Paid New Value Does Not Count as a Preference Defense – The Last Frontier

By: Bruce S. Nathan, Esq. and Scott Cargill, Esq.
Lowenstein Sandler LLP

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Trade creditors dealing with a financially distressed customer must be vigilant when deciding whether to sell product or provide services on unsecured credit terms. There is obviously a material risk of nonpayment if the customer defaults and files bankruptcy. However, perhaps even more concerning, a bankruptcy trustee may seek to recover, as a preference, sums that the creditor had received from the customer during the 90 days prior to the bankruptcy filing.

Fortunately, trade creditors can assert numerous defenses to reduce their preference liability. These defenses include the "subsequent new value" defense, which has received renewed attention by the courts over the last several years. The courts have grappled over whether the subsequent new value defense includes both paid and unpaid new value,
or is limited to just unpaid new value. Bottom line, the extent of a trade creditor's preference exposure depends on whether a court allows both paid and unpaid new value or just unpaid new value, which in turn, can vary based on where its customer files its bankruptcy case.

On January 9, 2019, the U.S. Bankruptcy Court for the Northern District of Illinois, in In re Calumet Photographic, Inc., ruled that any "new value" provided by a trade creditor to a debtor must remain "unpaid" on the bankruptcy filing date, thus limiting the amount of new value a trade creditor can use to reduce its preference exposure. The court followed precedent established by the United States Court of Appeals for the Seventh Circuit (covering Illinois, Indiana and Wisconsin) that limits the new value defense to only unpaid new value. This represents the minority view and runs counter to the majority view that five United States Circuit Courts of Appeal have followed allowing a creditor to include both paid and unpaid new value as part of a creditor's subsequent new value defense.

It will be left to the United States Supreme Court, or Congress through future bankruptcy legislation, to eventually resolve this split among the United States Circuit Courts of Appeal in determining whether the subsequent the new value defense includes both paid and unpaid new value or is limited to just unpaid new value. The amount of a trade creditor's preference exposure could be at stake depending on how this split is ultimately resolved.

Preference Claims and the New Subsequent Value Defense

A bankruptcy trustee can avoid and recover a preferential payment or other transfer under Bankruptcy Code § 547(b) by proving that (i) the debtor transferred its property, such as by making a payment, to or for the benefit of a creditor; (ii) the transfer was made on account of antecedent or existing debt that the debtor owed the creditor; (iii) the transfer was made when the debtor was insolvent, based on a balance sheet definition of liabilities exceeding assets, which is presumed during the 90-day period prior to the debtor's bankruptcy filing date; (iv) the transfer was made during the 90-day preference period with respect to a transfer made to a non-insider creditor of the debtor, such as a trade creditor; and (v) the transfer enabled the creditor to receive more from the transfer than the creditor would have received in a Chapter 7 liquidation of the debtor's assets.

Once a bankruptcy trustee proves all of the above elements of a preference claim, a creditor then has the burden of proving one or more of the preference defenses contained in Bankruptcy Code § 547(c) to reduce or eliminate its preference liability. The subsequent new value defense is among the defenses contained in Bankruptcy Code § 547(c)(4), stating as follows:

> [t]he trustee may not avoid under this section a transfer . . . to or for the benefit of a creditor, 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 or for the benefit of such creditor (emphasis added).

The subsequent new value defense reduces a creditor's preference liability to the extent the creditor replenished the debtor's bankruptcy estate by providing new goods and/or services

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on credit terms subsequent to receiving the preference payment. The new value defense, like other preference defenses, is supposed to encourage creditors to continue doing business with and extending credit to their financially distressed customers and thereby reduce the risk of the customers' bankruptcy filing. The defense is premised on the lack of any harm to a debtor's other unsecured creditors when a preference payment is followed by the preference recipient's delivery of goods and/or provision of services on credit terms to the debtor.

Courts have reached conflicting conclusions concerning whether the subsequent new value defense includes paid, as well as unpaid new value, or is limited to only new value that remains unpaid as of the bankruptcy filing date. The United States Courts of Appeal for the Fourth Circuit (covering Maryland, North and South Carolina, Virginia and West Virginia), the Fifth Circuit (covering Louisiana, Mississippi and Texas), the Eighth Circuit (covering Arkansas, Iowa, Minnesota, Missouri, Nebraska and North and South Dakota), the Ninth Circuit (covering Arizona, California, Idaho, Montana, Nevada, Oregon and Washington), and most recently the Eleventh Circuit (covering Alabama, Florida and Georgia), in In re BFW Liquidation LLC, have all held that the subsequent new value defense includes paid new value that was not paid by an "otherwise unavoidable transfer", as well as unpaid new value. The United States Court of Appeals for the Seventh Circuit (covering Illinois, Indiana and Wisconsin) reached the contrary holding that new value must remain unpaid on the bankruptcy filing date in order to be included as part of a creditor's new value defense. The other United States Circuit Courts of Appeal have not decided whether paid new value counts as a preference defense. Accordingly, courts in these Circuits are not bound by either view.

Background

The Debtor, Calumet Photographic, Inc., filed a Chapter 7 bankruptcy petition on March 12, 2014. In March 2016, the bankruptcy trustee appointed in the case filed an adversary proceeding against Canon U.S.A. Inc. to avoid and recover approximately $3 million of payments the Debtor had made to Canon during the 90 day period prior to the bankruptcy filing. Canon raised the new value and the ordinary course of business defenses in its answer to the preference complaint.

The parties stipulated that Canon had provided approximately $2.15 million in subsequent new value to the Debtor. Of that amount, approximately $1.35 million was on account of goods for which Canon had not received payment from the Debtor and which the bankruptcy trustee conceded was subsequent new value that reduced Canon's preference liability. However, Canon provided the Debtor with approximately $804,000 of additional subsequent new value that the Debtor had thereafter paid. Canon sought to include this subsequent paid new value as part of its preference defenses. The trustee argued that Canon could not use the paid new value to reduce Canon's preference liability.

Canon moved for summary judgment on the narrow purely legal question of whether courts within the Seventh Circuit could allow a trade creditor to reduce its preference exposure by asserting both: (a) the unpaid new value as of the bankruptcy filing; and (b) the new value that debtor had paid with an avoidable transfer. Canon argued that the Seventh Circuit's 1986 decision, in In re Prescott, that has been cited in support of limiting the new value defense to only unpaid new value as of the bankruptcy filing date, is inconsistent with the "plain and unambiguous language" of § 547(c)(4) and § 547(c)(4)'s statutory history and important policy considerations behind the subsequent new value defense. Canon argued all of these factors supported including both paid and unpaid new value as part of its new value defense. Canon also relied on the Seventh Circuit's 2017 holding in In re OneStar Long Distance, Inc., which Canon asserted expanded the subsequent new value defense to include paid for new value.

The trustee opposed Canon's summary judgment motion and cross-moved for summary judgment. The trustee relied on the Seventh Circuit's decision in Prescott and later holdings following Prescott as binding precedent that limits the new value defense to only unpaid new value as of the bankruptcy filing date.

Legal Analysis

The Calumet court ruled in favor of the trustee, deciding that Canon could not use the approximately $804,000 of paid new value to reduce Canon's preference exposure. The court concluded that since it is in the Seventh Circuit, it was duty bound to follow the precedent established by the Seventh Circuit starting in Prescott and followed in subsequent Seventh Circuit rulings. These rulings follow the minority view that limits the new value defense to only unpaid new value as of the bankruptcy filing date.

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The court also rejected Canon's argument that the Seventh Circuit's decision in OneStar followed the majority view allowing both paid and unpaid new value as part of a creditor's new value defense. The court noted that the Seventh Circuit's holding in OneStar followed Seventh Circuit precedent starting in Prescott that new value must remain unpaid.

The court felt constrained and acknowledged that the Seventh Circuit precedent it was following, limiting subsequent new value to only unpaid new value, is the minority view. The court noted that the Fourth, Fifth, Eighth, Ninth, and most recently the Eleventh Circuits, allow both new value paid by an avoidable transfer and unpaid new value as part of a creditor's new value defense. The court also observed that Canon had raised a number of "interesting policy considerations" for allowing paid new value to offset preference exposure that encouraged the policy goal of incentivizing trade creditors to continue to sell on open credit terms to their economically distressed customers, potentially avoiding the need for the customers to file for bankruptcy at all. However, in the end, this argument did not trump Seventh Circuit precedent the Calumet court was bound to follow that limits the subsequent new value defense to only unpaid new value as of the bankruptcy filing date.

Conclusion

The court in Calumet followed binding Seventh Circuit law, which allows only unpaid subsequent new value on the bankruptcy filing date, to reduce a creditor's preference liability. The court's ruling conflicts with the majority view followed by five United States Circuit Courts of Appeal that allow both paid and unpaid subsequent new value.

This division among the U.S. Circuit Courts demonstrates that a trade creditor's ability to defend and limit liability on a preference claim can vary greatly depending upon where a customer files its bankruptcy case. Even if a trade creditor is sued in a jurisdiction following the minority view, the creditor would be well advised to raise the new value defense even with respect to goods for which the debtor subsequently paid. At a minimum, pursuing this defense may assist in settlement negotiations with a bankruptcy trustee that may be willing to compromise the claim rather than risk an adverse ruling before the bankruptcy court, or an appeals court.

The division among the Circuit Courts also makes it increasingly likely that the U.S. Supreme Court, or Congress in future bankruptcy legislation, will eventually have to decide whether or not paid new value should properly offset preference exposure. It is unlikely that the last chapter of this "paid" vs. "unpaid" debate has yet been written. Unfortunately, the Calumet case will apparently not be heading to the Supreme Court as Canon did not file an appeal from the adverse holding in the case.

About the Authors:

Bruce S. Nathan, Esq. *Partner in Lowenstein Sandler's Bankruptcy, Financial Reorganization & Creditors' Rights Department, has more than 30 years experience in the bankruptcy and insolvency field, and is a recognized national expert on trade creditor rights and the representation of trade creditors in bankruptcy and other legal matters.*

Scott Cargill, Esq. *of counsel for Lowenstein Sandler**,** has represented various parties in numerous restructuring and insolvency proceedings in bankruptcy courts. He has also advised clients on such matters as the auction and sale of debtor assets, setoff rights, preference and fraudulent transfer liability issues.*

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