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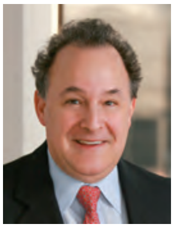
Bruce Nathan, Esq. and Eric Chafetz, Esq.



The Subsequent New Value Preference Defense for Services: A Practical Approach

Preference claims continue to be a thorn in the side of trade creditors' efforts to minimize their losses from a customer's bankruptcy filing. Creditors mitigate their losses by frequently relying on the subsequent new value defense.

A creditor should have little difficulty calculating the new value defense based on goods sold and delivered to a debtor on credit terms following an alleged preference payment. However, it has proven more challenging for a creditor providing services to a debtor to prove the new value defense, particularly when the creditor bills for its services on a monthly, instead of a daily, basis. In that event, the creditor might not be able to readily ascertain the value of its services provided to a debtor each day of the month after a preferential payment.

The United States Court of Appeals for the Seventh Circuit (the "Seventh Circuit"), in *In re OneStar Long Distance Inc.*, recently addressed this issue and upheld a creditor's calculation of the new value credit for its

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provision of services following alleged preference payments. The creditor had first calculated an assumed per diem or daily value for its services by dividing the creditor's monthly charge by the number of days in the month. The creditor then determined the amount of its new value credit by multiplying the daily value by the number of days of services the creditor was assumed to have provided to the debtor after the alleged preferential payments.[1] In the absence of evidence to the contrary, the court upheld this methodology for determining new value, based on a creditor's provision of services, even though the methodology did not necessarily capture the exact amount of new value provided on any given day.

The Preference Statute and Subsequent New Value Defense

Pursuant to section 547(b) of the Bankruptcy Code, a trustee (or debtor in possession) can avoid and recover a transfer as a preference by proving all of the following:

- The debtor transferred its property to or for the benefit of a creditor. The transfer of any type of property can be avoided, but the most frequent type of 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 to the creditor [section 547(b)(2)];
- The transfer was made when the debtor was insolvent [section 547(b)(3)];[2]
- The transfer was made within 90 days of the debtor's bankruptcy filing in the case of a transfer to a non-insider creditor [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)].[3]

There are several 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 a frequently invoked preference defense. It states 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.[4]

A creditor satisfies the new value defense by proving that it gave unsecured new value to the debtor by selling goods and/or providing services on credit terms to the debtor after an alleged preferential payment. The new value defense, like other preference defenses, is designed to encourage creditors to continue doing business with, and extending credit to, companies with financial problems. The net effect of the new value 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.

Facts

In April 2002, OneStar Long Distance Inc. ("OneStar") and MCI Inc. ("MCI")[5] entered into a contract under which MCI had agreed to provide certain telecommunications services to OneStar (the "MCI Contract"). There were two different categories of services: (a) switch services, which were billed at a variable usage rate, and (b) unswitched services[6], which were billed at a fixed monthly charge.

On December 31, 2003 (the "Petition Date"), an involuntary Chapter 7 bankruptcy case was commenced against OneStar. Thereafter, OneStar's Chapter 7 Trustee (the "Trustee") sought to avoid and recover as preferences 23 check payments, totaling $1,900,012.81, made by OneStar to MCI during the 90-day period prior to the Petition Date (the "Preference Period")[7]. MCI asserted the subsequent new value defense to rebut the Trustee's preference claim.

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In support of its new value defense, MCI provided evidence that it had billed OneStar approximately $3.7 million during the Preference Period that was not paid for by OneStar. The unpaid monthly invoices were as follows:

Month Services Were Provided	Total Amount of Unpaid Invoices
October 2003	$1,294,694.97
November 2003	$1,284,754.57
December 2003	$1,128,543.14
Total	$ 3,707,992.68

The issue for MCI and the Trustee was determining the value of MCI's services provided to OneStar after any given preference payment. This was not so straightforward here where, as a result of a lack of detail in MCI's monthly invoices about exactly when services were provided, it was unclear on which days MCI had actually provided services to OneStar.

The Trustee also challenged MCI's new value defense as a result of OneStar's assignment of its rights and indebtedness under the MCI Contract to OneStar's newly formed affiliate, IceNet, just a week before the Petition Date. This allegedly compensated MCI for its new value, and thereby nullified MCI's new value defense, by releasing MCI from its contractual obligations to OneStar, with MCI now being obligated to provide services to IceNet, instead of OneStar, and with IceNet then being obligated to provide services to OneStar.

The court adopted a methodology for determining new value for services by fixing a per diem value to the services MCI had provided to OneStar based on a daily average of the total monthly value of these services.

The United States Bankruptcy Court for the Southern District of Indiana (the "Bankruptcy Court") ruled that MCI had provided sufficient services after the alleged preference payments to successfully assert a complete new value defense to the preference claim. The court adopted a methodology for determining new value for services by fixing a per diem value to the services MCI had provided to OneStar based on a daily average of the total monthly value of these services. This was calculated by dividing the total monthly amount that MCI had billed OneStar by the number of days in the month and then multiplying the resulting quotient by the number of days of the month following a targeted preference payment. The court also held that OneStar's assignment of the MCI Contract to IceNet did not compensate MCI for the new value it had provided to OneStar and, therefore, did not nullify MCI's new value defense because the new value remained unpaid.[8]

The parties then cross-appealed the Bankruptcy Court's ruling to the United States District Court for the Southern District of Indiana (the "District Court"). The District Court affirmed the Bankruptcy Court's ruling, concluding that MCI's new value defense had fully shielded MCI from preference liability. The parties then appealed to the Seventh Circuit.

MCI and the Trustee had agreed, based on the Bankruptcy Court's methodology, that MCI had provided sufficient services to OneStar following the October 2003 and November 2003 payments to support a new value defense that fully shielded these payments from preference liability. However, the parties did not agree on the applicability of the per diem methodology to OneStar's payments to MCI in December 2003 ($100,000 paid on Dec. 9 and $200,000 paid on Dec. 17). Instead, the Trustee argued that MCI could not prove that it had provided any services to OneStar after these payments to justify invocation of the new value defense.

The Seventh Circuit's Decision

The Seventh Circuit held that MCI had a full new value defense to the preference claim. The Seventh Circuit adopted the Bankruptcy Court's per diem calculation of the daily average of the value of MCI's services provided to OneStar as the appropriate methodology for determining MCI's new value defense, absent evidence to the contrary, where MCI could not have otherwise readily ascertained the daily value of its services from its monthly invoices issued to OneStar.

The Seventh Circuit noted that the per diem amount for all of the services MCI had provided OneStar in December 2003 was $36,404.62 ($1,128,543.14 divided by 31 days). The Court then concluded that MCI had advanced more than $800,000 of new value after Dec. 9 ($36,404.62 x 22 days) and more than $500,000 of new value after Dec. 17 ($36,404.62 x 14 days), assuming MCI's services to OneStar were evenly distributed throughout December. This amount of services was more than double the amount of new value necessary to cover OneStar's Dec. 9 and Dec. 17 payments to MCI.

The Seventh Circuit also found it "highly improbable" that MCI had provided all or a vast majority of its approximately $1.128 million of services to OneStar in December 2003 at the beginning of December. That would have meant MCI had front-loaded a significant portion of its unpaid services at the beginning of December. The Court also noted that a portion of MCI's services carried fixed charges, which reduced the likelihood of large fluctuations in total charges. Also, OneStar's revenues between December 2003 and January 2004 declined only slightly from $2.5 million to $2.2 million, which meant that OneStar's use of switched services likely would not have precipitously dropped in the middle of December.

The Seventh Circuit adopted a very practical, yet unscientific, approach in calculating MCI's subsequent new value credit for its services provided to OneStar.

The Seventh Circuit also rejected the Trustee's attempt to nullify MCI's new value defense as a result of OneStar's assignment of the MCI Contract to IceNet. The court concluded that the assignment was not a transfer for MCI's benefit that would have negated MCI's new value defense because OneStar's indebtedness was assigned and not discharged and IceNet became a pass-through intermediary (conduit) between MCI and OneStar. In addition, the assignment was not on account of, and had nothing to do with, the services representing the new value that MCI had provided to OneStar.

Conclusion

The Seventh Circuit adopted a very practical, yet unscientific, approach in calculating MCI's subsequent new value credit for its services provided to OneStar. The result might have been different if the Trustee had provided evidence that the services MCI had provided to OneStar each day in December 2003 were not of an equal value. Significantly, the Seventh Circuit's decision appears flexible enough to allow for the introduction of evidence to demonstrate that services were front-loaded, back-loaded or dispersed in a different way during any given month.

This means that a trade creditor providing services can potentially manage its risk when faced with a financially distressed customer that the creditor suspects may file for bankruptcy as the creditor could better estimate its new value credit and potential preference exposure. Likewise, a trade creditor providing services, if beneficial, could explicitly specify on its invoices either that the services are being provided in an equal amount each day of the month or that the amount of services provided varies in some quantifiable way each day.

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1. For example, if a month had 30 days and the total value of services the creditor had provided was $9,000, the daily value of the services would be $300 ($9,000/30 days). If a preferential payment was made on the 10th day of a 30-day month, the value of services eligible to be treated as new value would be $6,000 provided during the remaining 20 days of the month ($300 x 20 days).

2. Insolvency is based on a balance sheet definition: liabilities exceeding assets. The debtor's insolvency during the 90-day preference period is also presumed, which makes it easier for a trustee or a debtor-in-possession to prove.

3. This requirement is generally 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.

4. In the Seventh Circuit, unlike most other jurisdictions, the subsequent new value must remain unpaid.

5. MCI was purchased by Verizon Business Global LLC ("Verizon") after this action was commenced by the Trustee and Verizon was substituted in as defendant for MCI. However, for ease of reference, the authors will refer only to MCI throughout this article.

6. Switch services involve connecting calls from one line to another, while unswitched services are long-haul services that did not require switching.

7. The Trustee initially sought to recover approximately $2.47 million paid by 27 checks to MCI, but throughout the appellate process, the amount demanded was decreased.

8. MCI also relied on the ordinary course of business defense, which the Bankruptcy Court rejected and the District Court did not address.

Bruce Nathan, Esq., is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy, Financial Reorganization and Creditors' Rights Group and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM, is a former member of the board of directors of the American Bankruptcy Institute and is a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached via email at bnathan@lowenstein.com.

Eric Chafetz, Esq., is counsel at the law firm of Lowenstein Sandler LLP. He can be reached at echafetz@lowenstein.com.