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How Valuable Is "New Value" in Preference Litigation?

It is not uncommon for a supplier of goods or services to receive a demand letter or adversary complaint alleging that it received avoidable transfers—commonly known as "preferential payments" or "preferences"—during the 90 days preceding a customer's bankruptcy filing. Such claims arise under section 547 of the Bankruptcy Code, and can result in a supplier having to return certain payments made during the 90-day preference period.

One of the most common defenses to an alleged preference is the "new value" defense.[1] Simply stated, the "new value" defense provides that, to the extent a creditor gives "new value" (usually in the form of additional goods or services provided on credit) to the debtor after receiving preferential payments, the creditor is entitled to reduce its preference exposure by offsetting the new value against the preferential payments. See 11 U.S.C. §§ 547(a)(2) and (c)(4).

An example of a straightforward application of the new value defense is as follows:

> A supplier received a $10,000 payment from a debtor 70 days before the debtor's bankruptcy filing. Five days after receiving the $10,000 payment (on the 65th day before the bankruptcy filing), the supplier shipped $5,000 worth of goods to the debtor on credit, thereby making the supplier a creditor of the debtor in the amount of $5,000. The supplier expected to be paid for the additional $5,000 of shipped goods within 30 days after invoice, per stated invoice terms. Unfortunately, the debtor never paid the $5,000 invoice, and filed bankruptcy before payment was made. The supplier will be entitled to offset this $5,000 "new value" against the $10,000 potential preference payment received by the supplier on the 70th day before bankruptcy, thereby reducing the supplier's preference exposure to $5,000 before the application of other possible defenses. The supplier is also entitled to file a general unsecured claim in the debtor's bankruptcy case for $5,000—the amount of the unpaid invoice.

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Limitations on the "New Value" Defense

In order to be used as part of a “new value” defense, "new value" cannot be "secured by an otherwise unavoidable security interest." 11 U.S.C. § 547(c)(4)(A). Basically, this means that the creditor cannot have a security interest securing its right to payment for the “new value.”

Further, "new value" can only be used as a defense if "the debtor did not make an otherwise avoidable transfer to or for the benefit of such creditor" on account of the “new value”. 11 U.S.C. § 547(c)(4)(B). This requirement can be interpreted in simple terms to mean that the creditor cannot have received payment for amounts that it seeks to use as part of a “new value” defense. However, in practice, this portion of the statute is not so straightforward.

"New Value" Paid by a Payment That Is Itself Subject to Avoidance

In some instances, a creditor may have been paid on account of “new value” with a payment that is itself subject to avoidance as a preference. In many jurisdictions, a theory known as the "subsequent advance" approach may be applied to permit a creditor to assert “new value” as a defense under these circumstances. *See e.g., Hall v. Chrysler Credit Corp. (In re JKJ Chevrolet, Inc.)*, 412 F.3d 545, 552 (4th Cir. 2005); *Jones Truck Lines, Inc. v. Central States, Southeast & Southwest Areas Pension Fund (In re Jones Truck Lines, Inc.)*, 130 F.3d 323, 329 (8th Cir. 1998); *Mosier v. Ever-Fresh Food Co. (In re IRFM, Inc.)*, 52 F.3d 228, 231-32 (9th Cir. 1995); *Wahoski v. Am. & Efrid, Inc. (In re Pillowtex Corp.)*, 416 B.R. 123, 130-131 (Bankr. D. Del. 2009); *Frey Mech. Grp., Inc. v. Mull (In re Frey Mech. Grp., Inc.)*, 446 B.R. 208, 217-219 (Bankr. E.D. Pa. 2011).

The policy behind the "subsequent advance" approach is twofold: first, a creditor who continues to extend credit to the debtor in reliance on prior payments would merely be increasing his bankruptcy loss in the absence of the rule; and second, the limited protection provided by the "subsequent advance" rule encourages creditors to continue their revolving credit arrangement with financially troubled debtors, potentially helping the debtor avoid bankruptcy altogether. See In re Pillowtex, 416 B.R. at 130-131. The following is an example of an application of the "subsequent advance" theory:

> Suppose a supplier receives a $10,000 payment 80 days before the

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> bankruptcy petition date. The supplier then ships $5,000 worth of goods to the debtor 70 days before the petition date. The debtor then pays for this $5,000 worth of goods 40 days before the petition date. Assuming that this is the entire universe of payments and shipments made during the preference period, and further assuming that no other preference defenses are available to the supplier, under the "subsequent advance" theory, the supplier's preference exposure would be $10,000 because the $5,000 payment is itself subject to avoidance and can therefore be used as "new value" to offset the initial $10,000 payment.

Other courts, including those in the Seventh Circuit, do not apply the "subsequent advance" theory where “new value” is paid by an otherwise avoidable transfer. *See Matter of Prescott*, 805 F.2d 719 (7th Cir. 1986) (rejecting "subsequent advance" approach for new value paid by avoidable transfer); *McKloskey v. Schabel (In re Schabel)*, 338 B.R. 376, 381 (Bankr. E.D. Wis. 2005) (noting that "subsequent advance" theory as applied to new value that is paid with an avoidable transfer "comports with the statutory language" but identifying that Wisconsin bankruptcy courts are bound by the *Prescott* decision). In such courts, the creditor's preference exposure in the scenario described above would be $15,000 because the creditor would not get "new value" credit for the $5,000 in goods shipped 70 days prior to the petition date; therefore, both the full initial $10,000 payment and the $5,000 payment would be subject to avoidance as preferential payments.

"New Value" That Is Paid Post-Petition

One of the primary unresolved issues relating to the "new value" defense is whether the "new value" must remain unpaid indefinitely, or whether it need only to have been unpaid as of the bankruptcy petition date. While several courts have stated, arguably in dicta, that "new value" must remain unpaid as of the petition date,[2] until recently, few courts have squarely addressed the issue of whether post-petition payment of invoices that were unpaid as of the petition date renders such "new value" unusable as a preference defense.

Section 503(b)(9) of the Bankruptcy Code grants administrative priority to certain unsecured claims for goods shipped and received by the debtor within 20 days preceding the debtor's bankruptcy filing. 11 U.S.C. § 503(b)(9). Accordingly, courts often enter orders allowing payment of such "503(b)(9) claims" shortly after the debtor's bankruptcy filing. Because the invoices comprising a creditor's 503(b)(9)

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claim were unpaid as of the petition date but become paid post-petition, a question arises as to whether or not these 503(b)(9) invoices can be used as both an administrative claim and as "new value" to offset preference exposure. A similar situation arises where a creditor's prepetition claim is paid pursuant to a court order permitting payment of prepetition invoices to "critical vendors."

Recently, several courts have held that "new value" is fixed as of the petition date; therefore, post-petition payments of prepetition amounts, such as 503(b)(9) claims, do not prevent those amounts from being asserted as "new value" in a preference action. *Burtch v. Revchem Composites, Inc. (In re Sierra Concrete Design, Inc.)*, 463 B.R. 302, 306 (Bankr. D. Del. 2012); *Friedman's Inc. v. Roth Staffing Companies, L.P. (In re Friedman's Inc.)*, Adv. No. 09-50364, 2011 WL 5975283 at *4 (Bankr. D. Del. Nov. 30, 2011); see also *McKloskey v. Schabel (In re Schabel)*, 338 B.R. 376 (Bankr. E.D. Wis. 2005) (allowing amounts to be used as "new value" despite the fact that such amounts had been partially repaid by the debtor voluntarily after discharge); *Commissary Operations, Inc. v. Dot Foods, Inc. et al. (In re Commissary Operations, Inc.)*, 421 B.R. 873, 878 (Bankr. M.D. Tenn. 2010) (holding that possibility of payment on account of a 503(b)(9) claim does not remove such amounts from definition of "new value").

However, some courts have held that post-petition payment of amounts that were unpaid as of the petition date negates such amounts' qualification as "new value" because section 547(c)(4)(B) requires that amounts used as "new value" remain unpaid indefinitely.[3] *Circuit City Stores, Inc. v. Mitsubishi Digital Electronics America, Inc. (In re Circuit City Stores, Inc.)*, Adv. No. 10-03069, 2010 WL 4956022 at *8 (Bankr. E.D. Va. Dec. 1, 2010); *TI Acquisition, Inc. v. Southern Polymer, Inc. (In re TI Acquisition, Inc.)*, 429 B.R. 377, 385-386 (Bankr. N.D. Ga. 2010); *Moglia v. American Psychological Ass'n (In re Login Bros. Book Co., Inc.)*, 294 B.R. 297, 300-301 (Bankr. N.D. Ill. 2003); but see *Energy Cooperative, Inc. v. Cities Serv. Co. (In re Energy Cooperative, Inc.)*, 130 B.R. 781, 789 (N.D. Ill. 1991) (expressly holding, as have more recent courts, that the requirement that new value remain unpaid applies only through the date of the filing of the bankruptcy petition).[4]

For now, this issue remains largely unresolved, and is decided on a case-by-case, court-by-court basis. In coming years, this issue is likely to be addressed by various circuit courts of appeal.

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Conclusion

The application of the "new value" defense varies somewhat from jurisdiction to jurisdiction, with some courts taking a liberal view of "new value" and others limiting its availability as a defense. Accordingly, jurisdictional differences should be considered when formulating defenses to preference complaints.

Please contact your Reinhart attorney or any attorney in Reinhart's Bankruptcy and Creditors' Rights Legal Service Area if you have any questions concerning the application of the "new value" defense.

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[1] There are a number of other preference defenses available to creditors, including the widely used "ordinary course" defense. If you are the recipient of a preference demand or the defendant in preference litigation, your attorney can discuss your best defenses with you.

[2] *See e.g., New York City Shoes, Inc. v. Bentley Int'l, Inc. (In re New York City Shoes, Inc.)*, 880 F.2d 679, 680 (3d Cir. 1989) (noting that section 547(c)(4) requires that "the debtor must not have fully compensated the creditor for the 'new value' as of the date that it filed its bankruptcy petition" in a case where post-petition payment of new value was not at issue); *U.S. Bank Nat'l Ass'n v. Plains Marketing Canada LP (In re Renew Energy LLC)*, 463 B.R. 475, 483 (Bankr. W.D. Wis. 2011) (citing *In re Globe Bldg. Materials, Inc.*, 484 F.3d 946, 949 (7th Cir. 2007) for proposition that “new value” must remain unpaid "as of the date of the bankruptcy petition").

[3] One wonders how these courts reconcile their holdings with the fact that many general unsecured claims will eventually be partially repaid through the bankruptcy process. It would be nonsensical to argue that general unsecured claim amounts cannot be used as "new value" in a preference case, as this would negate the "new value" defense altogether. However, following these courts' logic to its ultimate conclusion—that "new value" amounts must remain unpaid in perpetuity—any amounts paid on account of an unsecured claim would have to be removed from the definition of "new value." Because payments on general unsecured claims are often not made until after preference litigation is concluded, it would be virtually impossible to "true up" the "new value" amounts and the post-petition payments.

[4] It appears that the bankruptcy court in the Login Bros. Book Co. case simply ignored the binding precedent of the Northern District of Illinois court in issuing its decision.

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