

Everything You Need to Know About New Value as a Preference Defense, and More

*By: Bruce S. Nathan,
Scott Cargill and
David M. Banker*

Abstract

Preference claims have always been a thorn in the side of every credit professional. However, there are defenses to preference claims that can reduce or eliminate the risk of liability. The new value defense, found in section 547(c)(4) of the Bankruptcy Code, is one such defense. It is based on the premise that, when a creditor provides a debtor with goods and/or services after the delivery of a preferential payment, the creditor should be able to apply such new value on a dollar for dollar basis to reduce its preference exposure.

While the new value defense sounds easy to prove, its application can be complex in practice and a savvy trustee may raise a number of obstacles that limit or altogether prohibit use of the defense. This article will address the mechanics of the new value defense, including its proper application to reduce a trade creditor's potential preference liability. The article also addresses a number of issues that a trustee may raise to attempt to reduce the effectiveness of the new value defense.

What is a Preference

Under section 547(b) of the Bankruptcy Code, a trustee can avoid and recover a transfer as a preference by satisfying all of the following requirements:

The debtor transferred its property to or for the benefit of a creditor. The debtor's transfer of any type of property may be avoided as a preference, but the most frequent example of a transfer is the debtor's payment to a creditor [section 547(b)(1)]; The transfer was made on account of antecedent or existing indebtedness that the debtor owed the creditor [section 547(b)(2)];

The transfer was made when the debtor was insolvent [section 547(b)(3)]. Insolvency is based on a balance sheet definition - liabilities exceeding assets. The debtor's insolvency within the 90-day preference period is also presumed, which makes it easier for the trustee to prove. The

creditor has the burden to present some evidence of the debtor's solvency to rebut this presumption. If rebutted, the burden shifts back to the trustee to prove the debtor's insolvency;

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

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.

What is the New Value Defense?

Once a trustee proves all of the above elements of a preference, there are affirmative defenses that can reduce a creditor's preference exposure. The new value defense, contained in section 547(c)(4) of the Bankruptcy Code, is one such defense that provides in relevant part:

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.

In short, a creditor satisfies the new value defense by proving that the creditor gave unsecured new value to the debtor by selling goods and/or providing services on credit terms after an alleged preference. In terms of dollars and cents, a trade creditor is entitled to an offset to reduce its preference liability to the extent the creditor had sold goods or provided services to the debtor on credit terms following delivery of each alleged preference payment.

The new value defense, like other preference defenses, is designed to encourage creditors to continue doing business with, and extending credit to, companies in financial distress. The new value defense protects creditors from preference exposure where the creditor replenishes the debtor and its bankruptcy estate by extending new credit subsequent to a preference payment. The net effect of the defense is that the debtor's other unsecured creditors are no worse off by the preferential payment to the extent of any new credit the creditor subsequently provides to the debtor. Of course, a trustee may contest a creditor's new value defense where the goods and/or services claimed as new value did not conform to what the debtor had ordered, or the goods were damaged, defective, rejected or returned, because the creditor did not provide value to the debtor.

The new value, however, cannot be secured by a security interest in the debtor's assets that is "otherwise unavoidable" and cannot be paid by "an otherwise unavoidable transfer" to or for the creditor's benefit. This limitation does not restrict the use of new value when it remains unpaid at

the time of the bankruptcy filing. However, there has been a plethora of arguments over whether a creditor can use new value that was paid during the preference period, to reduce preference exposure.

Calculation of the New Value Defense

New value is only available for the value of goods sold and delivered and services provided by a creditor to the debtor after the creditor had received a preferential payment. This new value credit is used to reduce the amount of the preferential payments previously received. A simple example of the application of the new value defense is set forth in the following table.

Date Payment Received or New Value Shipped	Preference Payment by Debtor	New Value Reduction	Preference Exposure (Running Balance)
1/1/2011	\$2,000		\$2,000
1/7/2011		\$500	\$1,500
1/8/2011		\$250	\$1,250

Excess new value can never be carried forward. To determine preference exposure based on the application of the new value defense, a creditor cannot simply net out the amount of all goods or services provided during the preference period from the total payments the creditor had received during the preference period (known as the “net result rule”). The following chart provides an example of the proper application of new value defense compared to improperly applying the net result rule:

Date Payment Received or New Value Shipped	Preference Payment by Debtor	New Value Reduction	Preference Exposure Proper Application of New Value (Running Balance)	Preference Exposure Improperly Carrying Forward New Value (Running Balance)
1/1/2011	\$2,000		\$2,000	\$2,000
1/7/2011		\$1,500	\$500	\$500
1/8/2011		\$1,000	\$0	-\$500
1/15/2011	\$1,000		\$1,000	\$500
1/21/2011		\$500	\$500	\$0

The majority of courts, including three U.S. Circuit Courts of Appeal (the federal courts immediately below the U.S. Supreme Court), namely, the Fourth Circuit (covering Maryland, North and South Carolina, Virginia and West Virginia), in *Crichton v. Wheeling Nat’l Bank (In re Meredith Manor Inc.)*, the Fifth Circuit (covering Louisiana, Mississippi and Texas), in *Williams v. Agama Systems (In re Micro Innovations Corp.)*, and the Ninth Circuit (covering Arizona, California, Idaho, Montana, Nevada, Oregon and Washington), in *Mosier v. Ever-Fresh Food Co. (In re IRFM Inc.)*, allow a creditor to deduct new value from the payment immediately preceding the extension of credit, as well as all prior preference payments. This methodology for

determining new value increases the amount of new value available to reduce a creditor's preference liability. These courts reasoned that the language of section 547(c)(4) shields all preferences to the extent of all new value that a creditor subsequently provides to a debtor (that is not otherwise disqualified under clauses (A) or (B) of section 547(c)(4)), and nothing in its language limits the application of new value to reduce only the immediately preceding preference payment. These courts have also concluded that their methodology for calculating new value furthers section 547(c)(4)'s goal of encouraging creditors to continue to deal with troubled companies. According to the *IRFM* court, creditors "will be more likely to continue to advance new value to a debtor if all these subsequent advances may be used to offset a prior preference."

However, over twenty years ago, the U.S. District Court for the District of Maine in *Leathers v. Prime Leather Finishes Co.*, limited the new value defense by allowing the creditor to apply a subsequent extension of credit to reduce only the immediately preceding preference payment. Contrary to the holdings of virtually all other courts that have considered this issue, the *Leathers* court prohibited carrying back the new value to prior preference payments.

The *Leathers* court rejected the net result rule, finding that the legislative intent behind the section 547(c)(4) new value defense, as set forth in the published legislative history, required that the calculation of new value be based on the formula set forth in section 547(c)(4). The court interpreted the statute literally, by allowing for a reduction in new value "after such transfer" is made as opposed to after all transfers are made, and held that "the proper mode of analysis is that after each preferential payment, an assessment must be made as to how much property the creditor restored to the debtor before the next preferential payment was made." The following chart compares the calculation of new value endorsed by the *Leathers* court to the calculation used by a majority of courts, and shows how *Leathers* methodology limits the amount of new value available to reduce preference liability:

Date Payment Received or New Value Shipped	Preference Payment by Debtor	New Value	Preference Exposure <i>Leathers</i> Calculation (Running Balance) ¹	Preference Exposure Proper Application of New Value (Running Balance)
1/1/2011	\$2,000		\$2,000	\$2,000
1/7/2011	\$1,000		\$3,000	\$3,000
1/8/2011		\$3,000	\$2,000	\$0

A creditor seeking to properly calculate its new value defense must also understand at what point new value is extended and at what point an alleged preference payment is received. New value is

¹ In this example, according to *Leathers*, the \$3,000 of new value provided on January 8 can only be used to reduce the payment that immediately preceded it (namely, the \$1,000 payment received on January 7), and could not be used to reduce that \$2,000 payment received on January 1 (which did not immediately precede the new value).

deemed extended when the goods leave the creditor's premises or the service is provided. It is not relevant when title passes under the parties' contracts.

Nearly every court that has ruled on this issue, including every U.S. Circuit Court that has addressed it, has held that the date of delivery, and not clearance, of the alleged preference payment should be used when calculating the new value defense. Do not confuse this with the U.S. Supreme Court's ruling in *Barnhill v. Johnson*, that a payment by check occurs upon clearance for the purpose of determining whether a payment was received within the 90-day preference period. The Court made clear that it did not decide the applicable transfer date for determining preference defenses, such as the new value defense.

Many courts have ruled that a check is delivered when the creditor receives the check, though some have argued that a check is delivered when it is deposited into the mail. This is consistent with the intention of the new value defense to encourage creditors to continue to do business with troubled companies. Creditors selling on credit terms treat their customer's payment by check as a cash transaction, and ordinarily ship new orders or provide services upon their receipt of a check. This facilitates continued business with a struggling company. Arguably, it would be inconsistent with Congressional policy to treat a goods or service provider, that extended credit to the debtor after receiving a check, less favorably than a seller that waited until clearance of the check to extend credit to the debtor. In either case, the debtor's estate was replenished by the creditor's extension of credit.

Situations often arise where goods are shipped or services are provided the same day that the creditor receives an alleged preference. In this situation, as a matter of law, the creditor would need to determine which action came first. As a matter of practice, when both occur on the same day, creditors typically argue the new value was extended after receipt of the alleged preference, which reduces their preference exposure. Of course, if the issue of timing is raised, the creditor has the burden of proving that the new value was provided after receipt of the check.

When services are provided over an extended period of time for a flat rate, such as under a leasing arrangement, the issue of how new value is applied is less black and white. Landlords may charge for monthly rent in advance at the beginning of the month. Does that mean that the new value should be counted as of the date the rent is payable, typically on the first day of the month to which the rent relates? In practice, when the new value provided cannot be easily linked to specific transactions, it should be prorated over the term to which the service relates. For example, if the rent on a property lease is \$3,000 per month for a 30 day month, the new value per day would be \$100.

Whether New Value Must Remain Unpaid

There is no question that the new value a creditor provides to a debtor following an alleged preference, that remains unpaid as of the bankruptcy filing date, counts as new value reducing preference liability. This is considered "unpaid new value."

However in many instances when a customer is financially distressed, a creditor will shorten payment terms in order to reduce its exposure. Creditors in certain industries also generally have shorter payment terms. In either instance, whenever the debtor pays within a shorter term, many

invoices related to goods shipped or services provided during the 90-day preference period will be paid. This results in creditors subject to preference exposure asserting that the new value they had provided to the debtor during the 90-day preference period and had paid for, should still be counted as new value to reduce their preference exposure.

The following example shows the difference in preference liability when applying solely unpaid new value, as opposed to counting both unpaid and paid new value.

Date Payment Received or New Value Shipped	Preference Payment by Debtor	New Value Reduction (Paid New Value Reflected with *)	Preference Exposure Counting Both Paid and Unpaid New Value (Running Balance)	Preference Exposure Counting Just Unpaid New Value (Running Balance)
1/10/2011	\$1,000		\$1,000	\$1,000
1/20/2011		\$1,000*	\$0	\$1,000
1/30/2011	\$1,000		\$1,000	\$2,000
2/10/2011		\$1,000*	\$0	\$2,000
2/20/2011	\$1,000		\$1,000	\$3,000
2/28/2011		\$1,000	\$0	\$2,000

The U.S. Third Circuit Court of Appeals, which includes New Jersey, Pennsylvania, Delaware and the Virgin Islands, has on two occasions [*New York City Shoes Inc. v. Bentley Int'l Inc. (In re New York City Shoes, Inc.)* and *Schubert v. Lucent Technologies Inc. (In re Winstar Comm'n Inc.)*], stated that the new value defense 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.” Based on these cases, many debtors and trustees have argued that the Third Circuit rejects the validity of paid new value as part of the new value defense. This position is also followed by the Seventh Circuit Court of Appeals (Illinois, Indiana and Wisconsin) in the *Matter of Prescott*; and the Eleventh Circuit Court of Appeals (Alabama, Florida and Georgia) in *Charisma Inv. Co., N.V. v. Airport Systems, Inc. (In re Jet Florida System, Inc.)*.

These courts have reasoned that new value must remain unpaid based on their interpretation of section 547(c)(4)(B)’s language that “[t]he 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 -- on account of which new value the debtor did not make an otherwise unavoidable transfer to...such creditor.” They reason that the policy and intent behind the preference statute, to promote the equality of treatment of creditors, dictates that new value remain unpaid. In that light, new value should only be allowed to the extent that it enhances and replenishes the bankruptcy estate. These courts have found no benefit to the estate where the new value was paid. Further, to the extent that creditors are entitled to assert paid new value as part of their new value defense, they would be receiving a double benefit because they were paid for the new value and were also able to use the new value to reduce their preference liability. Instead, allowing creditors to assert only unpaid new value as part of their new value defense, would promote the equality of treatment of creditors and be fair and equitable.

Conversely, the following U.S. Circuit Courts of Appeal have ruled that paid new value reduces preference exposure as long as the new value was not paid by an “otherwise unavoidable transfer”: the Fourth Circuit Court of Appeals, in *Crichton v. Wheeling Nat’l Bank (In re Meredith Manor Inc.)* and *Hall v. Chrysler Credit Corp. (JKJ Chevrolet, Inc.)*; the Fifth Circuit Court of Appeals, in *Laker v. Vallette (Matter of Toyota of Jefferson, Inc.)*; and the Ninth Circuit Court of Appeals, in *Mosier v. Ever-Fresh Food Co. (In re IRFM Inc.)*.

The courts that have allowed paid new value also rely on the language of section 547, and the policy behind it, but have come to the exact opposite conclusion. In contrast to those courts that accept only unpaid new value, courts giving credit for paid new value have noted that section 547(c)(4) is not ambiguous, and that a plain reading of the statute dictates that paid new value must be allowed where the payment for the new value is avoidable. If, on the other hand, the payment for the new value is protected by another preference defense (such as the ordinary course of business or contemporaneous exchange defense), or was a cash in advance payment that is not avoidable as a preference, the invoices it paid could not be included as part of a creditor’s new value defense. Courts giving credit for paid new value have concluded that courts allowing only unpaid new value have misinterpreted section 547(c)(4), and specifically the language in section 547(c)(4)(B) that “[t]he 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 -- on account of which new value the debtor did not make an otherwise unavoidable transfer to...such creditor.”

The rationale used by the courts allowing paid new value is that the bankruptcy estate is replenished by the new value, despite its repayment, by virtue of the preference recovery on account of the payment. These courts concluded it would be unfair for a creditor to continue to extend credit to a debtor in reliance on prior payments when, in reality, the creditor’s bankruptcy loss would be significantly increased if its paid for extensions of credit are not counted as new value (in that all of the payments received during the 90-day preference period could be counted as preferences – assuming no other preference defenses apply - without the ability to count any paid new value). This would be an unfair result for a creditor that conservatively extended credit during the preference period, got paid and then once again extended further credit. Courts requiring new value to remain unpaid have unduly narrowed the scope of section 547(c)(4). Their interpretation would result in a creditor not only losing the benefit of the paid new value, but also potentially returning the payment of the new value as a preference – in essence, a double detriment. Courts ruling in favor of allowing a reduction for paid new value have reasoned that there should be no distinction in the new value context between a creditor whose new value was paid by a transfer that is avoidable as a preference and a creditor that was never paid at all. Put another way, if the creditor had to give back the payment that paid the new value, in essence, the new value would then be unpaid, and should be counted by all courts as unpaid new value to reduce preference liability. Also, from a policy standpoint, courts ruling in favor of paid new value reason that it encourages creditors to extend credit to troubled companies on a revolving basis with the hope of avoiding bankruptcy. Protecting creditors who continue to replenish the debtor is not unfair to other creditors.

Two separate panels of the Eighth Circuit Court of Appeals (covering Arkansas, Iowa, Minnesota, Missouri, Nebraska and North and South Dakota) have handed down conflicting

opinions on the issue of whether new value must remain unpaid. In 1991, a panel of the Eight Circuit ruled, in *In re Kroh Brothers Development Co.*, that new value must remain unpaid, relying on the *New York City Shoes* case and the reasoning in favor of limiting new value to only unpaid new value stated above. In 1997, a different panel of the Eight Circuit ruled, in *In re Jones Truck Lines, Inc.*, that paid new value may be used to reduce preference exposure provided the new value was not paid by an “otherwise unavoidable transfer.”

The remainder of the U.S. Circuit Courts have not ruled on the “paid new value” issue. The bankruptcy courts within these circuits have ruled both ways, allowing paid new value as part of a creditor’s new value defense and limiting new value to only unpaid new value.

Recently, courts in the Third Circuit have questioned whether the Third Circuit Court of Appeals has ever ruled on the validity of “paid new value” as part of the new value defense. The issue decided by the Third Circuit in both the *New York City Shoes* and *Winstar* cases was not whether new value must remain unpaid, nor did either of these cases directly address whether paid new value can be asserted as part of the new value defense. The late Judge Brozman, a well-respected bankruptcy judge in the Southern District of New York, put it well in an opinion handed down in the *In re Maxwell Newspapers, Inc.* case, that “most of the courts that are cited as requiring that new value be ‘unpaid,’ have not actually held as much, but... have only repeated the requirement *in dicta*.² This explains those courts’ employment of the term ‘unpaid’ not as a statement of law, but rather as a shorthand requirement of section 547(c)(4)(B).”

Judge Carey, a Delaware bankruptcy court judge, held in the *In re Pillowtex Corp.* case, that there was no “controlling law” in the Third Circuit on the “paid new value” issue and the previous Third Circuit decisions referenced above addressed the “paid new value” issue *in dicta*. Judge Carey concluded that the Third Circuit has not decided whether paid new value can be included as part of a creditor’s new value defense and its earlier decisions are not binding on the Delaware Bankruptcy Court. This implies that each bankruptcy court in the Third Circuit has the ability to allow the “paid new value” defense without contradicting the binding precedent of the Third Circuit Court’s decisions.

The *Pillowtex* court then concluded that it was required to follow the plain language of section 547(c)(4) to allow paid new value. Section 547(c)(4) states that new value cannot be repaid with *an otherwise unavoidable transfer*. That means paid new value can count as part of the new value preference defense to the extent the payment for the new value is subject to avoidance as a preference and not subject to the ordinary course, contemporaneous exchange or other preference defenses. The court also noted that allowing paid new value is consistent with the purposes of the section 547(c)(4) new value defense: to encourage trade creditors to continue extending credit to financially troubled debtors and thereby assist the debtors in avoiding bankruptcy altogether; and to fairly treat those creditors that had replenished the debtors’ bankruptcy estates with new value after having received a preference.

² Statements made “*in dicta*” represent opinions, observations or remarks by a court that are not necessary for the resolution of the dispute between the parties before the court and are not binding upon lower courts.

Even more recently, Judge Coleman, a bankruptcy court judge in the Eastern District of Pennsylvania, similarly ruled, in *In re Frey Mechanical Group*, that paid new value should be allowed, citing to Judge Carey's decision and reasoning in *Pillowtex* in support of the applicability of paid new value.

New Value that is Paid or Returned Post-Petition

The courts are divided over whether a debtor's post-petition repayment of new value reduces the amount of the new value defense. This has a major bearing on the utility of critical vendor orders approving a debtor's post-petition payment of pre-petition invoices that would otherwise support a creditor's new value defense.

In *Phoenix Restaurant Group, Inc. v. Proficient Food Company*, the U.S. District Court for the Middle District of Tennessee held that a creditor cannot include a valid reclamation claim as part of its new value defense to preference liability. The court concluded that a creditor did not enhance and replenish the debtor and its estate to justify the creditor's invocation of the new value defense by delivering goods subject to a valid reclamation claim that the debtor had subsequently returned to the creditor pursuant to a critical vendor order. Whatever benefit the debtor had derived from the creditor's shipment of goods to the debtor was negated by the creditor's exercise of its reclamation rights that resulted in the court-approved return of these same goods. The court ruled that any new value sought by the creditor must be reduced to reflect its valid reclamation claim.

Similarly the *Arizona Fast Foods LLC* court in the U.S. Bankruptcy Court for the District of Arizona held that a creditor's reclamation claim that was afforded administrative priority could not be counted as new value to reduce the preference claim against the creditor because the creditor was paid post-petition by an otherwise unavoidable transfer. Only new value by a creditor that replenishes the debtor for the diminution caused by the preferential transfer should be counted to reduce preference exposure. If the new value were repaid by a transfer that is itself an avoidable transfer, and is, therefore, subject to disgorgement, the debtor's estate would be replenished by the paid new value and such new value should count to reduce the preference claim. However, where the new value was repaid by an unavoidable transfer that is not otherwise subject to recovery (such as the debtor's court-approved post-petition payment of its valid reclamation claim as a priority claim), such new value did not replenish the bankruptcy estate for the diminution caused by the prior preference and does not qualify as deductible new value.

In the *Login Bros. Book Company* case, in the United States Bankruptcy Court for the Northern District of Illinois, a creditor shipped goods, consisting of books sold on credit terms, to a debtor following the creditor's receipt of alleged preferences. The chapter 7 trustee sued the creditor for recovery of the preferences and the creditor claimed, as new value, the books the creditor had shipped to the debtor during the 90-day preference period. The trustee contested the creditor's new value because after the bankruptcy filing, the trustee had returned the books to the creditor pursuant to a bankruptcy court order.

The court held that the creditor's pre-petition shipments of books on credit to a debtor following payment of the alleged preferences did not count as new value to reduce the creditor's preference liability because the trustee had returned the books to the creditor pursuant to a court order

following the bankruptcy filing. Relying on the language of section 547(c)(4)(B), the court reasoned that the trustee's post-petition return (repayment) of new value pursuant to a court order was an otherwise unavoidable transfer that precluded the applicability of the new value defense. The court noted that the policy behind the new value defense – replenishment of the estate by the creditor's extension of credit to the debtor – would be defeated if the creditor were allowed to keep a preferential transfer based on its extension of new value that was subsequently repaid or returned. It should not matter whether the repayment or return of goods occurred before or after the commencement of the bankruptcy case. The statutory preclusion of the repayment of the new value by an otherwise unavoidable transfer (namely, the trustee's post-petition return of books pursuant to court order), contains no limitation on the timing of the repayment or return of new value.

The courts' holdings in *Phoenix Restaurant Group, Inc. v. Proficient Food Company, Login Bros.* and *Arizona Fast Foods LLC* have not been universally followed. For instance in *In re Energy Cooperative Inc.*, the United States District Court for the Northern District of Illinois held that a creditor could assert the new value defense based on a pre-petition extension of credit that was paid post-petition. Contrary to the holdings in *Login Bros.* and *Arizona Fast Foods LLC*, the *Energy Cooperative* court relied on section 547(c)(4)(B) as conditioning the applicability of the new value defense to new value that remained unpaid as of the date of the filing of the bankruptcy petition, but not after the filing. Any post-petition repayment of the new value does not reduce the availability of the new value defense. In fact, the *Energy Cooperative* court cited *New York City Shoes*, which noted as one of the standards for new value, that “the debtor must not have fully compensated the creditor for the “new value” to the debtor as of the date that it filed its bankruptcy petition.”

In *Phoenix Restaurant Group, Inc. v. Ajilon Professional Staffing LLC*, another adversary proceeding brought in the *Phoenix Restaurant Group* bankruptcy case, the United States Bankruptcy Court for the Middle District of Tennessee allowed a creditor to include, as new value in reduction of its preference claim, the pre-petition services it had provided to the debtor during the preference period that were subsequently paid by an unauthorized post-petition transfer. The court reasoned that the plain language of the new value defense closes the preference window on the bankruptcy filing date. Conversely, post-petition goods or services provided to a debtor in possession do not qualify as “new value” for purposes of section 547. By definition, new value is given “to or for the benefit of the debtor,” which, according to the *Phoenix Restaurant* court, implies that subsequent advances of new value are only those given pre-petition, because any post-petition advances are given to the debtor's estate and not the pre-petition debtor. The *Phoenix Restaurant* court also observed that, had Congress intended for section 547(c)(4)(B) to disqualify new value that was paid post petition, the section would have stated that new value may be not be counted if it is paid by “an otherwise unavoidable transfer of an interest of the estate in property to or for the benefit of such creditor.” Instead, only new value paid by “the debtor” (not the debtor's estate) may be disqualified. The court noted that this approach is also consistent with other Bankruptcy Code remedies that only apply post-petition, such as the administrative priority claim under section 503(b)(1) of the Bankruptcy Code granted to parties that provide goods and services to the debtor post-petition. Interestingly, because the debtor's post-petition payment of new value in this case was unauthorized, the debtor's estate

could have asserted a cause of action against the creditor under section 549 of the Bankruptcy Code. The estate, however, failed to do so prior to the expiration of the statute of limitations. In light of this division among the courts over the eligibility of new value paid post-petition, creditors seeking critical vendor status should require that a critical vendor order either provide for a waiver of preference claims or preserve the creditor's new value defense to preference liability.

The Interplay Between Section 503(b)(9) Priority Claims and New Value

Three cases in the past few years have considered whether a creditor can assert its section 503(b)(9) "20 day" goods priority claim³ ("Section 503(b)(9) Priority Claim"), that was fully paid or funded post-petition, as part of its new value defense to reduce its preference liability. The courts in these cases grappled with the same issues as the courts that considered the applicability of new value where it was subsequently paid after the bankruptcy filing.

The *Circuit City* bankruptcy court in the Eastern District of Virginia, and the *TI Acquisition* bankruptcy court in the Northern District of Georgia, ruled that fully paid or funded Section 503(b)(9) Priority Claims may not be counted as new value, while the *Commissary Operations* court, in the Middle District of Tennessee, allowed Section 503(b)(9) Priority Claims as new value, regardless of whether such claims were paid or fully funded.

The *Circuit City* and *TI Acquisition* bankruptcy courts ruled that the creditors could not assert their allowed and fully funded Section 503(b)(9) Priority Claims as part of their new value defense to reduce their preference liability because they could not satisfy section 547(c)(4), requiring that "the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor." The courts noted that in each case, the debtor had funded payment of the Section 503(b)(9) Priority Claim that was authorized by both the bankruptcy court and the Bankruptcy Code. As a result, the new value claimed by each creditor was paid by an "otherwise unavoidable transfer." The creditors were entitled to a single benefit from the goods they had delivered to the debtors within 20 days of their bankruptcy filing. They could either obtain payment for the goods as part of their allowed Section 503(b)(9) Priority Claims or include the goods as part of their section 547(c)(4) new value preference defense, but not both.

The *Circuit City* and *TI Acquisition* courts further noted that the debtors and their bankruptcy estates did not benefit from the creditors' sales and deliveries of goods subject to the creditors' fully funded or paid Section 503(b)(9) Priority Claims. The dual policy considerations underlying section 547(c)(4) - encouraging creditors to extend credit to financially troubled companies and promoting equality of treatment among creditors - are fostered by allowing a creditor to either obtain payment of its Section 503(b)(9) Priority Claim or include the same goods comprising that claim as part of the creditor's new value defense. Otherwise, the creditor would receive a double recovery by receiving payment for goods that are part of its fully paid or

³ Section 503(b)(9) grants goods sellers an administrative priority claim for:

the value of any goods received by the debtor within 20 days before the date of commencement of a [bankruptcy] case . . . in which the goods have been sold to the debtor in the ordinary course of such debtor's business.

funded Section 503(b)(9) Priority Claim and then using those same goods as part of its new value defense to reduce its preference exposure.

The *Circuit City* and *TI Acquisition* courts cited the court's holding in *Phoenix Restaurant Group, Inc. v. Proficient Food Company* (discussed above) that a creditor cannot include a valid reclamation claim as part of its new value defense to preference liability. Specifically, the creditor in that case was not entitled to invoke the new value defense because it did not enhance the debtor and its estate when it had delivered goods subject to a valid reclamation claim that the debtor had subsequently returned to the creditor pursuant to a critical vendor order. Similarly, the *Circuit City* and *TI Acquisition* estates were not enhanced by their receipt of goods that were part of the creditors' allowed and fully funded Section 503(b)(9) Priority Claims. In short, if goods that a debtor had subsequently returned to a creditor could not be allowed as part of the creditor's new value defense, neither could a fully funded Section 503(b)(9) Priority Claim.

Conversely, in *Commissary Operations*, the United States Bankruptcy Court for the Middle District of Tennessee refused to consider any post-petition payment of new value, that was entitled to section 503(b)(9) priority, as grounds for disqualifying such new value. The court relied on the holding of *Phoenix Restaurant Group, Inc. v. Ajilon Professional Staffing LLC* (discussed above) that allowed a creditor to include as new value, in reduction of its preference liability, the pre-petition services it had provided to the debtor during the preference period, that were subsequently paid post-petition. The *Commissary Operations* court closed the window for determining new value when the debtor filed for bankruptcy, and it limited the new value defense to new value provided and payment of new value received before the debtor's bankruptcy filing. In short, new value could only be reduced to the extent it had been paid for prior to the bankruptcy filing. Because the new value entitled to section 503(b)(9) priority in the *Commissary Operations* case remained unpaid on the bankruptcy filing date, it could be used to reduce the creditor's preference liability, regardless of whether or not the claim was ultimately paid post-petition.

The *Commissary Operations* court concluded that Congress did not intend section 547(a)(2), which defines new value; section 547(c)(4), which contains the requirements of the new value defense; and section 503(b)(9), which grants goods sellers a priority claim for the goods the debtor had received within twenty days of bankruptcy, to limit a creditor's ability to include its Section 503(b)(9) Priority Claim as part of its new value defense to a preference claim asserted against it. Indeed, allowing a creditor to assert its Section 503(b)(9) Priority Claim as part of its new value defense is consistent with the intent of section 503(b)(9) and section 547(c)(4) to encourage creditors to continue selling goods on credit terms to troubled companies, and to provide these creditors with a priority claim. Section 503(b)(9) claimants would be deprived of the full benefit of their priority claim if they could not also assert the claim as additional new value to reduce preference exposure.

Post-Petition New Value

Another contested area involving the new value defense is whether a creditor could include unpaid post-petition shipments or services as part of its new value defense. A trustee will likely argue that for new value to count, it must have been provided to the debtor after the creditor's receipt of the alleged preference, but prior to the debtor's bankruptcy filing. A majority of the

courts do not allow post-petition new value. For instance, the Eight Circuit Court of Appeals, in *Bergquist v. Anderson-Greenwood Aviation Corp. (In re Bellanca Corp.)*, held that only new value extended by a pre-petition debtor can reduce preference liability. The Eight Circuit relied on the language in section 547(c)(4)(B) “to the extent that . . . such creditor gave new value to or for the benefit of the debtor. . .” and ruled that these words imply that eligible new value is limited to new value provided to the debtor pre-petition, and not to new value provided to the debtor's estate post-petition.

A minority of courts (and no Circuit Courts of Appeals), have ruled that unpaid post-petition invoices may be counted as new value. These courts reason that there is no distinction between a pre-petition debtor and a post-petition estate, and accordingly, it is irrelevant whether the new value was extended to a pre-petition debtor or a post-petition estate. In either case, the debtor and its estate were replenished by, and benefitted from, the creditor’s post-petition new value.

A trustee arguing against allowing post-petition new value, while at the same time arguing against counting new value paid post-petition, is trying to have it both ways. Trustees often argue that post-petition new value should not count because it was extended to the post-petition estate, and not the pre-petition debtor (a distinct entity). Then, with the exact opposite logic, the same trustees will often argue that new value remaining unpaid by the debtor as of the bankruptcy filing date, but subsequently paid by the post-petition estate, should not be counted as new value because there should be no distinction over whether a debtor or post-petition estate pays for the new value.

Regardless, creditors should be sure to timely and properly pursue their post-petition claims arising during the bankruptcy case and assert such claims as counterclaims in connection with any preference action that is pursued against them.

Conclusion

On its face, the new value defense is an easy preference defense to satisfy to allow a creditor to reduce or eliminate its exposure on a preference claim. However, as this article has pointed out, a trustee can raise many obstacles to limit the applicability of the defense. It is up to the savvy trade creditor to calculate new value in a manner to minimize its preference liability and invoke the law in support of its position.

Bruce Nathan is a partner with Lowenstein Sandler PC’s New York City office and can be reached via e-mail at bnathan@lowenstein.com.

David Banker is counsel in Lowenstein Sandler’s New York City office and can be reached via e-mail at dbanker@lowenstein.com