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Paid New Value Reduces Preference Liability Yet Again!

A creditor defending a preference claim frequently relies upon the subsequent new value defense under Section 547(c)(4) of the Bankruptcy Code. A creditor can get more mileage out of the new value defense to reduce its preference liability by relying on both paid and unpaid new value. However, paid new value as a defense to preference liability is not as clear cut as unpaid new value.

The United States District Court in New Hampshire, in the *Amherst Technologies, LLC* bankruptcy case, has joined the bandwagon of court decisions that have allowed paid for new value by recently ruling that Section 547(c)(4) allows a preference defendant to include *both* paid and unpaid new value as part of its new value defense. This is more good news as we usher in 2012 for trade creditors dealing with the onslaught of preference actions being commenced by trustees these days.



computer components, to Amherst on an unsecured credit basis for over nine years.

Before the end of 2004, Amherst usually paid Avnet's invoices within 60 days. However, Amherst's balances owing to Avnet had substantially increased by the end of 2004 as a result of an influx of orders that required Amherst to purchase additional goods from Avnet. Avnet, thereafter, insisted that Amherst reduce its outstanding balance owing to Avnet. Avnet sought to reduce its exposure by having Amherst pay Avnet \$2.00 for every \$1.00 of goods that Avnet had sold and delivered to Amherst on many new orders. As a result, Amherst's payments to Avnet from late April 2005 through June 24, 2005 were applied to nearly 300 invoices, all but nine of which were for invoices more than 60 days old.

In late June 2005, Amherst ordered \$4 million of software from Avnet to fill a large order that Amherst had

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The Facts of the *Amherst Case*

Amherst Technologies, LLC was a value-added retailer that provided information technology services to its customers. Avnet, Inc., Amherst's largest unsecured creditor, is a global distributor of electronic products. Avnet sold goods, consisting primarily of software and

received from American Honda. On June 29 and 30, Amherst issued checks made payable to Avnet totaling \$4 million, and directed that Avnet apply \$2.9 million to pay Avnet's outstanding invoices and the remaining \$1.1 million as pre-payment for the software Amherst had ordered from Avnet to fill the Honda order.

On July 1, 2005, Avnet delivered \$4 million of software to Amherst to fill the Honda order. Between April 20, 2005 and July 13, 2005 (the date of Amherst's last pre-petition payment to Avnet), Amherst paid Avnet a total of \$8.1 million on outstanding invoices. During the same period, Avnet shipped software and computer components, on unsecured credit terms and at invoice prices totaling in excess of over \$7 million, to either Amherst or Amherst's customers on Amherst's behalf. Amherst used a portion of the June 29 and 30 payments to pay for a portion of these shipments.

On July 20, 2005 (the "Petition Date") Amherst filed for bankruptcy and a trustee was appointed. Avnet claimed that Amherst owed it more than \$5.3 million on outstanding invoices on the Petition Date.

In July 2007, the trustee commenced a lawsuit against Avnet seeking to avoid and recover as preferences the \$8.1 million of payments that Avnet had received from Amherst during the 90-day period prior to Amherst's bankruptcy filing. The bankruptcy court awarded the trustee only \$337,521 by counting both unpaid and paid new value as part of Avnet's Section 547(c)(4) subsequent new value defense. The bankruptcy court concluded that Avnet had provided new value every time it had delivered software and computer components to Amherst and its customers during the preference period. It did not matter that some of the new value that Avnet had asserted was "paid for" because the payment for such new value was *not* subject to the Section 547(c)(1) contemporaneous exchange for new value (COD) or Section 547(c)(2) ordinary course of business defenses.

The trustee appealed the bankruptcy court's judgment to the United States District Court. The trustee asserted that Avnet's preference liability exceeded \$4 million, rather than the \$337,521 awarded by the bankruptcy court, because Avnet could assert only new value that was unpaid on the Petition Date as part of its Section 547(c)(4) subsequent new value defense. The trustee argued that it would be unfair to other creditors if Avnet were able to obtain the double benefit of reducing its preference liability by new value that was subsequently repaid.

The Section 547(c)(4) Subsequent New Value Defense

There are several defenses that a creditor can assert to reduce or eliminate liability on a preference claim. Section 547(c)(4)'s subsequent new value defense is one such preference defense. The subsequent new value defense reduces a creditor's preference exposure to the extent the creditor had replenished the debtor, by providing new goods or services subsequent to the

preference. This defense applies to all sales and deliveries of goods, or provisions of services, on credit terms to the debtor subsequent to the preference. It is based on the creditor's replenishment of the debtor's estate by providing new value, such as new goods or services, subsequent to the preference. The new value defense is supposed to encourage a creditor to continue doing business with its financially distressed customers by promoting continued revolving credit arrangements where the creditor is continuing to advance new value (goods or services provided on credit terms) to the debtor after the debtor's payment of old debt.

One of the requirements of the subsequent new value defense, contained in Section 547(c)(4)(B), precludes a creditor from counting any new value that was paid *by an otherwise unavoidable transfer to or for the creditor's benefit*. Section 547(c)(4)(B) suggests some new value can be paid by the debtor and still be included as part of a creditor's new value defense. Paid new value counts where the payment of the new value is an avoidable preference that is *not* subject to any other preference defense (other than the new value defense), such as Section 547(c)(2)'s ordinary course of business or Section 547(c)(1)'s contemporaneous exchange for new value defense.

The trustee argued that it would be unfair to other creditors if Avnet were able to obtain the double benefit of reducing its preference liability by new value that was subsequently repaid.

While Section 547(c)(4)(B) allows paid for new value in certain circumstances, the United States Courts of Appeal (the federal courts immediately below the U.S. Supreme Court) have reached differing holdings on whether the Section 547(c)(4) new value defense includes paid for new value. The Third Circuit Court of Appeals (covering New Jersey, Pennsylvania, Delaware and the Virgin Islands), in *New York City Shoes, Inc.*; the Seventh Circuit Court of Appeals (covering, Illinois, Indiana and Wisconsin), in *Matter of Prescott*; and the Eleventh Circuit Court of Appeals (covering Alabama, Florida and Georgia), in *In re Jet Florida Systems, Inc.*, have been cited as holding that new value must remain unpaid in order to be eligible as a defense to a preference claim under Section 547(c)(4). The Fourth Circuit Court of Appeals (covering Maryland, North and South Carolina, Virginia and West Virginia), in *JK Chrysler-Plymouth*; the Fifth Circuit Court of Appeals (covering Louisiana, Mississippi and Texas), in *Matter of Toyota of Jefferson, Inc.*; and the Ninth Circuit Court of Appeals (covering Arizona, California, Idaho, Montana, Nevada, Oregon and Washington), in *In re IRFM, Inc.*, held that paid for new value reduces preference exposure as long as the new value was not paid by an "otherwise unavoidable transfer." The Eighth Circuit Court of Appeals (covering Arkansas, Iowa, Minnesota, Missouri, Nebraska, and North and South Dakota) has reached conflicting holdings on the applicability of

paid new value as a preference defense. The other circuit Courts of Appeal, covering the remaining states and including the First Circuit (where the *Amherst* court sits), have not ruled on whether a creditor can include paid new value as part of its defense to a preference claim, leaving it to the lower courts in these Circuits to decide whether new value can be paid.

The *Amherst* District Court was called upon to decide the circumstances under which paid for new value can count to reduce a creditor's preference exposure. That required the court to determine the meaning of Section 547(c)(4)(B)'s requirement that the new value cannot be paid by "*an otherwise unavoidable transfer to or for the benefit of such creditor.*"

The *Amherst* District Court's Holding

The United States District Court in *Amherst* upheld the bankruptcy court's holding that Avnet could avail itself of both paid and unpaid new value to reduce its preference liability to \$337,521, instead of the greater than \$4 million sought by the trustee based on only unpaid new value. The court relied on the holding of the United States Bankruptcy Court for the Western District of Michigan in *In re Check Reporting Services*. The plain meaning of Section 547(c)(4)(B) counts all paid new value to reduce a creditor's preference liability as long as the payment of new value is itself "otherwise avoidable" by the trustee. The *Check Reporting Services* court reached its holding because:

"...[t]here was no logical reason to distinguish between a creditor that was paid for an avoidable transfer and one that was never paid at all. At the end of the day, in both cases the creditor has been wholly uncompensated for his new value."

The *Amherst* District Court also adopted the bankruptcy court's holding that paid for new value counts to reduce preference liability as long as the payment is not protected by any of the other preference defenses, (*apart from* the new value defense). The bankruptcy court interpreted the word "otherwise," included in Section 547(c)(4)(B)'s requirement that the debtor did not make an otherwise unavoidable transfer on account of the new value, as relating to all preference defenses *other than* Section 547(c)(4) new value defense. Thus, payment of a debtor's invoices, that are included as part of a creditor's new value defense, disqualify the new value from offsetting the creditor's preference liability when the payment is *unavoidable* under Section 547(c)(1)'s contemporaneous exchange for new value (COD) defense or Section 547(c)(2)'s ordinary course of business defense, but not when the payment is unavoidable under the Section 547(c)(4) new value defense.

Allowing this paid for new value encourages creditors to continue extending unsecured credit to financially distressed companies and thereby give these companies the time they need to resolve their problems. It also rewards creditors that continue to do business with a struggling customer by reducing their preference liability through their reliance upon both paid and unpaid new value as part of their Section 547(c)(4)

subsequent new value defense. That mitigation of risk is contingent upon the creditor's thereafter continuing to provide the debtor with something of value, such as new goods or services, that benefits the debtor's estate. A creditor seeking to protect itself from preference risk arising from a debtor's payment for previously advanced new value must provide new credit (new goods or services) and if that second extension of credit is paid, the creditor must thereafter advance yet more credit by providing additional goods or services. The benefit to *Amherst's* estate from such allowance of paid new value outweighs the risk to *Amherst's* other creditors of any "double dip" resulting from Avnet's reduction of preference liability due to Avnet's new value that was subsequently repaid.

The Section 547(c)(1) Contemporaneous Exchange for New Value (COD) Defense Did Not Apply to Limit Avnet's Paid for New Value Defense

The trustee also attempted to limit Avnet's paid new value defense by arguing that *Amherst's* payments to Avnet on June 29 and 30, for outstanding invoices, included as part of Avnet's new value defense, were subject to Section 547(c)(1)'s contemporaneous exchange for new value defense. As a result, at least according to the trustee, the paid for new value claimed by Avnet did not satisfy Section 547(c)(4)(B) because it was "otherwise unavoidable" under Section 547(c)(1).

The benefit to *Amherst's* estate from such allowance of paid new value outweighs the risk to *Amherst's* other creditors of any "double dip" resulting from Avnet's reduction of preference liability due to Avnet's new value that was subsequently repaid.

The Section 547(c)(1) contemporaneous exchange for new value defense excuses any payment or other transfer that the debtor and creditor had intended as a contemporaneous exchange for new value and was, in fact, a substantially contemporaneous exchange. Section 547(c)(1), like the other preference defenses, is supposed to encourage creditors to continue doing business with, and extending credit to, financially troubled companies. A creditor that provides new goods and/or services substantially contemporaneously with a payment (such as a payment by check) replenishes the debtor and should not be forced to return the payment based on the credit extended for the time it took for the check to clear the debtor's bank.

The trustee argued that *Amherst* and Avnet had intended the June 29 and 30, 2005 payments totaling \$4 million to be

contemporaneously exchanged for the new Honda software invoiced at \$4 million that Avnet was selling to Amherst. It did not matter that Avnet, per Amherst's instructions, had applied a portion of the June 29 and 30 payments to outstanding invoices for antecedent debt because Amherst and Avnet had intended to exchange the \$4 million of payments on June 29 and 30 for new Honda software worth \$4 million, regardless of how Avnet applied these payments. The trustee relied on an "I ship, you pay" argument, where Amherst and Avnet had intended a contemporaneous exchange based on an understanding that Avnet would not ship the Honda software until Amherst had made the June 29 and 30 payments to Avnet. If the court accepted the trustee's position, Amherst's payment of Avnet's new value would have been unavoidable, as subject to the Section 547(c)(1) contemporaneous exchange for new value defense, and would not be counted as part of Avnet's new value defense .

The *Amherst* court rejected the trustee's argument, holding that Avnet did not satisfy Section 547(c)(1)'s contemporaneous exchange for new value defense. This defense applies to COD transactions and protects a debtor's payment for goods or services that were contemporaneously provided to the creditor, such as payment for goods or services by check. A creditor's provision of goods or services in exchange for the debtor's payment of invoices for a prior shipment of goods or provision of services cannot be subject to the Section 547(c)(1) defense as a contemporaneous exchange for new value. Amherst's payments of \$2.9 million on June 29 and 30 toward outstanding invoices for prior shipments (that Avnet claimed as new value) were *not* "otherwise unavoidable" under Section 547(c)(1)'s contemporaneous exchange for new value defense. As such, the new value that was paid on June 29 and 30 was paid by an "avoidable preferential transfer" and should be counted as part of Avnet's Section 547(c)(4) subsequent new value defense.

Conclusion

The holding in the *Amherst* case is more good news for trade creditors confronting an increased risk of being sued on a preference claim. The recent trend in court decisions upholding paid for new value as part of a creditor's Section 547(c)(4) subsequent new value defense affords trade creditors a much better shot at reducing or eliminating their preference liability. What a nice way to usher in 2012; Happy New Year! ●

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