket No. 2881.

11 Declaration of Michael Atkinson in Support of Confirmation, *In re Mallinckrodt plc*, Case No. 20-12522 (JTD) (Bankr. D. Del.), Docket No. 5319.

12 Declaration of Mark Greenberg in Support of UCC Plan Settlement, *In re Mallinckrodt plc*, Case No. 20-12522 (JTD) (Bankr. D. Del.), Docket No. 4644.

a claims-objection process.[13] Mediation within the separate general unsecured claims trust is a mandatory first step for certain general unsecured constituencies for any dispute over the liquidation of claims.[14]

In *Mallinckrodt*, this series of mediations produced a confirmed plan with the consent of most major parties, reducing the complexity of the confirmation hearing and obviating most preconfirmation claims objections. After confirmation, the plan and trusts then rely on mediation to preserve the trust assets against depletion via administrative expenses.[15]

Post-Confirmation: Mediation Stays the Course

Post-confirmation mediation may address how funds are distributed to various constituents. Mediation is often deployed to address the limited funds that a debtor must pay creditors. In a liquidating case, this is a pot of diminishing returns, as there is only so much money, as opposed to a reorganizing entity with the ability to potentially add value through ongoing operations. The more parties fight, the less money there is to pay to creditors. Some liquidation trusts use a dwindling pot to corral disputes into mediation. The *Mallinckrodt* general unsecured claims trust required a party to move before the bankruptcy court if it wished to escape mandatory mediation.[16] This imposed a meaningful cost even on an attempt to avoid a foray into the mediation process.

In liquidations, mediation is an economic tool to efficiently resolve claims vs. litigation. If used correctly, mediation is a good way to reduce the costs associated with claim allocations. A properly structured trust run by a conscientious trustee will seek to allocate the limited pool of funds to valid claimants, obtain a global settlement, and make a quicker disbursement without the necessity of many claims objections.

This issue becomes complicated when dealing with § 502(h) claim waivers or claim waivers in general.[17] Splitting trusts into different buckets can make negotiating resolutions difficult. Good trust design should anticipate subsequent mediation and negotiations around claims disputes and allocations. For example, if one trust governs creditor distributions and another trust governs claim objections, then claim waivers are not really relevant when negotiating resolutions to adversary proceedings (*i.e.*, trading claim waivers to reduce payment of funds back to the estate).

Adversary Proceedings: Mediation and Economics

Even outside bankruptcy, most courts have recognized that burgeoning litigation costs cry out for mediation. Many parties and courts turn to alternative dispute resolution to minimize litigation costs, streamline processes and expedite resolution. Given the comparatively short timelines used by bankruptcy courts and restructuring professionals, mediation is often at the top of a solution pile — if used effectively and appropriately to control costs and timelines.

Not every commentator is convinced that mediation in the plan context is the shortest, fastest route to resolving mass tort claims, although many practitioners and bankruptcy courts believe that it is. This may be a gut call until more empirical evidence becomes available. Facially, mass tort bankruptcy cases have high price tags that are hard to compare with a realistic nonbankruptcy litigation approach.

To be clear, one size does not fit all. Matters must be litigated, and the individual in the black robe must decide the case. However, there are often other options available, including mediation, if the parties look past their war shields.

Conclusion

Mediation is a flexible and well-accepted tool used during every phase of the plan-formulation process, from pre-filing to post-confirmation and beyond. The efficacy of mediation is that it often works in parallel with main proceedings, focuses on specific parties and objections, and promotes consensus in a private or semi-private environment. Mediation is also enormously flexible and can accommodate nearly any proceeding format, including the heavy use of remote-appearance technology.

The power of mediation as a core part of the plan process has most recently been shown in most, if not all, recent mass tort cases such as *Mallinckrodt*, *LTL Management*, *Purdue Pharma*, *Boy Scouts* and *USA Gymnastics*, among others. Mediation is often essential to achieving a confirmed plan, but the systemic use and its efficacy remains poorly tracked and measured. In addition, some orders and practices severely limit basic factual disclosures.[18] Working with courts and practitioners to provide metrics on the uses of and types of mediation processes would help with further research and findings.

Part II of this series will return to the familiar territory of mediation use in preference and avoidance actions and other adversary proceedings about claims allowance, going beyond the usual and highly covered topics. The authors will share insights in Part II on such less frequently discussed issues as the effects of mandatory mediation on creditors, mediator-selection practices and limitations, and court-ordered mediation practices. abi

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13 Opioid Trust Governing Documents, *In re Mallinckrodt plc*, Case No. 20-12522 (JTD) (Bankr. D. Del.), Docket No. 7684.

14 General Unsecured Claims Trustee's Procedures for Disputed General Unsecured Claims, *In re Mallinckrodt plc*, Case No. 20-12522 (JTD) (Bankr. D. Del.), Docket No. 7684.

15 As of June 2023, Mallinckrodt is encountering some difficulties in performing its funding obligations. *See* Lauren Berg, "Mallinckrodt Considers New Bankruptcy over Opioid Payment," *Law360* (June 5, 2023), *available at* law360.com/articles/1684983/mallinckrodt-considers-new-bankruptcy-over-opioid-payment (subscription required to view article). No matter the outcome of these difficulties, it still serves as a useful example of the various mediation dynamics in large cases.

16 *See supra* n.10.

17 11 U.S.C. § 502(h).

18 Order Establishing Mediation Protocol, *In re LTL Mgmt.*, Case No. 21-30589 (MBK) (Bankr. D.N.J.), Docket No. 1780 at ¶ 4(k), limiting disclosure of basic facts about the mediation except with the express written authorization of the mediators. The amended mediation order replaced this paragraph with a comprehensive multi-part section on confidentiality. *Id.* at Docket No. 2300 at 5. This restriction is in addition to other confidentiality provisions in protective orders or other agreements. *See* Order Entering Agreed Protective Order, *id.* at Docket No. 948.

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The Use of Mediation in Large Chapter 11 Cases: Useful, Voluntary and Mandatory (Part II)

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A previous article[1] discussed the rising prevalence of mediation in large chapter 11 bankruptcies, especially its use in previously rare scenarios such as plan confirmation. Part II considers a more traditional mediation topic: adversary proceedings.

Traditional Topics of Mediation

While adversary proceedings in bankruptcy can address a variety of causes of action, avoidance claims are possibly the most common. In an avoidance proceeding, a party — the trustee, debtor or post-confirmation trust — seeks to unwind transactions that took place before the bankruptcy filing and while the debtor was insolvent or under the statutory bankruptcy construct of a preference. In large bankruptcy cases, it is common for dozens, or even hundreds, of avoidance actions to be filed, usually on the same day, often to toll or meet a statute of limitations.

Avoidance actions are knotty because the plaintiff, who has access to the debtor's books and records, may readily establish the elements of a *prima facie* case by determining when the debtor became insolvent and subsequent transfers occurred. Relevant in preference actions is the waterfall of the debtor's assets; again, this is information that may be known only to the plaintiff. However, the numerous complex defenses to avoidance actions are usually fact-specific and often rely on facts that are available to the defendant but inaccessible to the plaintiff.

For example, a transfer is not constructively fraudulent if it is made for reasonably equivalent value. A post-confirmation trust may be a mere assignee of constructive fraud claims, without detailed knowledge of the debtor's business. It cannot evaluate the value given to the debtor without a great deal of detailed — and expensive — analysis. As for a preference, the post-confirmation trust may be merely running a 90-day check-register analysis believing that payments are within the appropriate time period, but it might not appreciate the complete historical relationship between the company and vendor. The vendor may have more facts that could change the initial surface analysis.

Given these constraints, mediation offers a useful first step in the adversary process. It is a platform for the parties to clarify and discuss their arguments, plus share with each other relevant facts in a less formal and less costly environment. It is also a forum to have a third party weigh in on the merits of the respective arguments and perhaps shed some light on strengths and weaknesses.

Further, it is often inefficient to litigate avoidance actions when a collectability against a defendant is at issue. Under the cloak of confidentiality in mediation, parties may address the practicalities of collection in a way that will not become public if the dispute goes to court. For example, financial disclosures could occur up front. This allows the trust (or plaintiff) to conduct a cost-benefit analysis of pursuing claims to judgment vs. settling out early to avoid the time and costs of obtaining a potentially worthless judgment.

Beneficial Mediation Processes

Successful mediations (ones that produce settlements or meaningfully narrow the issues) are not accidents. Proper processes increase the likelihood

1 Leslie A. Berkoff, Candice L. Kline & Turner N. Falk, "The Use of Mediation in Large Chapter 11 Cases: Useful, Voluntary and Mandatory (Part I)," XLII *ABI Journal* 8, 20-21, 52-53, August 2023, *available at* abi.org/abi-journal.

of a successful mediation, meaning how parties conduct them; the forum, the written statements and other processes all matter.

While remote mediation by Zoom is more common than ever, mediations are more likely to succeed if held in person. In-person mediation lowers the barriers, encourages real, practical communication among parties, and ensures that each party experiences the efficiency of mediation and appreciates the much-higher costs of litigation.

Using Zoom where the issues are discrete and focused — while keeping costs low and providing a quick process from a scheduling perspective — might still help parties expeditiously reach a settlement. Communication seems harder during remote mediations. A good mediator (and good advocates) recognize that the interpersonal connections made during the process are a reason why mediation successfully resolves disputes. The issue is how to best replicate the in-person experience in a remote mediation.

The ability to communicate across the proverbial table and connect is what leads to success and seems less obtainable via Zoom. At times, the ability to "reach" the client diminishes when not everyone is in the room together, even in a private caucus, putting aside the benefits of using a joint session effectively. When people are sitting privately in their own respective offices (formal or informal), they become distracted, intentionally or otherwise. They hop on and off other matters, and their focus is not fully on the matter at hand. When everyone is sitting in a conference room and left to discuss the case in between sessions, even if participants deviate at times to address other matters, their focus is still on the dispute at hand. Even the best mediator cannot focus attention as well when participants are not literally "all together."

Mediations almost always involve the submission of a mediation statement by each party. These statements may be for the mediator's eyes only, or may be accessible to all parties, depending on the agreed-upon mediation process. Attorneys often approach the mediation statement as if it was a court pleading. Better viewed, it is completely different and serves a different purpose.

Mediation statements should do more than merely repeat legal arguments and case law. They should address the practical issues in the case, with a realistic eye toward resolving and addressing the other side's concerns. They should be settlement-focused, analyzing and recognizing strengths, weaknesses and risks. Have parties make their statements available to all parties, with a supplemental statement for the mediator only, in which the party frankly addresses items like collectability, insurance coverage or a client's intransigence that will aid the mediator in facilitating a settlement.

The more honest a party is in its confidential statement to the mediator, the more effective a mediator can be in crafting a trajectory or path to resolve a matter. Discovering halfway through a mediation a key piece of information that changes the course of a negotiation could undermine the trust of the other side, and could compel the mediator to retract from a settlement path that they had been positioning for the parties.

When a large case generates numerous concurrent avoidance actions, many practitioners implement streamlining procedures for the mediation, settlement and discovery process. Among these useful procedures, a pre-mediation stay of discovery may help keep costs down while the parties exchange informal relevant materials through mediation. Likewise, a simple notice procedure for settlements minimizes the time and expense of Bankruptcy Rule 9019 settlement approval in cases with many small-dollar avoidance actions.

In the bankruptcy of Hahnemann University Hospital in Philadelphia, the bankruptcy court authorized streamlined mediation and adversary procedures for the simplified resolution of a mass of preference claims.[2] The debtor named four mediators who would be splitting up the nearly 100 avoidance adversaries. Defendants were able to select from among these four mediators for an automatic referral prior to any discovery. The procedures extended the time to file a response to the complaint, waived the pretrial and scheduling conference requirements, and stayed discovery until the mediation's conclusion. Participants reported that it was successful; between the entry of the procedures order in September 2021 and September 2023, all but two of these adversaries were resolved by settlement.

Confidentiality is key to a successful mediation, and the major large-case jurisdictions have already implemented strong confidentiality protections via mandatory procedures or local rules. However, if the parties have other concerns about specific information being exchanged, it is common for them to make requests to enter into supplemental confidentiality agreements regarding certain information being exchanged. As noted in previous articles written on this topic, all parties should consider the potential limitations on confidentiality.[3]

Timing of Mediation

Mediation may occur at many stages of the bankruptcy process depending on when the adversary case is filed and the issues in dispute. Where there is a need to define classes or rights of creditors, early-stage mediation is often extremely use-

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2 Order Establishing Streamlined Procedures Governing Adversary Proceedings Brought by Debtors Pursuant to Sections 502, 547, 548 and 550 of the Bankruptcy Code, *In re Center City Healthcare LLC d/b/a Hahnemann Univ. Hosp., et al.*, Case No. 19-11466 (MFW) (Bankr. D. Del.), Docket No. 2850.

3 Leslie A. Berkoff, "Is Your Dispute Resolution Process Truly Confidential?," *New York Law Journal* (Aug. 7, 2023); Leslie A. Berkoff & John G. Loughnane, "Limitations on Confidentiality," XLI *ABI Journal* 9, 26-27, 47, September 2022, *available at* abi.org/abi-journal.

ful.[4] Further, mediation is used to resolve confirmation issues to avoid protracted confirmation hearings or address side issues that could hang up or delay confirmation. For example, in *Garret Motion Inc*., the debtor, the committees and various other parties were negotiating the terms of a reorganization plan and reached an impasse. The debtor then asked the court to order the parties to mediation. The court agreed and issued an order outlining multiple issues that would be covered by a mediation process.[5] As another example, to bring some level of consensus to the confirmation process in *San Bernardino*, Hon. **Meredith Jury** ordered city officials into mediation with one of the few creditors still challenging the city's bankruptcy plan.[6]

Mediation was intended to reach consent to avoid a confirmation cramdown fight, because in the end, those fights often leave nothing for the victor. If mediation occurs later in the case — after confirmation or creation of a liquidating trust — the mediation dynamic is often very practical. The debtor is already liquidated or reorganized and has no pride or stake in the outcome aside from estate maximization. In this context, the plaintiff's main concern is money, since the outcome cannot impact any ongoing aspect of the reorganization.

Why Parties Mediate

In prior decades, referral to mediation happened on a case-by-case basis. As time has gone by, several bankruptcy jurisdictions have adopted local rules governing mediation. Most large cases often include mediation protocols with the commencement of large adversary proceedings. Today, it is almost routine to consider referring not just avoidance actions to mediation (either in large or small cases) but for other types of adversary proceedings, as well outside of traditional avoidance actions.

The authors have represented parties in large chapter 11 cases where the presiding judge has "strongly suggested" that a potential adversary action should be mediated, even where local rules do not otherwise require it. It is always a good tactical move to take the judge up on such a "suggestion." It may be that the suggestion is a way of telegraphing that the matter should be resolved either because there could be a delay in deciding it, the cost of trying it is disproportionate to the dispute itself, or the result of a decision will be truly unpleasant for one side.

A mediation referral is straightforward when all parties agree. In situations where one party affirmatively seeks mediation, the party generally has a good reason to do so. If representing the opposing side, counsel should seek to understand why their opponent wants to mediate. Do they want to keep costs down, streamline discovery or keep vital case information out of public filings? The rationale for seeking mediation could be key to obtaining a quick and satisfactory settlement. It is also important to recognize that suggesting mediation is not a sign of weakness, but rather a practical recognition of the economics of a case for all concerned.

Who Are Mediators?

By local rule or procedure, many courts have a panel of pre-approved mediators, many of whom are insolvency professionals highly knowledgeable about the intricacies of avoidance actions. It is important to consider using bankruptcy practitioners in cases involving traditional bankruptcy constructs, or even general claims within the bankruptcy context. Understanding how a liquidated claim fits within a bankruptcy scheme and the Bankruptcy Code is often integral to properly analyzing the strengths and weaknesses of the claim.

In cases involving unique or highly technical issues, it might be useful for the parties to agree to someone outside these panels to mediate, or even to consider co-mediation, so issues may fold into the bankruptcy structure. A specialist could give an assessment of strength based on deep industry knowledge in factually complex cases, such as those involving oil and gas, intellectual property, software and coding, or highly regulated industries. Finally, using the services of another bankruptcy judge to mediate a dispute may offer special expertise or gravitas; at times, such an appointment may be necessary to bring warring parties to the table if egos are such that only a current or former judge's view would count.

If Mediation Is Good, Why Oppose It?

Despite its benefits, parties sometimes oppose mediation. One concern is the cost associated with the mediation process akin to a "tax" — especially where mediation is mandatory. However, you get out of mediation what you put into it, and if properly approached, even unsuccessful mediations usually provide a benefit to the parties by identifying key facts, allowing the parties to better understand arguments and streamlining key issues.

When the parties desire a court hearing or trial, mandatory mediation and any public-position statements that merely repeat legal arguments may do little more than function as a kind of preliminary dispositive-motion procedure. Failure of the mediation then leads to the filing of an actual dispositive motion, and the mediation costs appear to be sunk. Although a valid quibble with mandatory mediation, one or both parties might be to blame for incorrectly approaching the mediation opportunity. Conscientious mediation procedures might aid the parties by placing pure legal argument on the back burner to focus on meaningful settlement discussions. A good mediator could help drive those discussions — if both parties cooperate and actively participate.

Some parties may genuinely prefer to litigate their dispute without mediation. Opposition to mediation can arise at any time, including during the appeals stage, when parties have hardened in their positions and desire judicial review. The authors have successfully used a staff mediation program at the circuit level, even when experiencing all of the usual headwinds to a global settlement, including a desire to win the appeal.

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4 *See* Debtors' Motion for Entry of an Order (I) Appointing a Judicial Mediator, (II) Referring Certain Matters to Mandatory Mediation, and (III) Granting Related Relief, *In re Boy Scouts of Am. and Delaware BSA LLC*, Case No. 20-10343 (LSS) (Bankr. D. Del.), Docket No. 17. These mediation procedures set up a dialog whereby the tens of thousands of abuse claimants supported the plan with more than 73 percent accepting. *See id.* at Docket No. 8141.

5 Order Establishing Terms for Plan Mediation, *In re Garrett Motion Inc., et al*., Case No. 20-12212 (MEW) (Bankr. S.D.N.Y.), Docket No. 954.

6 Document Indicating Case Is Being Sent to Mediation, *In re City of San Bernardino, California*, Case No. 12-28006 (MAJ) (Bankr. C.D. Cal.), Docket No. 2060. As an aside, the authors, in less well-known cases, have served as mediators or participated in mediations involving competing plans, warring factions or lingering disputes between secured creditors and unsecured creditors.

Litigants often hold strong principles and believe that pursuing litigation is necessary to uphold those principles. They may refuse to engage in settlement discussions based on the principle that it would compromise their position and bolster their opponent's claims. The belief that justice is only achieved through a full trial, regardless of the cost, is deeply ingrained in American culture. However, litigants often fail to recognize the financial and emotional costs associated with protracted litigation, or the "price of principle."[7]

In preparing this article, the authors asked a number of mediators and attorneys who have participated in major mediations whether an investment in principles in one case has ever borne fruit in another case. The uniform answer to this informal survey was clear: No avoidance plaintiff had ever meaningfully shied away from a potential defendant because of a strong stand in an earlier case. Instead, other factors, such as the choice of defendant's counsel, may influence the trajectory of a mediation.

Conclusion

Mediation in large chapter 11 cases offers a valuable alternative to lengthy and costly litigation. It addresses substantive legal issues, promotes efficient discovery and provides a platform for parties to express their principles. It also offers confidentiality compared to an open-court process. While opposition to mediation exists due to concerns about costs, transparency and a desire for parties to have their day in court, the price of principle should be carefully evaluated.

Mediation, with the aid of skilled mediators, often helps parties navigate the complexities of their disputes, manage their expectations and explore mutually beneficial resolutions. By considering costs, risks and business-judgment aspects through a mediation process, parties might achieve better-informed decisions that serve their best interests and a fair and efficient resolution. abi

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7 Leslie A. Berkoff & Connor Bifferato, "The Price of Principle," XLI *ABI Journal* 6, 18-19, 60-61, June 2022, *available at* abi.org/abi-journal.

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Mediation Matters

By Leslie A. Berkoff and John G. Loughnane

Limitations on Confidentiality

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Confidentiality is a core component of, and integral to, the mediation process. Parties entering into mediation reasonably expect that communications and disclosures will be treated as confidential to the fullest extent permissible under applicable law. Protection and fulfillment of that expectation is thus important, as is understanding limitations on confidentiality in the mediation context.

Of course, not every mediation is successful. In some small number of instances, unfortunately, participants committed to a litigation strategy may attempt to seek discovery of documents or discussions obtained or exchanged during a prior mediation in furtherance of continued litigation.

A prudent mediator understands this risk and will take steps to promote and ensure the confidentiality of the mediation process. Moreover, parties to a mediation, and the mediator, should consider the issue of confidentiality prior to sharing information or making any disclosures in contemplation of a mediation, both during the process itself and after the conclusion of the mediation.

As discussed in a recent article,[1] there is no national rule that provides any certainty of confidentiality. Rather, parties must ensure that applicable rules governing the mediation provide such protection or reach a similar result through court approval of a consensual agreement governing the process from start to finish. In addition, recently amended Local Rule 9019-5(d) of the Local Rules of the U.S. Bankruptcy Court for the District of Delaware (effective Feb. 1, 2022) provides an example of a local rule promoting confidentiality.[2]

The lack of a national standard for ensuring confidentiality stands in contrast to the protection afforded ordinary settlement communications pursuant to Rule 408 of the Federal Rules of Evidence, as made applicable to bankruptcy proceedings by Rule 9017 of the Federal Rules of Bankruptcy Procedure. The confidentiality rule governing settlement communications under Rule 408 is generally well understood and provides effective guidance in protecting against the admissibility of communications focused on settlement.[3]

This article first discusses issues arising in two Delaware cases (both arising prior to the recent rule amendment) to demonstrate how courts have grappled with limitations on confidentiality. It then suggests some strategies for improving confidentiality given the absence of a comprehensive national rule.

Cases of Significant Import

In the ongoing case of *In re Boy Scouts of America and Delaware BSA LLC*,[4] Hon. **Laurie Selber Silverstein** recently wrestled with limitations on confidentiality in a complex mediation. The issue before the court was the debtor's motion for a protective order in connection with ongoing mediation proceedings, and related requests for discovery concerning that process that were tied to upcoming confirmation hearings.

The debtor (BSA) had sought to mediate certain plan-related issues with various parties. The governing mediation order previously entered by the court included a provision providing that "no person shall seek discovery from any participant in the mediation with respect to any information disclosed during mediation."[5] The BSA mediation order further included a specific exception providing that "if a party puts at issue any good-faith finding

1 Tyler Layne, "Mediation Privilege and Confidentiality: New Local Rules and the Need for National Guidance," XLI *ABI Journal* 5, 42-43, May 2022, *available at* abi.org/abi-journal.

2 *Id.*

3 The recently amended Delaware rule specifically provides that Federal Rule of Evidence 408 applies "[t]o the fullest extent applicable ... to the mediation conference and any communications with the mediator related thereto."

4 Case No. 20-10343 (LSS) (Bankr. D. Del. 2021).

5 References to "BSA TR" refer to the Oct. 25, 2021, transcript of hearings before Judge Silverstein in this matter, a copy of which is available for purchase at cle.abi.org (2022 ABI Annual Spring Meeting session titled "Privileges & Confidentiality in Bankruptcy Litigation" at p. 13). Order (I) Appointing Mediators, (II) Referring Certain Matters to Mediation, and (III) Granting Related Relief (the "BSA Mediation Order"), dated June 9, 2020 Dkt. No. 812; Tr. at 2.

concerning the Mediation in any subsequent action concerning insurance coverage, the [party's] right to seek discovery, if any, is preserved."[6]

In connection with various pending hearings, BSA filed a motion and sought to protect certain documents on various grounds, including, but not limited to, an assertion of a mediation privilege. In analyzing the existence of such a privilege, the court noted that only the Sixth Circuit had adopted and recognized the existence of a mediation privilege in *In re Lake Lotawana Community Improvement District*.[7] The court concluded that "without the existence of a federal mediation privilege, relevant information in a confidential mediation is subject to discovery, when jurisdiction is based on a federal statute. But notwithstanding the lack of binding precedent in this circuit, Local Rule 9019-5 exists and was incorporated into my order [quoted above]," allowing for discovery with respect to information disclosed during a mediation.[8] The court further recognized how this provision was inconsistent with the construct of mediation and suggested that this was a bit of a "square peg, round hole" situation.[9] In so doing, the court noted the distinction between a smaller dispute that goes to mediation based on the consent of the two impacted parties, with self-determination and the ability to fully control the outcome of the process, as opposed to a larger case with a multi-party mediation where not all parties were involved in every aspect of the comprehensive resolution and a plan vote by all creditors was still necessary.

The court recognized that in the context of BSA and the mediation in that case, not all parties were involved in the mediation process, and like most large cases, any resolution would need to be approved by the creditor body as a whole. As a result, the court found that certain communications were not protected by the construct of a mediation privilege. The court was focused on questions of proof related to confirmation of the existence of good faith, stating that "it cannot be the case that if a party is relying on the very fact of mediation to meet its standard of proof, that discovery is prohibited regarding the *bona fides* of the mediation."[10] However, while the court allowed some discovery, it did not rule on admissibility of that evidence at future hearings, and further explicitly noted that the denial of the motion seeking protective relief was without prejudice to the debtors raising the request again at a future time, as the court noted that the request might have been premature at that point in the cases.

Separate and apart from the issues previously discussed, the court also considered and rejected the attempt to raise and apply mediation privilege to protect the production of documents by Prof. Eric Green, who had been initially proposed as a mediator in the *BSA* case, but not ultimately selected by the court.[11] The court found that any information provided to Prof. Green or exchanged in contemplation of his engagement, and communications related thereto, could not be subject to a mediation privilege on any grounds, as he never was approved as a mediator.[12]

Another case emanating out of the Delaware Bankruptcy Court years ago, *In re Tribune Co., et al.*,[13] also required a balancing of competing tensions between the needs of multiple parties over a discovery dispute and the need for information contrasted with the need to protect and preserve the integrity of the mediation process. In that case, various parties sought information concerning a pending settlement arising out of a mediation conducted by Hon. **Kevin Gross**. The documents sought were withheld from production on grounds of being both procured during or related to that mediation, as well as a common-interest privilege asserted by various parties to that process. The proponents of the settlement were in a "catch-22" situation, faced with either waiving the protections of the mediation order or being precluded from introducing evidence that they would need to provide to buttress the mediator's endorsement of the settlement and evidence that the plan itself was the result of arm's-length bargaining.

In balancing all of these competing interests, presiding Bankruptcy Judge **Kevin J. Carey** (ret.) recognized that there was a strong policy promoting the full and frank discussions during the mediation process and that confidentiality was essential for an effective mediation.[14] As a result, the court crafted an order to protect communications between the mediator and mediation parties, as well as communications between the mediation parties on mediation days (but not on off mediation days) and, as a result, worked out a solution that allowed for areas that opened the door to information that fell outside the context of the mediation to move forward.[15]

Strategies for Improving Confidentiality

As these cases demonstrate, challenges to confidentiality can (and do) arise in various settings. Mediators and parties participating in a mediation can strengthen claims of confidentiality by carefully reviewing at the outset proposed forms of order governing the proceeding. If the order will be entered in a jurisdiction lacking a robust local rule that might independently cover confidentiality, then parties should seek to provide as much protection as possible by incorporating provisions specifically geared toward maximizing confidentiality provisions.

For example, parties should carefully consider provisions similar to the language found in the amended Delaware Local Rule 9019 providing that the "mediator shall not be compelled to disclose to the Court or to any person outside the mediation any records, reports, notes, communications ... or other documents receive[d] or made by or to the mediator." Language contained in this Rule further providing that the mediator shall not testify or be sub-

6 *Id.*

7 563 B.R. 909 (2016). Tr. at 11.

8 Tr. at 11-12. As previously noted above and in footnote 2, the BSA Mediation Order was entered on June 9, 2020, and important amendments to Local Rule 9019-5 became effective on Feb. 1, 2022. The amended rule explicitly acknowledges that "[c]onfidentiality is necessary to the mediation process, and mediations shall be confidential under these rules and to the fullest extent permissible under otherwise applicable law."

9 *Id.*

10 Tr. at 13-14.

11 In the *BSA* case, the parties were not free to choose their mediator and the court had selected the mediators, which is why there was an exchange of information prior to approval of the mediator.

12 The court noted that to the extent that Prof. Green might have a basis to assert other privileges (such as the attorney/client privilege), he was free to have those independently considered by the court.

13 No. 08-13141 (KJC) (Bankr. D. Del.).

14 Memorandum and Order entered by Judge Carey, dated Feb. 3, 2011, at p. 16 (citing *Sheldone v. Pennsylvania Turnpike Comm'n*, 104 F. Supp. 2d 511, 514 (W.D. Pa. 2000) (citations omitted) (quoting *Lake Utopia Paper Ltd. v. Connelly Containers Inc.*, 608, 928, 930 (2d Cir. 1979), which is also embraced by Local Delaware Rule 9019-5(d))). A copy of both the memorandum and order are available at "Privileges & Confidentiality in Bankruptcy Litigation," *supra* n.5, at p. 32.

15 *Id.*

poenaed or compelled to testify regarding the mediation is also supportive in protecting confidentiality and should be incorporated into any order authorizing mediation. Even in situations where a mediation is not directed by a court, parties can choose to seek approval of (or stipulate and agree upon) such provisions to govern a consensual mediation in the interest of judicial efficiency.

Further, any order approving a mediation should clearly state that the only communication authorized to the court about the session is limited to a basic report or certificate of completion of the mediation. Such a report should be limited to indicating compliance with the order of referral by the court (or agreement to mediate) and noting either a successful mediated resolution or not. Nothing more should be or needs to be said to preserve the integrity and confidentiality of the process.

In addition to ensuring an acceptable form of order and the incorporation of language mirroring robust local rules, a mediator and participating parties should enter into a binding agreement (with court approval) that recognizes the obligation of confidentiality. A mediator should also inform the parties at the outset of the meditator's standard practice of shredding mediation notes and materials promptly upon the conclusion of the final mediation session to ensure that no documents with confidential information from the process remain going forward that are capable of being discovered.

Parties can also consider not sending certain highly confidential pieces of information by way of email to the mediator and/or the other party. Wiping information off an email trail or server is far more difficult than shredding hard copies of information at the conclusion of a mediation. While this step might not be necessary or practical for every piece of information, some consideration should be given to guarding more sensitive information in order to protect it from resting on a server or document-management system. The convenience of email might be outweighed by the need to ensure privacy and confidentiality down the road.

Other steps that can be taken are for mediators to keep time records in a very generic form so that there is little to no detail contained within such records. Unlike professional fee time records that require detail under § 330 of the Bankruptcy Code, there is simply no reason for specific details to be contained within a mediator's time records, other than to ensure the time in question related to the mediation. Moreover, many mediations are flat-fee-based, so time record might be irrelevant.

Conclusion

Confidentiality is a fundamentally important concept in any mediation. While it is generally upheld and recognized in most situations, there have been cases (including the two noted, for example) where challenges to confidentiality have been asserted. Sometimes, such challenges arise in cases involving settlements that need to be approved pursuant to Rule 9019. The disclosure and scrutiny that comes along with that process can create additional conflict or tension with the sanctity of confidentiality in the mediation process. As previously noted, the best time for a mediator and participating parties to deal with potential confidentiality issues is at the outset of the mediation through a well-developed order that incorporates robust protections combined with the approval of a well-negotiated consensual agreement binding all parties participating in the process. abi

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Strategies To Protect Your Company From Clawback Actions During These Turbulent Times and Beyond

By Leslie A. Berkoff

In-house counsel are frequently confronted with questions on how to handle delinquent accounts and how to work with customers/vendors/suppliers (collectively, "customers") who appear to be in financial distress. Counsel who have felt the impact of even one bankruptcy filing have become quickly familiar with the concept of a "preference" or "clawback" claim, which is the claim to recover money received from a customer within the 90 days prior to a bankruptcy filing. Unfortunately, these claims are the harsh reality of doing business with a financially troubled company. For those who practice in the restructuring space, it is an unpleasant conversation to have with a client; nothing is worse than explaining to a client who may already be out considerable dollars on account of unpaid obligations that they may now have to return money that they otherwise legally collected. Given the number of companies struggling to survive in light of the economic constraints created by COVID-19 and the anticipated influx of bankruptcy filings, now, more than ever, you should be considering proactive measures for managing delinquent accounts in an effort to avoid a clawback claim.

What Is a Preference?

As a starting proposition, it is important to understand what a preference is and when the claim arises. Section 547(b) of the Bankruptcy Code establishes, in salient part, that a preference is "a transfer of an interest of the debtor in property: (1) made 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 date of the filing of the [bankruptcy] petition or within one year if the creditor is an insider [of the debtor]. . . ; (5) that enables such creditor to receive more than such creditor would receive… [in a chapter 7, liquidation]." 11 U.S.C. Section 547(b). In short, this means that anytime your company settles a claim, receives or accepts a payment of an outstanding obligation within the 90-day period preceding the filing of a debtor's bankruptcy petition (a.k.a., the "Preference Period"), or even does business with a financially distressed company, it may be subject to a preference claim brought by, or on behalf of, that debtor to recover a "preferential payment" that, under any other circumstance, your company is entitled to receive.

Of course, some financial relationships do not ordinarily give cause for concern. For example, if your company receives payment during the Preference Period on account of a fully or partially secured obligation and does not receive more in payment than the value of the collateral at that time, then there should be no valid basis to assert a preference claim with respect to that payment—this is because you have not received more than you would on liquidation and thus no prime facie preference claim could be established. More often than not, given that most companies' day-to-day customer relationships are unsecured in nature, these payments are fodder for a preference claim.

The possibility of having to return some or all of the payments received during the Preference Period, years after those payments were received, is difficult to comprehend, particularly when your company may have ended up never collecting all of the amounts due and owing.[1] However, there is a rationale behind the development of the construct known as a preference. This section of the Bankruptcy Code was actually enacted to promote fairness, its underpinning was to level the playing field to avoid a

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debtor "preferring" one creditor over another and paying them outside the ordinary course prior to filing. If your company did not receive any payment on account of obligations owed during the Preference Period, but a host of other companies received payments within the 90-day Preference Period, you would want some mechanism employed to equalize the financial impact of the debtor's bankruptcy filing. By allowing for preferential payments to be "clawed back" from those who were preferred, the clawed-back payments can be distributed to creditors on a *pro rata* basis, based on payment priority, so that all creditors receive the same "fair" treatment.[2] Unfortunately, the cost and time delay in recovering these funds does not always allow for a real return to creditors to be effectuated at times.

Can You Take Steps To Avoid Risk at the Outset?

While there are a variety of defenses to a preference action, some of which will be touched on below, it is preferable to implement measures that can help you avoid being subject to a preference claim from the outset—which means engaging in practices that minimize the risk of a prima facie claim being made. The most common mistake companies make is the automatic application of taking late incoming payments and applying them to the oldest invoice possible. In so doing, you have just facilitated a quintessential preferential transfer–payment on account of an antecedent debt. Instead, assuming the payor has not otherwise earmarked the payment for a specific older invoice,[3] you want to consider if there is a legitimate way to apply that payment to an invoice for a shipment of current goods or provision of services. You may be able to argue that the payment was not on account of an antecedent debt by making it a contemporaneous exchange of value. This is not foolproof, as a change in course of dealings can also raise a concern, but merely provides another argument to the mix.

Options for Application of Funds to Past Due Invoices

Alternatively, if you only have past due invoices, and the payment is not otherwise earmarked, you still have some options when considering how to apply that payment to open invoices, versus just automatically applying the payment to the oldest invoice. For this purpose it is important to understand your payment history with this customer so that you do not apply the payment in a manner that alters your ordinary course of business practice. Thus, if you received a payment and have various outstanding invoices–and can consider how best to apply it—the question becomes which invoice(s) should the payment be applied to in order to try to protect the same from avoidance down the road.

Let us explore this concept. While your company's standard invoice may have terms that say net 30 days, over time it is not uncommon for this arrangement to slip to net sixty days in practice such that while your stated business terms remain the same, your "ordinary course" relationship now differs from those terms. Assuming that there is a level of consistency to this change in practice you could take a later payment in and apply it to an older invoice consistent with that revised business practice and potentially have what is known as an "ordinary course" defense to a preference claim. While you have still received a preference, because payment is on account of a past due obligation, you would be able to argue that the historical relationship between the parties changed over time and this payment was made consistent with these practices.

Keep in mind that these claims often arise one to two years down the road after you have received the payment, after the company files for bankruptcy and once the bankruptcy case becomes ripe to pursue those claims. In order to establish an ordinary course of business defense, bankruptcy practitioners resort to preparing various forms of statistical analysis to provide snapshots of the payment relationship between the parties over varying time periods (usually to capture a schematic most closely aligned with the timing of any challenged payments). So as a general matter it is important to keep good records to support any changes or deviations in practice to allow you to rebut a challenge to your initial taking of a payment and buttress your ability to prove any of these defenses. Remember that defenses to a preference action are evidentiary in nature and you have the burden to prove the facts necessary to support your affirmative defense. Key information such as copies of invoices, due date of the same, date of delivery of goods or services as well as the type of payment and date it was received are all important.

Of course, the easiest way to avoid having to perform this analysis in the first place to ensure that the terms and conditions of a purchase order are clearly stated, understood, and complied with throughout the transaction, including the terms of credit and terms of payment by all parties concerned. This means if your business terms with the customer change, and a new billing practice is established, you should also change your invoices to match the terms at that time. For example, if the customer was originally required to pay you net 30 days of invoice, but you agree to allow the customer to pay net 60 days instead, you should modify the agreement and note the change on your invoices to the client. At the time the change in payment terms is made, you should also be sure to memorialize the new understanding in writing either by letter or email to the client (and be sure to save that writing in your records!). Allowing for slippage and ongoing deviations from these terms and conditions should be avoided as it allows for a trustee to argue that your receipt of a late payment during the preference period is outside the ordinary course, which undercuts your establishment of a new ordinary course relationship with the customer.

Don't Make Dramatic Changes

Also upon learning that a customer is having financial troubles you should try to avoid making any sudden, unilateral changes in the timing of payments by the customer that could be construed as creating circumstances for a customer (soon to be bankrupt debtor) to prefer you over other creditors. For example, you should avoid dramatically constricting payments terms with the customer so that a historic net 30-day relationship is changed to a net five- or 10-day period. Courts can view these changes in the relationships and in payment structure as a deviation that justifies seeking recovery of a preference, so getting paid sooner all of a sudden is not good and may not be considered ordinary course between the parties.

Standardize Your Collection Practices

It is also important to standardize your collection practices. If your employees engage in threatening or harassing calls to "extort" payment to be made, an argument can be made that the payment(s) in question were in response to threats and that is why the debtor "preferred" your company. In fact, some courts will find that aggressive collection activities that result in payment undermine any ability to contend that it was an ordinary course payment. Note that prompt payment demands resulting in more expedited payments during the preference period may also be viewed as preferential and outside the ordinary course of business. Therefore, the more uniform your collection practices are for any past due obligation, the easier it will be to substantiate that the company did not deviate from the norm as concerns its dealings with the potential debtor.

To be clear, performing an extensive analysis of a customer's payment history for day to day relationships with customers is not economically viable or realistic. The foregoing presumes that perhaps these are effectuated for large payments or significant obligations. So how do you deal with more mundane day-to-day payments (or even avoid issues on the bigger ones)? Change the timing of when you get paid completely to avoid having the payment be one that is made on "account of an antecedent debt." So look to take cash before delivery or on delivery. This will allow you to argue that payment is due when the customer get the goods or before, so that the exchange is not on account of an antecedent debt. Even if one were to try to consider the exchange antecedent in nature, there is also an independent defense to a preference claim for a contemporaneous exchange for value that would apply.

How To Handle Settlement Payment

What about the question of settlement payments for pending or threatened disputes? Those are clearly being made on account of an antecedent debt. In fact any demand letter or claim you make for those obligations will certainly spell out that the obligations are past due. Unfortunately, you cannot simply build into the settlement agreement a waiver that the payment is not a preferential one, as that wavier would not be upheld in a bankruptcy court. Of course, you could put in language that says in the event that a compromised or reduced payment sum is later found to be a preferential transfer and unwound, you reserve the right to assert the full amount remains due and owing; this way you are not left with both a returned payment and a lower claim amount (of course in a case where unsecured creditors can get pennies on the dollar, that helps only just so much).

If your settlement includes a release of claims then there are some additional steps you can take. First, you also could incorporate into the settlement agreement that by providing the release, the company is getting new value in exchange for the settlement—in such instance I would have the agreement recite the consideration that is being given in exchange for the payment and that the release has value and the exchange is intended to be contemporaneous in nature. Depending upon the facts this might work to stave off a claim.

Second, you could also consider if the agreement includes releases for the primary obligor and potential third parties, not giving releases under the settlement agreement until 91 days after the last payment is received to try to avoid the preference claim. Other than when dealing with insiders of a company (insiders are generally family members or corporate affiliates or parties in control of corporate entities generally), the lookback for a preference is the 90 days prior to filing (for insiders it is a year). So if you are settling claims, and are going to give releases to other parties, perhaps hold these releases until the 91st day passes so that there is some incentive for the payor to hold off filing for bankruptcy.

Third, consider whether a third party can make the payment instead of the potential bankrupt entity and earmark them as payment for this obligation. The earmarking doctrine protects transfers that are made to the creditor by a non-debtor third party and, if properly structured, would avoid a preference claim. It should be noted that depending upon the facts, if the paying company subsequently files for bankruptcy, and no consideration is received by them in exchange for this payment, then this transfer could be considered to be a fraudulent conveyance against the creditors of their estate. One key practice pointer across the board is that no company can receive a payment from anyone who is not the obligor, so absent a structured agreement that provides a reasoned basis to do so, you will leave the realm and risk of preferences and end up in the area of fraudulent conveyances—which has a much longer lookback period. So in deciding to take a payment from a third party you need to run some risk analysis on this as well.

When All Else Fails

In the end it is important to remember that there is nothing wrong with accepting payment for an outstanding debt—it is not illegal or wrong; possession is indeed nine-tenths of the law, so better in your pocket than the debtor's pocket. The risk of a preference payment has become part of the cost of doing business. Not every distressed company files for bankruptcy and not every bankruptcy leads to demands for recovery of preference claims or fraudulent conveyances and thus there may never be a need to return the payment. Moreover, even if repayment is demanded, you may only need to return a portion of that payment. Of course hiring a good bankruptcy lawyer who can guide you in considering how to address doing business with a financially troubled company and/or responding to these demand letters is the first step to protecting money that you have received. Given that this question will not arise for some period of time if at all, when in doubt it is always better to accept the payment. Accepting the risk of a potential Preference Claim is part of the cost of doing business, but using some of the protective measures discussed in this article will help place you in the best position possible in the event a trustee does attempt to claw back the payment from you sometime down the road.

Endnotes

1. In most cases, the clawback actions are brought by the bankruptcy trustee (or debtor in possession) on or shortly before the two-year anniversary of the filing of the debtor's bankruptcy petition to avoid having their clawback claims barred by the two year statute of limitations.
2. It is important to note that there is no intent requirement at all for establishing a preference, so it does not matter whether the debtor intended preferred your company or not for a trustee to bring a preference action against you. In many cases, trustees simply bring preference claims against any creditor that received a payment during the Preference Period and will sort out the valid claims after the fact (and after your company is forced to retain an attorney to negotiate a resolution with the trustee). Recent changes to the Bankruptcy Code require a level of due diligence prior to commencing these claims.
3. If the payment is made and specifically delineates that it is on account of an invoice or series of invoices, you have to apply the payment to those invoices and any option on your part is removed.

Mediating With the New Kid in Town

By Leslie A Berkoff

Bankruptcy Mediation – A Different Construct than Other Forums

Mediation in the bankruptcy forum is a unique process different than other types of mediation. In almost all bankruptcy courts, mediation is used in both business and consumer cases. Mediation is used to resolve multi-party disputes, discrete issues in larger litigations, and oftentimes to resolve traditional clawback claims brought under 11 U.S.C. §§ 544, 546, 547, 548 and 550. However, there is often a key difference to mediation in other forums. In bankruptcy, the party acting as the plaintiff in the bankruptcy mediation process is oftentimes not the original business owner but rather a litigation committee or liquidation trustee who is running a court ordered process long after the debtor has failed or has sold off these claims to a litigation trust. Oftentimes, the premise for the action being sent to mediation is the trustee's duty to pursue "clawback actions" (preferences or fraudulent conveyances which are creatures of bankruptcy law), although the underlying business facts governing the transfers are key. As a result, the dynamic is very different than other types of cases where both parties involved in the mediation were also involved in the original underlying "dispute" and have history and first-hand knowledge of the key facts. In fact, in bankruptcy mediation the plaintiff may have no historical knowledge of the underpinning business transactions which relate to the dispute at hand. Moreover, it is entirely possible that the key employees or other parties with knowledge of the history of the dispute and the related facts are long since gone from the company – having lost their jobs months or years prior during the failed restructuring of the corporate operations or having left for greener pastures when things turned rocky or uncertain. This means that the plaintiff has to learn all of the key facts at a time when there may be no one with first-hand knowledge to educate them and must rely on books and records interpreted by unfamiliar parties.

Despite the New Plaintiff – Does the Process Still Work?

Can you successfully mediate with a new and unfamiliar party at the table? The answer, this author believes, is yes and, by experience, quite well. Mediation is still an incredibly useful and productive tool and its use is on the rise in bankruptcy cases as a way to minimize costs and streamline the litigation process. In fact, in bankruptcy cases where there can be hundreds of "clawback" actions brought at one time, it can be an essential means to implement a successful collection process. Moreover, mediation can be singularly effective in these cases because the party negotiating for the estate is actually charged to act as a fiduciary and must maintain his or her focus, the concern to maximize assets, minimize and justify expenses, and strive to provide a return for creditors. This is not necessarily the same in non-bankruptcy mediations where plaintiffs are involved in the history of the dispute and tied to the company in a different fashion by their ongoing responsibilities in management and operations. In my experience, this new plaintiff can oftentimes survey the facts with more benign objectivity. True, they don't know the history, but these plaintiffs can be educated on the specific business facts, unique to the debtor's business currently at play and incorporate that into knowledge gleaned from other businesses where they might have served in a similar capacity in the past. Moreover, they lack the emotional or historical baggage that can impede a mediation in a more traditional setting. These are not the people who caused the problem at hand or are responsible for the facts that led to the dispute.

They are simply able to analyze the pros and cons of the litigation risks that are before them and decide how to proceed.

Bankruptcy in Mediation is a Cost Saving Tool

The filing of a bankruptcy case is usually commenced with a flurry of motion practice, which can mount quickly into significant fees. The multitude of motions that need to be filed to set the stage for the reorganization or liquidation process and the breadth of creditors that these motions can reach and affect, oftentimes leads to voluminous responsive filings and multiple hearings. Additional contested matters are created by the ancillary obligation for debtors and trustees to commence separate "spin off" litigations during the reorganization process to determine the value of collateral, the validity of liens, facilitate the recovery of assets, and/or determine various property rights. In order to reduce mounting legal fees (which will reduce recoveries to creditors or impact the ability of a debtor to successfully reorganize) many bankruptcy courts have turned to mediation as a means to address these issues.

Recognizing the usefulness of the mediation process in balancing costs and resolving disputes has led bankruptcy courts to encourage the development and implementation of local rules providing for mediation and for administering the process. Most courts have now established mediation panels comprised of a pre-approved (and, at times, pre-vetted) panel mediators who can be called upon to serve in a case at times by the participants; at times these mediators are simply selected by the Judge. Although the Federal Rules of Bankruptcy Procedure are silent about the ability to use mediation in the bankruptcy forum, a significant number of bankruptcy courts have opted to create formal court rules that authorize the use of mediation; other courts have used mediation on an ad hoc basis. This is predicated in part on the fact that, in 1998, Congress passed the Authorization of Alternative Dispute Resolution in 1998 (Public Law 105-315-Oct. 30, 1998), which provides for the use of alternative dispute resolution in bankruptcy. Moreover, well recognized organizations, like the American Bankruptcy Institute, have enacted formal training programs for bankruptcy dedicated mediators.

General Use in Mega Case*s*

In recent years, mediation has been especially effective in the context of "mega-bankruptcy" cases such as *Enron Corporation* and the *Adelphia Communications Corporation* bankruptcy cases. So too, have a many other bankruptcy cases utilized this entering orders providing for proposed procedures in cases where a debtor, creditors' committee or trustee anticipates filing a large number of avoidance actions. *See, e.g., In re Eastman Kodak Company,* Case No. 12-10202 (ALG) (Bankr. S.D.N.Y.) (Docket No. 6380); *In re Oldco M. Corporation (f/k/a Metaldyne Corporation)*, Case No. 09-13412 (MG) (Bankr. S.D.N.Y.) (Docket No. 1726); *In re Lehman Brothers, Inc.*, Case No. 08-01420 (JMP) (Bankr. S.D.N.Y.) (Docket No. 2894); *In re Creative Group, Inc.*, Case No. 08-10975 (RDD) (Bankr.S.D.N.Y.) (Docket No. 421); *In re Bernard L. Madoff*, Adversary Case No. 08-01789 (BRL) (Bankr. S.D.N.Y.) (Docket No. 3141).
Mediation has also proven to be a significant tool in the Detroit bankruptcy case. In fact, it has been recognized that, absent the use of mediation, in this case the funds and resources were simply not there to efficiently resolve the issues. "What has transpired is a delicate balancing act in bankruptcy court, where the public's right to know how public money is being handled is

being weighed against the rights of creditors and debtors to resolved their disputes in private." *See* Tresa Baldas, Matt Helms & Alisa Priddle, *How Mediation has Put Detroit Bankruptcy on the Road to Resolution,* Detroit Free Press, Feb. 20, 2014, http://www.freep.com/article/20140202/NEWS01/302020063/Orr-Snyder-Rosen-Detroi-bankruptcy. As lead mediator, Chief Judge Rosen oversaw several contentious restructuring talks between the city and its creditors, brokered the rescue fund to boost pensions and shielded artwork from being sold.

Bankruptcy courts are courts of dispute resolution independent of mediation. An effective bankruptcy lawyer knows that productive negotiations with creditors to develop a consensual plan, if possible, are the keystone of a successful reorganization process. Part of the impetus in all of these cases to using mediation is the benefit of reducing costs in the bankruptcy case as litigation costs for the debtor (or estate representative) or litigation committee are paid from property of the estate; funds that are paid for litigation diminish and deplete creditor recoveries.

Defendants Benefit as Well

While many defendants often express concern over the use of a "litigation appointed plaintiff," in the process, more often than not the clinical and dispassionate approach applied by this new party when balanced by need to justify fees more than tempers any lack of historical knowledge or personal history. As noted earlier, plaintiffs feel constrained to justify any actions they take more keenly than other traditional plaintiffs do. So too, a creditor's committee has a fiduciary obligation to represent the interests of all unsecured creditors.

Mediation is a delicate process that works best when parties are committed to the resolution and keep their eye on the end goal of achieving a reasonable result that balances litigation risks and concerns. The insertion of a new party into the factual dispute between business entities that have a history as to which this new party may have no first hand familiarity does not adversely affect that dynamic.

Given the considerations that one must draw upon as guidelines in resolving matters in mediation i.e. costs, risks and closure, are the same kinds of concerns that underpin the fiduciary obligations owed by the plaintiff in these matters the consistency of these concerns only serves to facilitate a reasonable and expeditious result. Overall, defendants should appreciate that an increased level of objectivity is brought to bear on the process and recognize that the need to unemotionally balance these concerns may allow for a more expeditious and efficient result which benefits them in the end.

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By Leslie A. Berkoff and Jeffrey T. Zaino[1]

Mediation Allowed a Complex Dispute to Be Resolved Without Protracted Litigation

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Commercial debtors, creditors, bankruptcy practitioners and bankruptcy courts all experience the demands, stresses and uncertain outcomes of multi-party bankruptcy disputes. In complex cases involving multiple creditors sporting high-value claims, the parties and the court can reasonably expect that some of these disputes may already have had, or will have, protracted motion practice costing significant expenditures of time and resources for all parties involved (including the court).

In fact, many parties come to bankruptcy court having already having spent years and prohibitive amounts of money on pre-petition litigation just to find themselves potentially facing the need to engage in further expensive discovery and motion practice. While bankruptcy courts are well suited, as are bankruptcy practitioners, for dealing with fast-moving cases involving complex issues, the parties in these cases usually consider that the efficient, effective and economical resolution of disputes might be critical to the process of a successful reorganization or an orderly winding down of an estate.

Bankruptcy courts and practitioners have long recognized the economic benefit and utility of using mediation to resolve cases (both simple and complex) quickly and efficiently. Prior to the COVID-19 pandemic, most multi-party complex mediations were in person given the number of parties involved, along with the voluminous documents that parties might wish to refer to during mediation, as well as the perceived benefits of being in person to see, hear and negotiate disputes. The pandemic impeded that option as in-person meetings and travel were prohibited. While many practitioners acclimated to Zoom[2] or other online platforms for meetings involving a few parties, skillfully navigating a multi-party dispute with multiple caucus rooms, joint sessions and exhibits "online" were not things that every participant was adept at handling or keen to attempt. As commercial bankruptcy filings have increased over the past year as a result of government-mandated business shutdowns, parties are expanding the use of mediation for even the more complex cases simply out of necessity.[3]

Highland Capital Management LP is an effective example of a massively contested matter involving longstanding conflicts over substantial sums, and it demonstrates just how effective, versatile and valuable of a tool mediation can be when the parties commit to the process. In *Highland Capital*, out of the U.S. Bankruptcy Court for the Northern District of Texas and presided over by Hon. **Stacey G. C. Jernigan**, the court directed — and the parties consented to — the use of mediation to resolve discrete issues between the debtor and various significant creditors within the web of a very complicated case. The end result paved the way for a successful reorganization.

The disputes involved parties from multiple states during a time when the COVID-19 pandemic made travel, if not impossible, certainly a significant concern for a variety of reasons. In order to ensure that the process worked smoothly, the parties utilized the services of the American Arbitration Association (AAA), which not only has a roster of bankruptcy mediators, but also has the ability to facilitate an online platform for mediations while incorporating multiple platforms at the same time.[4] As a result, the parties were presented with a virtual format that enabled each of them to utilize the programs that they were most comfortable or familiar with, so that they could focus instead on addressing the legal and factual complexities of the case.

In *Highland Capital*, the debtor was an investment manager that filed a voluntary chapter 11 petition after various creditors obtained sub-

1 **Michael C. Troiano**, an associate with Moritt Hock & Hamroff LLP in the firm's Creditors' Rights and Restructuring Department, contributed to this article.

2 For a discussion of the unique benefits of alternative dispute resolution (ADR) processes, particularly in a virtual setting, *see* Leslie A. Berkoff & Hon. Louis H. Kornreich, "Taking Mediation Online: The Practicalities and the Pitfalls," XXXIX *ABI Journal* 6, 32, 56-57, June 2020, *available at* abi.org/abi-journal (unless otherwise specified, all links in this article were last visited on May 28, 2021).

3 According to statistics provided to ABI by the Administrative Office of the U.S. Courts, there was an onslaught of new chapter 11 cases, as commercial bankruptcy case filings rose by 29 percent nationally in 2020. "December 2020 Bankruptcy Statistics," ABI, Dec. 30, 2020, *available at* abi.org/newsroom/epiq-stats/december-2020-bankruptcy-statistics-commercial-filings.

4 For example, the AAA has the ability to accommodate each party's own videoconferencing software on its virtual ADR platform, thereby allowing each party to appear via whatever videoconferencing software it uses (Zoom, Skype, etc.) without mandating that all parties use a single software.

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stantial judgments against it following the completion of a series of highly contentious litigations. (The debtor, along with the Crusader Fund Creditors, UBS and Acis, are collectively referred to herein as the "parties.") The Crusader Fund Creditors and UBS were judgment creditors that had filed proofs of claim in the debtor's case that were predicated on long-running, highly charged disputes and involved in some manner alleged wrongful acts by the debtor and/or its agents.

In addition, there were other creditors, including Acis, that held significant causes of action against the debtor and had filed proofs of claim that needed to also be resolved in order to effectuate plan confirmation. The debtor objected to the claims asserted by the foregoing creditors on multiple grounds, and the creditors contested these objections.[5]

One set of fund-related creditors (the "Crusader Fund Creditors") had filed a series of claims totaling more than $200 million stemming from a pre-petition arbitration award, which the debtor had been challenging in the chancery court at the time that the bankruptcy petition was filed. There were disputes over the scope of the Crusader Fund Creditors' claims, including (but not limited to) the inclusion by the Crusader Fund Creditors of claims to recover funds that they claimed the debtor had allegedly prematurely taken from the Crusader Fund Creditors' accounts. The debtor contended that it would ultimately be entitled to those funds, or at least part of the same, upon liquidation of the accounts. There were also claims concerning the debtor's improper handling of certain shares of stock in which the Crusader Fund Creditors possessed an interest.

Another set of creditors, Acis Capital Management LP and Acis Capital Management GP LLC (together, "Acis"), which operated a portfolio-management company previously owned in part by the debtor's principal and managed by the debtor, also asserted a series of claims. At the time of the debtor's filing, Acis had just concluded its own heavily litigated chapter 11 case in front of Judge Jernigan, which had been commenced as an involuntary filing as a result of alleged bad acts committed by the principal of the debtor (Highland). The involuntary filing led to the appointment of a chapter 11 trustee and a web of adversary proceedings, including (but not limited to) a fraudulent conveyance suit by the chapter 11 trustee against the debtor (Highland), and objections to proofs of claim filed by the debtor (Highland) in the Acis case.

Acis had emerged from its involuntary chapter 11 case with a confirmed plan, which included the retention of the Acis estate's causes of action against the debtor (Highland) in its yet-to-be-concluded adversary proceeding in the Acis bankruptcy case (the "Acis adversary proceeding"). Based on the causes of action asserted in the adversary proceeding, Acis filed a proof of claim in the debtor's case containing "34 separate counts, all of which were extremely complex both factually and legally,"[6] to which the debtor objected and to which Acis filed a lengthy response.

Finally, UBS Securities LLC and UBS AG London Branch (together, "UBS") had also filed a factually and legally complicated claim stemming from a $1 billion state court judgment following an acrimonious 10-year litigation with the debtor. The debtor also objected to this claim. While the court had initially disallowed the UBS claim, it was subsequently allowed on a limited basis solely for the purposes of plan voting after another round of contested motion practice. Adding to the complexity of the UBS claim was the implication and involvement of several affiliates of the debtor that were defendants in a separate state court action and had been the recipients of assets transferred by the debtor, and UBS had asserted an interest.

All of the foregoing claim disputes involved parties involved in long-term highly adversarial relationships that were now battling to determine the scope and substance of claims to be allowed in the debtor's case in anticipation of a plan-confirmation process. Further litigation regarding the various issues surrounding these claims would have consumed significant chunks of the debtor's assets (which would otherwise have been available for distribution under the plan) and it would have monopolized time and resources of the court and the parties' practitioners for an extended period of time. As a result, this case was ripe for a cost-effective and potentially issue-dispositive mediation.

In August 2020 (almost a year after the case was commenced in October 2019), Judge Jernigan ordered the parties to mediate to see whether the various disputes could be resolved, as opposed to allowing them to continue to drain time and resources.[7] Given the pugilistic history and deeply entrenched mistrust among the parties, the situation required a mediator of significant acumen to resolve it. Consequently, the parties selected retired Judge **Allan L. Gropper** (U.S. Bankruptcy Court (S.D.N.Y.); New York) and **Sylvia A. Mayer** (S. Mayer Law PLLC; Houston) as co-mediators (the "mediators") to conduct the mediation. Through the mediation process, the parties settled each of their claims with the debtor within approximately eight months of the court's order directing mediation, clearly defining the amounts and sources of each of the agreed-upon claims and tying off the possibility of any further disputes among the parties regarding those particular claims.

For example, as a result of the mediation, the debtor's resolution with Acis resulted in the mutual release of a number of the factually and legally interconnected, and previously contested, claims stemming from Acis's prior involuntary bankruptcy, as well as the claims necessary to move forward with the debtor's plan confirmation.[8]

5 For an example of such a response, *see Highland Capital Mgmt. LP*, No. 19-34054-sgj11 (Bankr. N.D. Tex.), Docket No. 908 (*see* creditor Acis's response to debtor's claim objection to understand breadth of objections at play).

6 *Id.* at Docket No. 1087, p. 8.
7 *Id.* at Docket No. 912.
8 *Id.* at Docket No. 1087, pp. 9-10.

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The settlement between the debtor and the Crusader Fund Creditors resolved similarly longstanding intricate issues, as the debtor agreed to surrender certain wrongfully acquired interests and to market and sell certain securities for the Crusader Fund Creditors' benefit in exchange for mutual releases and significantly reduced claim amounts.[9]

The results of the mediation are even more impressive given some of the legal and factual issues that arose during the mediation process. For example, after the parties to the UBS dispute had participated in multiple mediation sessions and had agreed on a claim amount, they learned from an independent investigatory panel that the debtor had illegally transferred hundreds of millions of dollars' worth of assets to offshore accounts presumably to escape collection by UBS, thereby possibly exposing the estate to further claims and litigation. Through the mediation, the parties were able to renegotiate the claims of UBS at a substantial-yet-fair increase, thereby obviating the need for what would surely have been costly litigation regarding the improperly transferred assets.[10]

As these examples demonstrate, the retention of skilled mediators who were familiar with the complex issues presented by this bankruptcy case and the ability to manage the parties, as well as the parties' agreement and active participation in the process, led to the parties reaching consensus. As with most settlements in bankruptcy cases, the settlement agreements were then presented to the court for approval, and although there were objections, the court approved the resulting agreements.[11]

It is possible that absent the utilization of mediation, the multiple motions would have taken months to be heard and determined, leading to extensive discovery, hearings and trials, and potentially even appeals. By allowing the parties the opportunity to explore the validity of the various positions within the confines of the mediation process, and understand the risks associated with each of their respective positions, the parties were able to have a hand in the eventual resolution of their claims. With the claims of some of the debtor's most substantial claims' creditors settled in a timely fashion, the mediators helped pave the way for confirmation of a reorganization plan. In the end, the debtor was able to propose a confirmable plan shortly after the settlements were reached. abi

9 *Id.* at Docket No. 1089, pp. 7-8.

10 For a complete factual recitation of the UBS debtor-mediation process, including the discovery of and response to the unapproved transfers, *see Highland Capital Mgmt. LP* at Docket No. 2199 (debtor's motion for order approving settlement with UBS pursuant to Bankruptcy Rule 9019).

11 None of these objections were filed by the U.S. Trustee's Office. The most significant creditor objection to settlement was UBS's objection to the dollar amount of the debtor's agreement with the Crusader Fund Creditors; for objection, *see Highland Capital Mgmt. LP* at Docket No. 1190. The remaining objectors included the debtor's former principal and certain other fund creditors, all of whose objections were overruled by the court.

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Mediating With a Litigation Committee Or Trust

Bankruptcy cases offer key differences.

BIGSTOCK

BY LESLIE BERKOFF

While mediation is used in many forums, mediation in the bankruptcy context at times offers some very unique and key distinctions. One key difference is that the party often acting as the plaintiff in the adversary proceeding or contested matter[1] is not necessarily the business owner but rather a litigation committee[2] or trustee who is running a court ordered process long after the debtor has failed.[3] Thus, the procedural context is very different than other traditional cases where both parties involved in the mediation were also involved in the original "dispute" and are at the table resolving *their* own personal issues and competing claims. In these cases, the plaintiff has no historical knowledge of the facts, or underlying business arrangements that relate to the dispute at hand. Moreover, it is entirely possible that the key employees or other parties with knowledge of the history and facts are long since gone—having lost their jobs months or years prior during the failed restructuring of the corporate operations or having left for greener pastures when things turned rocky or uncertain. Thus, the plaintiff has to learn all of the key facts at a time when there may be no one with first-hand knowledge to educate them.

The question is—does the process still work? Can you successfully mediate with a new and unfamiliar party at the table? The answer, this author believes, is yes and by experience, it works quite well. The absence of a party with historical knowledge does not preclude the usefulness or success rate for the mediation process. Rather, the replacement at the table with a party whose primary obligation is to act as a fiduciary to maximize assets, minimize and justify expenses, and ensure a reasonable return for creditors may in fact allow for a more expeditious resolution of the case. In my experience, this new plaintiff can oftentimes survey the facts with more benign objectivity and can call upon knowledge gleaned from other similar businesses where they might have served in a similar capacity in the past. Thus, these plaintiffs are open to being educated on the specific business facts, unique to the debtor's business currently at play. Moreover, they can, without emotional or historical baggage, analyze the pros and cons of the litigation risks that are before them and decide how to proceed.

Recognizing the usefulness of the mediation process in balancing costs and resolving disputes has led bankruptcy courts to champion this process in the business context. Although the Federal Rules of Bankruptcy Procedures are silent about the ability to use mediation in the bankruptcy forum, 51 bankruptcy courts have opted to create court rules that authorize the use of mediation; other courts have used mediation on an ad hoc basis.[4]

Bankruptcy courts derive the power to implement mediation from both statutory and rule based authority. Specifically, Congress passed the Authorization of Alternative Dispute Resolution in 1998 (Public Law 105-315-Oct. 30, 1998), which provides for the use of alternative dispute resolution in bankruptcy.[5] Over time, many bankruptcy courts have established formal mediation programs and procedures and implemented local rules to govern the process.[6] Moreover, most courts have now established mediation panels comprised of pre-approved (and at times

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pre-vetted) panel mediators who can be called upon to serve in a case. This is simply not a new process for the bankruptcy courts.

In recent years, mediation has been especially effective in the context of "mega-bankruptcy" cases.[7] Examples of these cases include both the Enron and the Adelphia Communications bankruptcy cases, each of which eventually found their way to judicial mediators.[8] In both cases, multiple disputes within the bankruptcies cases were referred to mediation, including claims objections, efforts to recover assets, and declaratory judgment actions or specific discrete factual and legal issues.[9]

At their core, bankruptcy courts are courts of "dispute resolution where qualified debtors reapportion their debt allocation. Efficiency is the priority. Within this statutory framework, judges, trustees, and credit counselors serve dispute resolution roles identifying the creditors that are to be involved, facilitating the development of the plan and deciding on how the debt allocation will proceed."[10] Part of the impetus in all of these cases to using mediation is the benefit of reducing costs, as bankruptcy litigation costs for the debtor (or estate representative) or litigation committee are paid from property of the estate. Funds paid for litigation diminish and deplete creditor recoveries. Thus, plaintiffs bear the responsibility of carrying out their fiduciary duty to creditors and acting in a cost effective manner that must at the end of the day serve as a guiding force.[11] As a general rule, trustees (including liquidating trustees) are guided by their primary objective to maximize recovery for the estate or specific classes of creditors. Their decisions are governed by the business judgment rule, which holds that the trustee's decisions and actions are entitled to respect and deference, if the trustee can articulate a sound business reason for the action taken.[12]

While many defendants often express concern over the use of a "litigation appointed plaintiff," in the process, more often than not the clinical and dispassionate approach applied by this new party when balanced by need to justify fees more than tempers any lack of historical knowledge or personal history. Rather, plaintiffs feel constrained to justify any actions they take more keenly than other traditional plaintiffs do.[13] So too, a creditor's committee has a fiduciary obligation to represent the interests of all unsecured creditors.[14]

Mediation is a delicate process that works best when parties are committed to the resolution and keep their eye on the end goal of achieving a reasonable result that balances litigation risks and concerns. The insertion of a new party into the factual dispute between business entities that have a history as to which this new party may have no first hand familiarity does not adversely affect that dynamic.

Given the considerations that one must draw upon as guidelines in resolving matters in mediation, i.e., costs, risks and closure, are the same kinds of concerns that underpin the fiduciary obligations held by the plaintiff in these matters, the consistency of these concerns only serves to facilitate a reasonable and expeditious result. Overall, defendants should appreciate that an increased level of objectivity is brought to bear on the process and recognize that the need to unemotionally balance these concerns may allow for a more expeditious and efficient result that benefits them in the end.

1. Adversary proceedings are litigations brought within the context of a bankruptcy case and involve discrete issues that are being litigated in the bankruptcy forum, whereas contested matters arise when affirmative relief sought by motion practice is opposed. In either context, the rules of discovery come into play and mediation is often utilized to resolve the issues. See Rules 7001 and 9014 of the Federal Rules of Bankruptcy Procedure.

2. See *In re Commodore Int'l*, 262 F.3d 96, 99 (2d Cir. 2001) (recognizing the ability for creditor's committees to initiate adversary proceedings to pursue litigation in the name of the debtor); see also *In re STN Enters.*, 779 F.2d 901, 904 (2d. Cir. 1985).

3. Alternatively, it may be that the debtor is simply out of the picture having divested itself of such claims for the benefit of the unsecured creditor body under a plan or by other agreement. See Order Granting Motion of BGI Creditors' Liquidating Trust and the Liquidating Trustee to Establish Procedures Governing Adversary Proceedings Brought Pursuant to Sections 547 and 550 of the Bankruptcy Code, *In re BGI, f/k/a Borders Group*, Case No. 11-10614, Doc. No. 2922, and Order Establishing Procedures Governing Adversary Procedures Brought Pursuant to Sections 547 and 550 of the Bankruptcy Code, *In re Oldco M Corporation (f/k/a Metaldyne Corporation)*, Case No. 09-13412, Doc. No. 1726.

4. Elayne E. Greenberg, "ADR Meets Bankruptcy: Cross-Purposes or Cross-Pollination?: We Can Work It Out: Entertaining a Dispute Resolution System Design for Bankruptcy Court," 17 Am. Bankr. Inst. L. Rev. 545, 547 (2009) (noting that "[u]nbeknownst to many, bankruptcy courts have been using mediation as part of the case management of bankruptcy cases since 1986 when the Southern District of California established the first mediation program").

5. See 28 U.S.C. §§651-658, 651(b) (2014) (identifying current statutory citation).

6. Prior to the implementation of formal local rules, many bankruptcy judges relied on §105 of the Bankruptcy Code to facilitate the mediation process.

7. See Hon. Cecelia G. Morris & Cheryl J. Lee, "From Behind the Bench: Toward an Efficient Mediation Model—Evaluative Mediation in Bankruptcy," 4 Norton Bankr. L. Advisor 2, 6 (2007).

8. So too, have many other bankruptcy cases utilized this, entering orders providing for Proposed Procedures in cases where a debtor, creditors' committee or trustee anticipates filing a large number of avoidance actions. See, e.g., *In re Oldco M. (f/k/a Metaldyne)*, Case No. 09-13412 (MG) (Bankr. S.D.N.Y.) (Docket No. 1726); *In re Lehman Brothers*, Case No. 08-01420 (JMP) (Bankr. S.D.N.Y.) (Docket No. 2894); *In re Creative Group*, Case No. 08-10975 (RDD) (Bankr. S.D.N.Y.) (Docket No. 421); *In re Bernard L. Madoff*, Adversary Case No. 08-01789 (BRL) (Bankr. S.D.N.Y.) (Docket No. 3141).

9. See also Greenberg, supra note 4. Mediation has also proven to be a significant tool in the Detroit bankruptcy case. In fact, it has been recognized that, absent the use of mediation, in this case the funds and resources were simply not there to efficiently resolve the issues. "What has transpired is a delicate balancing act in bankruptcy court, where the public's right to know how public money is being handled is being weighed against the rights of creditors and debtors to resolved their disputes in private." See Tresa Baldas, Matt Helms & Alisa Priddle, "How Mediation has Put Detroit Bankruptcy on the Road to Resolution," Detroit Free Press, Feb. 20, 2014, http://www.freep.com/article/20140202/NEWS01/302020063/Orr-Snyder-Rosen-Detroi-bankruptcy. As lead mediator, Chief Judge Gerald E. Rosen oversaw several contentious restructuring talks between the city and its creditors, brokered the rescue fund to boost pensions and shielded artwork from being sold. Id.

10. Greenberg, supra note 4, at 547.

11. "[A] bankruptcy or reorganization trustee is a fiduciary of each creditor … . As such, he has a duty to treat all creditors fairly and to exercise that measure of case and diligence that an ordinarily prudent person under similar circumstances would exercise." David P. Primack, Note: "Confusion and Solution: Chapter 11 Bankruptcy Trustee's Standard of Care for Personal Liability," 43 Wm. & Mary L. Rev. 1297, 1309 (2002) (citing *Hall v. Perry (In re Cochise College Park)*, 703 F.2d 1339, 1357 (9th Cir. 1983)). For a lengthy discussion on the standard of care to be applied to actions of trustees, see id. ("The first and only Supreme Court case to address the issue of the standard of case for a reorganization trustee is *Mosser v. Darrow*."). In *Mosser v. Darrow*, the Supreme Court recognized that it needed to be proactive in protecting bankruptcy trustees so they were not hindered in making business judgments by others that these decisions could later be "open to serious criticism by obstreperous creditors aided by hindsight." *Mosser v. Darrow*, 341 U.S. 267, 273-74 (1951).

12. See *In re Diplomat Const.*, 481 B.R. 215, 220-21 (Bankr. N.D. Ga. 2012); see also *Comm. of Equity Security Holders v. Lionel (In re Lionel)*, 722 F.2d 1063, 1070 (2d Cir. 1983); *In re Thomson McKinnon Secs.*, 120 B.R. 301, 307 (Bankr. S.D.N.Y. 1990).

13. "The benchmark for determining the propriety of a bankruptcy settlement is whether the settlement is in the best interests of the estate." *In re Energy Coop.*, 886 F.2d 921, 927 (7th Cir. 1989); see also *Martin v. Kane (A & C Properties)*, 784 F.2d 1377, 1380 (9th Cir. 1986), cert. den. sub nom, *Martin v. Robinson*, 479 U.S. 854 (1986). The seminal case in this area is *Drexel v. Loomis*, which highlighted the paramount interests of the creditors and a proper deference to their reasonable views. *Drexel v. Loomis*, 35 F.2d 800, 806 (8th Cir. 1929). It is well established that compromises are favored in bankruptcy. See 9 Collier on Bankruptcy ¶ 9019.03 (15th ed. 2008). As the Supreme Court noted in *TMT Trailer*, "[i]n administering reorganization proceedings in an economical and practical manner, it will often be wise to arrange the settlement of claims to which there are substantial and reasonable doubts." *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry v. Anderson*, 390 U.S. 414, 424 (1967).

14. See, e.g., *In re Bohack*, 607 F.2d 258, 262 n.4 (2d Cir. 1979) (confirming that a "committee owes a fiduciary duty to the creditors, and must guide its actions so as to safeguard as much as possible the rights of minority as well as majority creditors" (citing *Woods v. City Nat'l Bank & Trust*, 312 U.S. 262, 268-69 (1941))); *In re Caldor*, 193 B.R. 165, 181 (Bankr. S.D.N.Y. 1996); *In re Ionosphere Clubs*, 101 B.R. 844, 855 (Bankr. S.D.N.Y. 1989); *In re McLean Indus.*, 70 B.R. 852, 862 (Bankr. S.D.N.Y. 1987).

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Timing is everything: One circuit says the new value window closes as of the petition date

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Introduction

Section 547 of Chapter 11 of Title 11,[1] (the Bankruptcy Code) empowers certain parties to claw back "preference payments" made by a debtor to a creditor within 90 days of a bankruptcy filing.

However, the new value that a creditor provides to the debtor after receiving a preference payment oftentimes may offset its preference liability on a dollar-for-dollar basis.[2] While the concept may seem straightforward, the "new value" cannot be counted where the debtor later makes an "otherwise unavoidable transfer"[3] to the creditor on account of, or, in other words, that satisfies, the new value received.[4]

Section 503(b)(9) of the Bankruptcy Code also focuses on the timing of a creditor's provision of value, in the form of goods, to a debtor. Under this provision, certain creditors are entitled to an administrative priority claim for "the value of any goods received by the debtor within 20 days before the date of commencement of a case."[5]

Not surprisingly, courts have reached inconsistent conclusions as to whether § 503(b)(9) invoices paid or reserved for post-petition can also be counted as part of a creditor's new value defense.

Recently, in *Auriga Polymers Inc. v. PMCM2, LLC*,[6] the 11th Circuit Court of Appeals (the Court) reversed a bankruptcy court's decision on direct appeal, which had held amounts reserved for post-petition payments of § 503(b)(9) claims cannot also be included as part of a creditor's new value defense because the funds being held in reserve for eventual payment were "otherwise unavoidable transfers."

In reversing the bankruptcy court's decision, the Court relied primarily on the analysis in *Friedman's Liquidating Trust v. Roth Staffing Cos. (In re Friedman's Inc.)*,[7] a 3rd Circuit Court of Appeals decision that previously had held that post-petition payments received by a creditor after a bankruptcy filing pursuant to a court-approved wage order could also be counted as part of a creditor's new value defense.

Thus, the Court held that the new value window closes on the petition date (i.e., courts should not consider payments made post-petition) and creditors can rely upon § 503(b)(9) invoices as part of their new value defenses to reduce preference liability.

Statutory framework

A. Preference claims

Under § 547(b) of the Bankruptcy Code, certain parties can "avoid" a transfer if the relevant *prima facie* preference elements are satisfied. Essentially, this cancels the transaction and compels the creditor to return or "disgorge" a debtor's payments or transfers of property so that such payments or property can be reallocated pro rata to all unsecured creditors.

For transfers avoided under this provision, 11 U.S.C. § 550(a) empowers the trustee to then "recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property."

The new value that a creditor provides to the debtor after receiving a preference payment oftentimes may offset its preference liability on a dollar-for-dollar basis.

Section 547(c) provides creditors with nine defenses to a preference claim, which were promulgated to encourage creditors to continue doing business with financially distressed companies and to give them a chance at avoiding a bankruptcy filing. The "new value defense," which is codified in § 547(c)(4), is one of those defenses, and states, in pertinent part:

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 [that was both:] (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.

Simply put, this means that a creditor that provides new value to the debtor after receiving a preferential transfer can use that new value to offset a portion of its preference liability.

B. Section 503(b)(9)

Section 503(b)(9) of the Bankruptcy Code grants certain creditors administrative expense priority for "the value of any goods received by the debtor within 20 days before the date of commencement of a case under [Title 11] in which the goods have been sold to the debtor in the ordinary course of such debtor's business."

Unlike the oftentimes miniscule recoveries creditors receive on account of their unsecured claims, § 503(b)(9) confers administrative claim priority to creditors that deliver goods within the 20-day window, which may result in full payment of such claims.

Procedural background and facts

Beaulieu Group, LLC, along with certain affiliates and subsidiaries (collectively, Beaulieu), was a vertically integrated family of companies in the carpet industry. Beaulieu filed for Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the Northern District of Georgia (the Bankruptcy Court) on July 16, 2017 (the Petition Date).

The Court held that a post-petition court-authorized transfer ... made on account of a § 503(b)(9) claim is not an "otherwise unavoidable transfer" within the meaning of § 547(c)(4) and, thus, does not reduce a creditor's new value defense.

Following the effective date of Beaulieu's plan of liquidation, Beaulieu's liquidating trust, administered by PMCM 2, LLC (the Trustee), filed a preference action against one of Beaulieu's suppliers, Auriga Polymers (Auriga). The Trustee sought to avoid and recover $2.2 million in payments (the Pre-Petition Transfers) made to Auriga during the 90-day period before the Petition Date, from March 18, 2017 to June 16, 2017 (the Preference Period) under §§ 547(b) and 550 of the Bankruptcy Code.

Also, during the Preference Period, Auriga delivered Beaulieu over $3.523 million of goods (the Goods). At least $694,502 of those Goods were delivered in the ordinary course of business within twenty days of the Petition Date, and thus satisfied the requirements of § 503(b)(9). The Trustee agreed to reserve $694,502 to cover Auriga's § 503(b)(9) claim as there was a dispute over the actual amount of the claim.

Auriga also asserted a new value defense under § 547(c)(4) in the amount of $421,119, which overlapped with a portion of Auriga's § 503(b)(9) administrative expense claim.[8] Thus, the question before the Bankruptcy Court was "whether post-petition transfers made under a 11 U.S.C. § 503(b)(9) request could also be relied upon to reduce the creditor's new value defense."

Specifically, the Bankruptcy Court had to address whether the funds the Trustee held in reserve to pay Auriga's § 503(b)(9) claim constituted an "otherwise unavoidable transfer" that could be used to offset Auriga's preference liability.

The Bankruptcy Court sided with the Trustee, holding that the funds being held in escrow by the Trustee for payment of Auriga's § 503(b)(9) claim were "otherwise unavoidable transfers," so the "new value" defense would not also be available for the § 503(b)(9) portion of Auriga's unpaid invoices.

Following the Bankruptcy Court's decision, Auriga appealed to the district court, which stayed the case to allow for an immediate appeal to the Court.

The court's decision

The Court reversed the Bankruptcy Court's decision. The Court first rejected the Trustee's argument that the 11th Circuit's prior decision in *Kaye v. Blue Bell Creameries, Inc. (In re BFW Liquidation, LLC)*,[9] which considered whether the pre-petition payment of new value invoices constituted "otherwise unavoidable" transfers, supported its position. The Court distinguished the *In re BFW Liquidation* decision based on the fact that Auriga's § 503(b)(9) claim escrow reserve was funded post-petition for the benefit of the Trust.[10]

The Court then considered the *Friedman's* decision, which to date had been the only circuit court decision to address the "otherwise unavoidable" concept in the post-petition context. The *Friedman's* decision held that court-approved post-petition invoice payments made pursuant to a wage order were "not otherwise avoidable" payments because the new value window closes as of the petition date.

While the *Friedman's* court did not explicitly address the § 503(b)(9) issue,[11] the Court determined that the *Friedman's* court's reasoning was just as applicable in the § 503(b)(9) context.[12]

The Court buttressed its holding by noting that the Bankruptcy Code is silent as to whether *post*-petition payments should impact the subsequent new value defense.

Acknowledging that the construction of § 547(c)(4) did not include an express temporal limitation, the Court reasoned that the meaning of the term "transfer" should be consistent throughout the provision, and since the other references to the term transfer in the provision are all clearly pre-petition, Congress did not intend for post-petition payments to affect a creditor's defenses.

In addition, the Court observed that the title of Section 547, "Preferences," also intimated that the "transfers" described in the section were only intended to be pre-petition transfers, as all such transfers need to occur pre-petition. This is further supported by the fact that creditors that deliver goods *post-petition* cannot include those deliveries in their new value defenses, so courts should also not consider post-petition payments.

Moreover, the Court addressed how the statute of limitations for the filing of avoidance actions in a voluntary bankruptcy case begins to run on the petition date.

Accordingly, if post-petition transfers could defeat a new value defense, "the calculation of preference liability could change

depending on when the preference avoidance action was filed," encouraging plaintiffs to wait and see if all or a portion of a creditor's claims are paid post-petition as such payments would arguably reduce the available new value defense.

Finally, Congress intentionally favored creditors who ship goods within 20 days before a bankruptcy filing (as set forth in § 503(b)(9)), and the Court did not want to disturb this policy.

Given the foregoing, the Court held that a post-petition court-authorized transfer, in this case, a reserve for future payment, made on account of a § 503(b)(9) claim is not an "otherwise unavoidable transfer" within the meaning of § 547(c)(4) and, thus, does not reduce a creditor's new value defense.

Conclusion

The *Auriga* decision is a very positive development for trade creditors who supply goods within the 20-day § 503(b)(9) window and continue doing business with financially distressed companies up until the days and weeks before the petition date.

However, it is important to keep in mind that the Court's decision is only a first step. Since the Court is the first circuit court to address this issue, as the 3rd Circuit in *Friedman's* carved out the post-petition payment of § 503(b)(9) claims from its holding, only time will tell how other circuit courts, or even potentially the Supreme Court, will resolve this issue.

Notwithstanding, this holding should provide creditors some additional protection against the prospect of preference exposure, at least for bankruptcy cases filed in states covered by the 11th Circuit (Alabama, Florida, and Georgia).

Notes

[1] United States Code §§ 101 *et seq*.

[2] *Id*. § 547(c)(4).

[3] The convoluted nature of the phrase "otherwise unavoidable," and the ambiguity surrounding Congress's intent in drafting § 547(c)(4), has long been a source of uncertainty for courts when considering the new value defense, especially in the context of pre-petition paid new value. For example, transfers made unavoidable under one of the other § 547(c) defenses could be said to be "otherwise unavoidable" for purposes of" § 547(c)(4)(B), although that is not entirely clear from the statutory text.

[4] *Id*. § 547(c)(4)(b).

[5] *See* § 503(b)(9).

[6] 2022 U.S. App. LEXIS 19761 (11th Cir. July 18, 2022).

[7] 738 F.3d 547 (3d Cir. 2013).

[8] Auriga's $694,502 § 503(b)(9) claim included $421,119 in new value provided by Auriga to Beaulieu. The Trustee disputed that Auriga could also use that same $421,119 as part of its § 547(c)(4) new value defense. The parties agreed, however, that Auriga had an allowed § 503(b)(9) claim for $273,382 (the difference between the total § 503(b)(9) claim of $694,502 and the disputed portion of $421,119). Thus, the Trustee made an interim distribution of $273,382 to Auriga and the Trustee established a reserve in the amount of $421,119, which would be sufficient to pay the full amount of Auriga's § 503(b)(9) claim as asserted.

[9] 899 F.3d 1178 (11th Cir. 2018).

[10] The Court focused on how all of the transfers at issue in *In re BFW Liquidation* were made pre-petition. Thus, the decision's reasoning and holding was not instructive as to whether *post*-petition transfers could be used to offset a creditor's new value defense. Moreover, because the use of the phrase "otherwise unavoidable transfer" in the context of § 547(c)(4)(B) specifically relates to pre-petition conduct, and does not address post-petition conduct, it would have been superfluous for the *In re BFW Liquidation* court to refer to these transfers as "otherwise unavoidable transfers *made pre-petition*."

[11] *See In re Friedman's Inc.*, 738 F.3d 547, 554 n.2 (3d Cir. 2013) ("The Wage Order in the instant case was filed pursuant to §§ 105(a) and 363(b) of the Bankruptcy Code, provisions often invoked in Critical Vendor Orders. Given the similarity of the Wage Order to a Critical Vendor Order, the issue presented in these cases is analogous.

Also analogous are cases in which post-petition payments were made pursuant to § 503(b)(9), which allows for administrative expense priority for the value of goods received by a debtor 20 days before filing for bankruptcy.")

[12] *See In re Friedman's*, 738 F.3d at 555.

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