

A SECOND LOOK AT THE NEW VALUE DEFENSE

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The new value defense is one of the most frequently raised defenses to a preference action. Generally, it has been touted as a simple, mathematical defense, which is not fact-sensitive and the scope and extent of which is easily determinable. Every professional who is involved in preference litigation has his or her standard new value charts, into which the alleged preferential transfers and new value are plugged. However, the possible theories by which new value may be disqualified are growing and changing and, for this reason, professionals should take a second look at the new value defense.

The new value defense is codified in section 547(c)(4) of the Bankruptcy Code² and, in essence, provides that a preferential transfer to or for the benefit of a creditor may not be avoided:

[T]o 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 such new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor ...

11 U.S.C. §547(c)(4) (emphasis added).

Clearly, not all “new value” may be utilized to reduce prior preferential payments. For

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² References to the Bankruptcy Code mean title 11 of the United States Code, §101, et seq.

example, if the new value is properly secured, it cannot be used. Likewise, new value that is paid by a non-preferential transfer is ineligible; such as new value paid by a cash-in-advance payment or by a payment that is shielded by the section 547(c)(2) ordinary course of business defense. However, the possible theories by which new value may be disqualified are evolving in the following ways.

I. “[A]fter such transfer, such creditor gave new value”

There are at least two issues raised by this phrase. For example: Can the new value only be used to reduce the immediately preceding transfer or any prior transfers? What if the transfer was made and the new value was given on the same day?

With respect to the first issue, new value may be used not only to shield the immediately preceding transfer but also any preference liability that remains from other, though not immediately preceding, transfers. See In re Meredith Manor, Inc., 902 F.2d 257, 259 (4th Cir. 1990); In re IRFM, Inc., 52 F.3d 228, 232 (9th Cir. 1995); In re Micro Innovations Corp., 185 F.3d 329, 336 (5th Cir. 1999). With respect to the second issue, the creditor bears the burden of proving that the new value was given after the transfer was made. 11 U.S.C. §547(g). Thus, if the transfer and the new value occur on the same date, the creditor must provide evidence of the date and time on which the new value was delivered and prove that the new value was given after the transfer was made. It is anticipated that the need for a creditor to obtain records from third-party transit companies and deposit records from banks to meet its burden of proof will increase.

II. “[S]uch creditor gave new value to or for the benefit of the debtor ... on account of such new value, the debtor did not make ...”

The use of the defined term “debtor” in section 547(c)(4) raises the question whether new value given to a debtor-in-possession or transfers made by a debtor-in-possession should be

disregarded for purposes of the new value defense.

Sections 101(13) and (41) of the Bankruptcy Code (when read together) define a “debtor” as the person (that is, an individual, partnership or corporation) or municipality concerning which a case has been commenced. Section 1101 of the Bankruptcy Code generally provides that, for purposes of chapter 11 only, a “debtor-in-possession” means a “debtor.” Indeed, the entity operating after the filing of a chapter 11 petition is generally considered a separate and distinct entity from the entity that filed the bankruptcy petition. For example, section 1107(b) of the Bankruptcy Code provides that a professional is not disqualified for employment by a “debtor-in-possession” under section 327 of the Bankruptcy Code only because such professional was employed by the “debtor” before the commencement of the case. An argument can easily be made that, if it was the drafters’ intent to have the terms debtor and debtor-in-possession represent the same entity in chapter 5 (and in other chapters) of the Bankruptcy Code, it would not have limited the applicability of section 1101 to chapter 11 only.

Several courts have relied on the distinction between the pre-petition “debtor” and the post-petition “debtor-in-possession” to prohibit creditors from using post-petition new value (that is, new value provided to a debtor-in-possession after the petition date) as part of a new value defense. For example, in In re D.J. Management Group, 161 B.R. 5 (Bankr. W.D.N.Y 1993), the court held that a supplier was not entitled to a new value credit for supplies it provided to the debtor’s bankruptcy estate after the petition date, concluding that new value is appropriate only if such new value is extended for the benefit of the debtor as opposed to the debtor’s bankruptcy estate. The court stated that the “phrase ‘the debtor’ is systematically used throughout the Bankruptcy Code to connote an entity different from ‘the estate,’ ... or ‘the debtor-in-possession.’” If Congress had intended to recognize a ‘new value’ exception for credit extended

to the ‘estate’ ... it would not have used the word ‘debtor.’” Id. at 6. See also, In re TennOhio Transportation Co., 255 B.R. 307, 310 (Bankr. S.D. Oh. 2000) (same); In re Sharoff Food Serv., Inc., 179 B.R. 669, 678 (Bankr. D. Colo. 1995) (same); In re Jolly ‘N’ Inc., 122 B.R. 897, 909 (Bankr. D. N.J. 1991) (same).

Similarly, at least one court has held that post-petition transfers on account of pre-petition new value rendered by a creditor did not disqualify such new value. In In re Phoenix Restaurant Group Inc., 317 B.R. 491 (Bankr. M.D. Tenn. 2004), the debtor made seven transfers to the creditor during the preference period and, after receiving such transfers, the creditor provided new value to the debtor that remained unpaid as of the petition date. After the petition date, however, the debtor paid the creditor on account of pre-petition invoices pursuant to a critical vendor order allowing payment of pre-petition employee obligations. Id. at 493.

The issue before the court was whether the debtor’s post-petition payment to the creditor on account of pre-petition services reduced the new value the creditor could assert in defense to a preference action. In holding that post-petition transfers on account of pre-petition services rendered by a creditor do not negate new value provided by such creditor, the court determined that “debtor” referenced in section 547(c)(4)(B) refers only to transfers by the “pre-petition debtor” and not the post-petition debtor-in-possession. The court stated:

Had Congress intended §547(c)(4)(B) to account for payments made post-petition, the section would have included something like ‘an otherwise unavoidable transfer of an interest of the estate in property to or for the benefit of such creditor.’ Instead, Congress disqualified only new value paid for by ‘the debtor’ with an otherwise unavoidable transfer.

Id. at 497. The court concluded that the reference to “debtor” effectively ends the analysis under section 547(c)(4) at the petition date.

Yet, other courts have held that post-petition payments made by a debtor-in-possession

eliminate the pre-petition new value paid thereby. For example, in In re NETtel Corp., Inc., 323 B.R. 1, 6 (Bankr. D.D.C. 2005), the court recognized that post-petition payments by the debtor-in-possession or trustee on a creditor's pre-petition invoice pursuant to a critical vendor program would take that invoice out of the calculation for new value if the post-petition is otherwise immune from avoidance. This interpretation essentially reads "the debtor did not make an otherwise unavoidable transfer" to also include payments by the debtor-in-possession.

Likewise, in In re Login Bros. Book Co., 294 B.R. 297 (Bankr. N.D. Ill. 2003), the court held that a creditor's new value defense was reduced by the amount of a post-petition return of such new value. The alleged new value was shipped by the creditor to the debtor following a preferential payment, and was returned to the creditor after the petition date pursuant to an order of the court. Because the post-petition return of the new value was made pursuant to court order, the court reasoned that it was "an otherwise unavoidable transfer" under subsection 547(c)(4)(B) and reduced the creditor's new value defense by the amount of that transfer. Id. at 300. The court stated that:

[B]oth the plain language and policy behind the statute indicate that the timing of a repayment of new value is irrelevant. The statutory requirement that new value not be repaid – set out at §547(c)(4)(B) – contains no limitation on the time that the repayment or return of new value (the 'otherwise unavoidable transfer to or for the benefit of such creditor') must occur ... And the policy behind the new value exception – that the estate be replenished by the new value – would be defeated if a creditor were allowed to keep a preferential payment of its debt on account of a new value contribution to the estate and also receive repayment of that contribution, regardless of whether the repayment occurred before or after the commencement of the bankruptcy case.

Id. See also, In re MMR Holding Corp., 203 B.R. 605, 609 (Bankr. M.D. La. 1996) ("[a]n unavoidable post-petition transfer on account of new value extended subsequent to a preference

should limit the use of §547(c)(4) by the amount of the unavoidable transfer, as without a reduction in the new value offset, the transferee would be receiving double use of the new value...”); In re JKJ Chevrolet Inc., 412 F.3d 545, 553 n.6 (4th Cir. 2005) (citing Login Bros. for the proposition that post-petition transfers may be considered under §547(c)(4)(B)).

III. [T]he debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor ...”

A strict reading of section 547(c)(4) of the Bankruptcy Code provides that a preferential transfer may not be avoided to the extent that, after such transfer, the creditor gave new value to the debtor that (i) is not secured by an otherwise unavoidable security interest, and (ii) on account of such new value the debtor did not make an otherwise unavoidable transfer to the creditor. Some courts have, however, added a third requirement to the new value defense – that is, the requirement that the new value must have remained unpaid. The rationale under which courts have added this third requirement is generally that, if a creditor receive payment on account of the new value, the debtor’s bankruptcy estate has not been replenished and, consequently, the creditor would thereby be permitted a double benefit of a new value defense – offsetting a prior preference payment while retaining the payment on the new value. However, the decisions that have added this third requirement have been criticized by several Circuit Courts of Appeal and the view not requiring new value to remain unpaid is clearly favored by courts more recently considering the issue. Indeed, virtually every court that has recently considered the question of whether new value must remain unpaid, when not bound by *stare decisis*, has rejected the proposition that it must remain unpaid.

The view that new value need not remain unpaid as of the petition date is known as either the “subsequent advance” approach or the “emerging view,” and focuses on a literal reading of section 547(c)(4)(B), as opposed to the judicial shorthand that gave rise to the unpaid new value

approach. Under the “subsequent advance” approach, the proper inquiry is not whether the new value extended by the creditor remains unpaid at the end of the preference period but, rather, “whether the new value has been paid for by an otherwise unavoidable transfer.” Prof. Countryman’s authoritative explanation of the “subsequent advance” approach has been cited repeatedly by the Circuit Courts of Appeal that have adopted this approach:

If the debtor has made payments for goods or services that the creditor supplied on unsecured credit after an earlier preference, and if these subsequent payments are themselves voidable as preferences (or on any other ground), then under section 547(c)(4)(B) the creditor should be able to invoke those unsecured credit extensions as a defense to the recovery of the earlier voidable preference. On the other hand, the debtor’s subsequent payments might not be voidable on any ground and [are] not voidable under section 547, because the goods and services were given C.O.D. rather than on credit, or because the creditor has a defense under section 547(c)(1), (2), or (3). In this situation, the creditor may keep his payments but has no section 547(c)(4) defense to the trustee’s action to recover the earlier preference. In either event, the creditor gets credit only once for goods and services later supplied.

Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 Vand. L. Rev. 713, 788 (1985). Thus, under this approach, each advance of new value offered by the creditor may be used to offset the aggregate preference balance, provided that such new value has not been repaid by the debtor via an otherwise unavoidable transfer.

At this time, there is still a split among the Circuit Courts of Appeals on this issue. The Fourth, Fifth, Eighth and Ninth Circuits allow paid new value to be used as part of a new value defense if the payment is avoidable; the Third, Seventh, Tenth, and Eleventh Circuits require that the new value must remain unpaid; and the First, Second, and Sixth Circuits have not ruled on this issue (although there are lower court opinions on this issue). In particular:

1. Although the First Circuit has not ruled on this issue, a bankruptcy court, in In re Saco Local Development Corp., 30 B.R. 859, 861 (Bankr. D. Me. 1983), held that new value must remain unpaid.

2. The Second Circuit has not ruled on this issue and decisions by bankruptcy courts are split. In In re Baumgold Bros., 103 B.R. 436 (Bankr. S.D.N.Y. 1989), the bankruptcy court stated that the new value exception was not “designed to limit credit for subsequent advances only to advances that remained unpaid, as such an interpretation would limit the exemption in §547(c)(4) to one subsequent advance when Congress clearly contemplated its application to more than one exchange.” Id. at 440, citing In re Paula Saker & Co., Inc., 53 B.R. 630, 634 (Bankr. S.D.N.Y. 1985)). See also, In re Maxwell Newspapers, Inc., 192 B.R. 633, 639 (Bankr. S.D.N.Y. 1996) (same); In re Van Dyck/Columbia Printing, 289 B.R. 304, 314-315 (D. Conn. 2003) (same). Yet, in In re Pameco Corporation, 356 B.R. 327, 341 (Bankr. S.D.N.Y. 2006), the bankruptcy court stated that the “elements necessary to meet the defense are that (i) the debtor received new value after the transfer, and (ii) such new value remained unpaid. Id. at 341, citing In re Teligent, Inc., 315 B.R. 308, 315 (Bankr. S.D.N.Y. 2004).

3. The Third Circuit still requires that the new value must remain unpaid as of the petition date. In In re New York City Shoes, Inc., 880 F.2d 679 (3d Cir. 1989), the Third Circuit, in setting forth the requirements of the new value defense, stated:

The three requirements of section 547(c)(4) are well established. First, the creditor must have received a transfer that is otherwise avoidable as a preference under [section] 547(b). Second, *after* receiving the preferential transfer, the preferred creditor must advance ‘new value’ to the debtor on an unsecured basis. Third, the debtor must not have fully compensated the creditor for the ‘new value’ as of the date that it filed its bankruptcy petition . . . If a creditor satisfies these elements, it is entitled to set off the amount of ‘new value’ which remains unpaid on the date of the

petition against the amount which the creditor is required to return to the trustee on account of the preferential transfer it received.

Id. at 680 (emphasis added). However, a bankruptcy court in the Third Circuit allowed a creditor to use new value that was paid as of the petition date as part of its new value defense. In In re Hechinger, 2004 WL 3113718 (Bankr. D.Del. Dec. 14, 2004), the plaintiff sued the defendant under section 547(b) of the Bankruptcy Code to avoid a series of allegedly preferential transfers. Although New York City Shoes would seem to require that that new value must remain unpaid as of the petition date, visiting Judge Paul B. Lindsey distinguished New York City Shoes and held that new value need not remain unpaid. In particular, Judge Lindsey stated that “[t]here are thirty-four allegedly preferential transfers at issue during the preference period and this case is more akin to the running account or rolling account analysis ... than to New York City Shoes, which deals with just one transfer ... Based on the language of §547(c)(4)(B) and the policy reasons of the code section the court finds that New York City Shoes is distinguishable.” Id. at *5.

4. The Fourth Circuit allows paid new value if the new value was paid by an “otherwise unavoidable transfer”; that is, a transfer that can be avoided even if the debtor or the trustee fails to take action to avoid the transfer. In re JKJ Chevrolet, Inc., 412 F.3d 545, 552 (4th Cir. 2005).

5. The Fifth Circuit allows paid new value to be used as part of a new value defense if the payment of such new value is avoidable. In In re Toyota of Jefferson, Inc., 14 F.3d 1088, 1092 (5th Cir. 1994), the Fifth Circuit rejected the decisions requiring that new value remain unpaid as of the petition date and held that the requirements of a new value defense are that new value: (i) must have been extended after the preferential payment sought to be avoided; (ii) must

not be secured with an otherwise unavoidable security interest; and (iii) has not been repaid with an otherwise unavoidable transfer.

6. The Sixth Circuit has not ruled on this issue. However, one of the most detailed decisions focusing on the clear language of the statute is from a bankruptcy court in the Sixth Circuit. In In re Check Reporting Servs. Inc., 140 B.R. 425 (Bankr. W.D. Mich. 1992), the bankruptcy court closely analyzed the case law relevant to the question of whether new value must remain unpaid and the language of section 547(c)(4)(B). In response to the argument that it should impose a requirement that new value remain unpaid, the court noted that the failure of earlier courts to read section 547(c)(4) properly was attributed in part to “[t]he statutory language, [which] consists of several layers of negatives.” Id. at 431. The court concluded that, “although section 547(c)(4) does contain a double negative, this fact makes the statute complicated, not ambiguous.” Id. at 434. The court concluded that there is no requirement that new value remain unpaid. Id. at 434. See also, In re Phoenix Rest. Group Inc., 2005 WL 114327 *7-8 (Bankr. M.D. Tenn. Jan. 10, 2005) (same).

7. The Seventh Circuit requires that the new value remains unpaid. In In re John B. Prescott, 805 F.2d 719 (7th Cir. 1986), the Seventh Circuit, in outlining the requirements of the new value defense, stated:

Section 547(c)(4) establishes a subsequent advance rule whereby a preferential transfer is insulated from a trustee’s avoiding powers to the extent that a creditor extends new value, which is unsecured and remains unpaid, to a debtor after the preferential transfer.

Id. at 728 (emphasis added) (citing In re Saco Local Development Corp., 30 B.R. 859, 861 (Bankr. D. Me. 1983)).

8. The Eighth Circuit has ruled that new value need not remain unpaid. In In re Jones Truck Lines, Inc., 130 F.3d 323 (8th Cir. 1997), the Eighth Circuit, citing to other Circuit

opinions in which the courts did not require that new value remain unpaid as of the petition date, stated that “we agree with courts that have construed our reference to ‘remaining unpaid’ as ‘an adequate shorthand description of [section] 547(c)(4)(B).” The court then held that the debtor’s “‘otherwise avoidable’ payments did not deprive [the creditor] of section 547(c)(4) protection.” Id. at 329. There exists, however, two earlier Eighth Circuit decisions that, in dicta, require that amounts remain unpaid and the Jones Truck Lines court did not expressly overrule these decisions. See In re Southern Technical College, Inc., 89 F.3d 1381, 1384-1385 (8th Cir. 1996) (new value must remain unpaid as of the petition date); In re Kroh Brothers Development Co., 930 F.2d 648, 653 (8th Cir. 1991) (same).

9. The Ninth Circuit has held that new value need not remain unpaid so long as the payment was an avoidable transfer. In In re IRFM, Inc., 52 F.3d 228 (9th Cir. 1995), the Ninth Circuit, in affirming the district court, held that new value provided to the debtor during the preference period did not need to remain unpaid in order for the creditor to utilize the new value defense of section 547(c)(4) of the Bankruptcy Code, if the payment with respect to such new value was an avoidable transfer. The Ninth Circuit stated:

First, to calculate the new value defense, consideration must be given to whether an increment of new value has been paid for by something other than an avoidable transfer. If so, this increment of new value may not be included in calculating the amount of the new value defense.

Second, assurance must be given that the creditor will not attempt to obtain double credit for a transfer. This requirement may be satisfied by disallowing a creditor from asserting a separate section 547(c) defense against a preference when the creditor has already used section 547(c)(4) to offset that preference. Subsequent advances of new value may be used to offset prior (although not immediately prior) preferences. A creditor is permitted to carry forward preferences until they are exhausted by subsequent advances of new value.

Id. at 228 (emphasis added).

10. Although the Tenth Circuit has not ruled on this issue, in In re Sunset Sales, Inc., 220 B.R. 1005, 1022 (B.A.P. 10th Cir. 1998), the Bankruptcy Appellate Panel affirmed the bankruptcy court's conclusion that the successful assertion of the new value defense required the creditor to demonstrate the following three elements: (i) a preference was received; (ii) after the preference was received, the creditor advanced additional credit to the debtor on an unsecured basis; and (iii) the post-preference credit was unpaid in whole or in part on the petition date.

11. The Eleventh Circuit has held that new value must remain unpaid. In In re Jet Florida System, Inc., 841 F.2d 1082, 1083 (11th Cir. 1988), the Eleventh Circuit stated that section 547(c)(4) requires "(1) that the creditor must have extended the new value after receiving the challenged payments, (2) that the new value must have been unsecured, and (3) that the new value must remain unpaid."

IV. Impact of Post-Petition Events on the Unpaid vs. Paid Debate

If a creditor receives a payment for pre-petition goods or services after a bankruptcy petition is filed, does that payment eliminate the use of the underlying new value? Not surprising, the party responsible for pursuing preference actions – a trustee, debtor-in-possession, or a plan administrator – will argue that such post-petition payment negates the use of the paid - for goods or services as part of a new value defense. However, such an argument is not a simple one. It involves not only the debate as to whether the terms "debtor" and "debtor-in-possession" are interchangeable for purposes of this defense (which is discussed above), but the argument also focuses on the timing and the avoidability of the payment.

As stated above, some circuits require new value to remain unpaid as of the petition date to be eligible for a new value defense. Certain courts in these circuits have held that post-petition payment of pre-petition invoices are irrelevant to the new value analysis in that *the only*

relevant inquiry is whether new value was unpaid as of the petition date. Thus, post-petition payments made to a creditor by a debtor-in-possession cannot reduce that creditor's subsequent new value defense. See e.g., In re Thurman Construction, Inc., 189 B.R. 1004, 1014 (Bankr. M.D. Fla. 1995); In re Energy Cooperative, Inc., 130 B.R. 781, 789 (Bankr. N.D. Ill. 1991). Accordingly, the payment of an administrative claim – such as a section 503(b)(9) – should not affect a creditor's new value defense. Interestingly, the tendency of courts to postpone the payment of section 503(b)(9) claims may actually help creditors, especially if a preference claim is prosecuted before the administrative claim is paid.

Other courts have focused their analysis on whether such payments are “otherwise unavoidable” as required by the explicit language of section 547(c)(4), rather than on the timing of such payments. For example, a key inquiry would be whether the payment was authorized by the court (and not recoverable pursuant to section 549), such as a payment made pursuant to a critical vendor program or in satisfaction of an administrative claim pursuant to section 546(c) (reclamation claim) or section 503(b)(9) (goods received within twenty days of the petition date). Further, even if the payment was authorized, would claw-back provisions in the authorization change the end result? In other words, if the post-petition payments can be avoided, the new value paid thereby may be available for use in a new value defense. If, however, payments cannot be avoided, new value paid thereby would not be available for use in new value defense. See e.g., Toyota of Jefferson, 14 F.3d at 1093 n. 2; In re PNP Holdings Corp., 167 B.R. 619, 629 (Bankr. W.D. Wash. 1994). The theory underlying these holdings is that, if the payment with respect to the new value cannot be avoided on behalf of the debtor, the debtor's bankruptcy estate has not been replenished by the new value and, consequently, the creditor would be permitted the double benefit of a new value defense and the repayment of the new value. It is

important to note that courts focus on whether payments are avoidable and *not* on whether payments were actually avoided.

V. SUMMARY

The scope and extent of the new value defense is evolving and the ability to use “paid” new value is still dependent upon where the debtor filed its bankruptcy case. However, the debate as to the ability to use paid new value will continue to grow in importance as unsecured creditors begin receiving payment for goods delivered within twenty days of the petition date pursuant to section 503(b)(9) of the Bankruptcy Code. A second look at the new value defense is encouraged.