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ALERT MEMORANDUM

March 26, 2014 clearygottlieb.com

Eighth Circuit Holds that § 547(c) "New Value" Need Not Come from Preferential Transferee

On March 20, 2014, the U.S. Court of Appeals for the Eighth Circuit, in *Stoebner v. San Diego Gas & Elec. Co. (In re LGI Energy Solutions, Inc.)*, Nos. 12-3899 and 12-4011, 2014 WL 1063209 (8th Cir. Mar. 20, 2014) (the "Opinion"), held that when a debtor makes a preferential transfer under § 547(b) of the Bankruptcy Code[1] to a third party for the benefit of a primary creditor, a contemporaneous or subsequent transfer by the primary creditor to the debtor is "new value" under § 547(c) of the Bankruptcy Code[2] that can shield the third party from preference liability in the amount of the "new value," even if the third party also is a creditor. The Opinion represents an issue of first impression in the Eighth Circuit, and the court's holding is significant because it closes the door to a potential end-run around the § 547(c) "new value" exceptions to preferential transfers in tri-party arrangements.

Background and Procedural History

Prior to its February 6, 2009 involuntary bankruptcy filing, LGI Energy Solutions, Inc. and LGI Data Solutions Company, LLC (collectively "LGI") performed bill payment services for their clients, which consisted of large utility customers, including Buffets, Inc. and Wendy's International, Inc. ("Buffets" and "Wendy's" respectively). *Id*. at *1. In LGI's business model, utility companies that provided services to LGI's clients sent invoices directly to LGI, rather than to their customers. *Id*. LGI periodically provided invoice summaries to its clients, which in turn paid the aggregate invoice amounts to LGI. *Id*. LGI placed these payments into a comingled account and used the pool of money to pay the utility companies for the outstanding invoice amounts. *Id*. The utility companies had no contractual relationship to LGI. *Id*.

During the ninety days prior to LGI's bankruptcy filing, LGI made payments on behalf of its clients Buffets and Wendy's for a total of $75,053.85 to San Diego Gas & Electric Company

[1] Section 547(b) of the Bankruptcy Code provides in relevant part that, "Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made (A) on or within 90 days before the date of the filing of the petition . . . ; and (5) that enables such creditor to receive more than such creditor would receive if (A) this case were under Chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title."

[2] Section 547(c) of the Bankruptcy Code provides in relevant part that, "The trustee may not avoid under this section a transfer (1) to the extent that such transfer was (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and (B) in fact a substantially contemporaneous exchange . . . (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor (A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor."

("SDGE") and $183,512.74 to Southern California Edison Company ("SCE," and together with SDGE, the "Utility Companies") to pay outstanding invoices for utility services provided to Buffets and Wendy's (the "LGI Payments"). *Id*. Subsequent to the LGI Payments but before LGI's bankruptcy filing, business continued as it had before; the Utility Companies provided services to Buffets and Wendy's and sent invoices directly to LGI, while Buffets and Wendy's paid roughly $297,000 to LGI pursuant to their existing contractual arrangement (the "Primary Creditor Payments"). *Id*.

Following the bankruptcy filing, the LGI trustee brought a preferential transfer action under § 547(b) to recover value the LGI Payments on behalf of the estates. In separate decisions, the bankruptcy court held that (1) the LGI Payments were preferential transfers within the meaning of § 547(b) "to or for the benefit of" the Utility Companies as creditors, and (2) the reference in § 547(c)(4) to "such creditor" requires that subsequent "new value" be provided by the creditor that received the preferential transfer, and as a result, the Utility Companies were entitled to a § 547(c)(4) "new value" setoff in preference liability only to the extent that they provided utility services to Buffets and Wendy's after the LGI payments. *In re LGI Energy Solutions, Inc.*, Nos. ADV 11-4065 and 11-4066 (Bankr. D. Minn. June 11, 2012).

The Utility Companies appealed the decision to the United States Bankruptcy Appellate Panel for the Eighth Circuit ("BAP") on the grounds that (1) the Utility Companies were not "creditors" of LGI within the meaning of § 547(b), (2) the transfers were not on account of antecedent debts owed to the Utility Companies within the meaning of § 547(b), and (3) the § 547(c)(4) "new value" setoff to the preferential transfer liability should have been allowed in the amount of the Primary Creditor Payments (i.e. all payments received after the dates of the challenged LGI Payments), rather than the value of the utility services provided to Buffets and Wendy's after the LGI Payments. *Stoebner v. San Diego Gas & Elec. Co. (In re LGI Energy Solutions, Inc.)*, 482 B.R. 809, 812 (8th Cir. BAP 2012). Consolidating the cases, the BAP denied the appeal on the first two grounds, but overruled the bankruptcy court's findings and held that the Utility Companies were entitled to a "new value" defense in the amount of the Primary Creditor Payments. *Id*. at 819-23. The trustee appealed the BAP's decision to the Eighth Circuit, arguing that the language of the preference statute mandates that any subsequent "new value" setoff to a defendant's § 547(b) preference liability must be provided by the same creditor who received the preferential transfer.

The Decision

The Eighth Circuit affirmed the BAP's holding, finding it consistent with existing Eighth Circuit precedent and the statutory purpose of §§ 547(b) and (c) that a party other than the preferential transferee in what was effectively a tri-party arrangement could provide "new value" for purposes of the statute. Opinion at *5.

Before addressing the merits, the court pointed out the inequities inherent in the trustee's position that § 547(c)(4) requires that any subsequent "new value" must be provided by the creditor that received the preferential transfer. Recognizing that LGI did not have a contract with the Utility Companies and the LGI Payments were not only made "to or for the benefit of" the Utility Companies, but also "to or for the benefit of" Buffets and Wendy's, the court noted that the trustee's position, if followed, would do "fundamental violence to the prime bankruptcy

policy of equality of distribution among creditors." *Id*. at *2 (internal quotation marks omitted). The court further explained that if the Utility Companies were not entitled to a § 547(c)(4) preference liability setoff in the amount of the Primary Creditor Payments, "the estate [would be] 'doubly replenished' entirely at the expense of only two creditors, Buffets and Wendy's," who were not sued directly but would be left in the untenable position of having made further payments to LGI that they would not recover, while remaining liable to the Utility Companies for their unpaid invoices because the Utility Companies would be required to return the payments they received from LGI with respect to these customers' invoices. *Id*. at *2. The court further noted that it was not asked to review the BAP's ruling that the Utility Companies were "creditors" within the meaning of § 547(b) – an essential element that "opened the door for the trustee's inequitable application of the preference statutes" – but that such a finding "seems open to serious question . . . [and] should *not* be considered Eighth Circuit precedent." *Id*. at *3.

Turning to the merits and addressing the issue of whether subsequent "new value" for the purposes of § 547(c)(4) must be provided by the party who received the preferential transfer, the court relied primarily on its prior decision, *Jones Truck Lines, Inc. v. Central States, Se. and Sw. Areas Pension Fund (In re Jones Truck Lines, Inc.)*, 130 F.3d 323 (8th Cir. 1997). In *Jones Truck Lines*, the Eighth Circuit concluded that transfers made by the debtor to an employee benefit fund pursuant to a collective bargaining agreement were exempted from preference liability to the extent that the employees (on whose behalf the transfer was made) provided the debtor with contemporaneous (or in the alternative, subsequent) "new value" by continuing to work for the debtor. Opinion at *3-4. The court agreed with the BAP and found the facts of the present case to be "closely analogous" to *Jones Truck Lines*, explaining that "LGI's preferential transfers to the [Utility Companies] were based upon its contractual obligations to the [Buffets and Wendy's], who benefitted from those transfers by having their utility bills paid. Applying the reasoning in *Jones Truck Lines*, each [Utility Company] may offset all new value Buffets and Wendy's transferred to LGI subsequent to an avoidable preference." *Id.* at *4. The court also noted that its decision is consistent with the statutory purpose of "encouraging creditors to deal with troubled businesses," *id*. at *4 (internal citations and quotation marks omitted), since it assures that creditors similarly positioned to Buffets and Wendy's will receive the benefit of the subsequent "new value" that they provide to the estate.

While the court explicitly limited its holding to the facts presented in the case, citing the complexity of § 547, it confirmed that "in three-party relationships where the debtor's preferential transfer to a third party benefits the debtor's primary creditor, new value (either contemporaneous or subsequent) can come from the primary creditor, even if the third party is a creditor in its own right and is the only defendant against whom the debtor has asserted a claim of preference liability." *Id*. at *5.

Significance of *LGI Energy Solutions*

LGI Energy Solutions is significant because it avoids inequitable consequences by closing a possible loophole under the preference statute created by the trustee's discretion in deciding which party it brings a preference action against. As the court notes in the Opinion, the trustee attempted an end-run around the § 547(c) "new value" exception to preferential transfers, suing only the preferential payment transferees which did not themselves replenish the estate. While this strategy would have been beneficial to the estate, it would have come at

the expense of only two creditors, violated the fundamental principal of equality of distribution among creditors, and discouraged creditors from working with financially distressed companies. The Eighth Circuit has successfully avoided such an inequitable result.

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Please feel free to contact Lisa Schweitzer (lschweitzer@cgsh.com) or any of your regular contacts at the firm if you have any questions.

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road
Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Sila Tower, 27th Floor
Sowwah Square, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T: +82 2 6353 8000
F: +82 2 6353 8099