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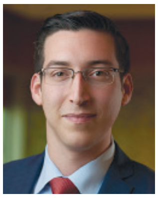
Is the Preference New Value Defense Limited to Unpaid New Value? The Saga Continues

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A financially distressed customer's request for trade credit is a tough ask for a creditor to accept in light of the significant risk of nonpayment. That ask is made even tougher as the customer is approaching bankruptcy where a creditor is facing—in addition to the risk of nonpayment—an increased risk that, even if the customer does make payments to the creditor, the payments prior to bankruptcy may later be clawed back as a preference.

The Bankruptcy Code prescribes several defenses to mitigate preference risk. Notably, the "subsequent new value" defense grants a creditor a dollar-for-dollar reduction in preference exposure where the creditor had provided new value in the form of goods sold and/or services provided on credit terms to the debtor after receiving an alleged preference payment.

The subsequent new value defense has been the subject of much litigation and numerous court decisions. One issue that has divided the courts is whether the new value defense may only be successfully asserted with respect to new value that remains unpaid as of the bankruptcy filing, or can be successfully asserted regardless of whether the new value was paid or unpaid. Many courts have followed the majority view that it makes no difference whether the debtor had paid for such subsequent new value. Most recently, in August 2018, the United States Circuit Court of Appeals for the Eleventh Circuit joined four other United States Circuit Courts of Appeal in following the majority view and allowing both paid and unpaid new value as part of a creditor's "subsequent new value" defense.

However, there is a minority view that limits the subsequent new value defense to only new value that was unpaid when a debtor files for bankruptcy relief. The United States Court of Appeals for the Seventh Circuit (the "Seventh Circuit"), covering courts in Illinois, Indiana and Wisconsin, follows the minority view. In *In re Calumet Photographic, Inc.*, the U.S. Bankruptcy Court for the Northern District of Illinois (which is in the Seventh Circuit) struggled over whether new value must remain unpaid in order to be included as part of a creditor's subsequent new value defense. The bankruptcy court concluded that it was bound by Seventh Circuit precedent to follow the minority view allowing only unpaid new value, despite the policy arguments in favor of, and the recent trends outside of the Seventh Circuit that support, the creditor-friendly majority view of allowing both paid and unpaid new value.

Preference Claims and the New Subsequent Value Defense

Pursuant to Section 547(b) of the Bankruptcy Code, a bankruptcy trustee can avoid and recover a transfer as a preference by proving all of the following:

- The debtor transferred its property to or for a creditor's benefit,

such as making a payment from its bank account to a creditor. [Section 547(b)(1)];
- The payment or other transfer was made on account of antecedent or existing indebtedness, such as outstanding invoices for goods sold and delivered and/or services rendered, that the debtor owed to the creditor [Section 547(b)(2)];
- The payment or other transfer was made when the debtor was insolvent, which is based on a balance sheet test of the debtor's liabilities exceeding its assets and is presumed during the 90-day preference period [Section 547(b)(3)];
- The payment or other transfer was made within 90 days of the debtor's bankruptcy filing in the case of a transfer to a non-insider creditor, such as a trade creditor [Section 547(b)(4)]; and
- The payment or other 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)].

In the event that a bankruptcy trustee proves all of the above elements of a preference claim, the creditor has the burden of proving one or more of the affirmative defenses contained in Section 547(c) of the Bankruptcy Code to reduce its preference exposure. Congress enacted the preference defenses to encourage creditors to continue doing business with, and extending credit to, financially struggling customers. One of these defenses is the "ordinary course of business" defense, which insulates a preference defendant from liability to the extent the alleged preference payment was on account of a debt the debtor had incurred in the ordinary course of business, and was made in the ordinary course of business between the debtor and the defendant or was made according to ordinary business terms.

The *Calumet* case involved another preference defense—the "subsequent new value" defense under Section 547(c)(4) of the Bankruptcy Code. According to Section 547(c)(4), a trustee cannot claw back a preference payment where a creditor gave new value to or for the debtor's benefit after a debtor's preference payment and (a) such new value was not secured by an otherwise unavoidable security interest and (b) the debtor did not make an otherwise unavoidable transfer to or for the creditor's benefit on account of such new value.

The subsequent new value defense reduces preference liability dollar for dollar based on the creditor's sale and delivery of goods and/or provision of services to the debtor on credit terms after the debtor's receipt of an alleged preference payment. The premise behind the new value defense is that a debtor's other unsecured creditors would not be harmed by a debtor's pre-petition payment followed by a creditor's delivery of goods or provision of services to a debtor on credit terms.

In *Calumet*, the bankruptcy court was faced with the task of balancing the policy goals underlying the subsequent new value defense against the prior holdings of the Seventh Circuit that limit the new value defense to unpaid new value. This is binding on all federal courts located in the Seventh Circuit, including the bankruptcy court in the *Calumet* case.

The United States Courts of Appeals for the Fourth, Fifth, Eight, Ninth and the Eleventh Circuits (covering over 20 states) have reached the opposite conclusion that the new value defense includes subsequent new value that was paid and unpaid as of the bankruptcy filing. The United States Court of Appeals for the Eleventh Circuit became the most recent United States Circuit Court to adopt the majority view in its August 2018 decision in *In re BFW Liquidation, LLC*.

Factual Background of the *Calumet* Case

Calumet Photographic, Inc. (the "Debtor") filed for Chapter 7 bankruptcy relief on March 12, 2014. In March 2016, the bankruptcy trustee (the "Trustee") appointed in the case filed an adversary proceeding against Canon U.S.A. Inc. ("Canon"), seeking to avoid and recover approximately $3 million in payments made by the Debtor to one of its creditors, Canon, during the 90 days prior to the Debtor's bankruptcy filing. Canon asserted the ordinary course and subsequent new value defenses to the preference claim.

The key facts of the *Calumet* case were not in dispute. Canon had provided the Debtors with approximately $2.15 million in subsequent new value in the form of goods shipped after Canon's receipt of the alleged preference payments. Of this amount, the parties stipulated that approximately $1.35 million of the new value remained unpaid by the Debtors and, therefore, could not be clawed back by operation of the subsequent new value defense. However, the parties disputed whether Canon could include the remaining $803,932 in subsequent new value, which was *paid* prior to the Debtor's bankruptcy filing date, as additional new value to reduce its preference liability.

Canon moved for summary judgment, arguing that the subsequent new value defense should be applicable regardless of whether the new value in question was paid or unpaid, despite long-standing Seventh Circuit precedent to the contrary. The Trustee cross-moved for summary judgment, arguing that the Seventh Circuit's 1986 decision, in *In re Prescott*, and subsequent decisions that new value must remain unpaid were binding on the bankruptcy court.

Canon asserted that the *Prescott* decision is inconsistent with the "plain and unambiguous language" of Section 547(c)(4) and the policy considerations behind the subsequent new value defense. Canon also argued that a more recent 2017 Seventh Circuit decision, in *In re OneStar Long Distance, Inc.*, expanded the application of the new value defense to include new value that had been paid by a debtor. In support of this argument, Canon pointed to the *OneStar* court's description of the standard for excepting preferential transfers from avoidance under Section 547(c)(4)—that "[i]f the debtor pays for the creditor's new value (and that payment isn't itself avoidable), then the new value is canceled out. That only leaves the preferential payment that Section 547 is designed to address in the first place."

The Bankruptcy Court's Decision

The bankruptcy court rejected Canon's interpretation of the *OneStar* decision, concluding that Canon had taken the Seventh Circuit's holding "out of context." The

Calumet court explained that the Seventh Circuit, in *OneStar*, did not reject its prior holding in *Prescott* that limited the new value defense to only unpaid new value, but instead had explicitly followed *Prescott* by ruling that "[t]he new value must remain unpaid in order to reduce the creditor's preference liability."

Having concluded that the Seventh Circuit still followed the "remains unpaid rule in determining the extent of a creditor's new value defense" the *Calumet* court had no choice but to follow the binding Seventh Circuit precedent. Accordingly, the *Calumet* Court ruled in favor of the Trustee and concluded that Canon could not use the $803,932 in paid new value to reduce its preference exposure.

Though bound to follow Seventh Circuit precedent, the *Calumet* court acknowledged that Canon had raised "a number of interesting policy considerations for allowing both unpaid and paid new value to offset preference liability." The court acknowledged that the goal of the preference defenses is to encourage creditors to continue to sell, on credit, to distressed customers and, therefore, potentially save those customers from "slipping into bankruptcy" as a result of its creditors' failure to continue supplying goods and/or services to the customers. The *Calumet* court also acknowledged, as the United States Courts of Appeals following the majority view have concluded, that limiting eligible new value to only unpaid new value is arguably inconsistent with that goal. Nonetheless, the *Calumet* court was handcuffed by its duty to follow Seventh Circuit precedent adopting the minority interpretation of Section 547(c)(4) that subsequent new value must remain unpaid to be included as part of a creditor's subsequent new value defense.

Conclusion

The *Calumet* court has acknowledged that its decision and the law of the Seventh Circuit runs contrary to the majority view the Fourth, Fifth, Eighth, Ninth, and—most recently—the Eleventh Circuits have followed that subsequent new value, as a preference defense under Section 547(c)(4) of the Bankruptcy Code, can be either paid or unpaid. Indeed, the *Calumet* court recognized the policy arguments in favor of the majority view. However, the court concluded that it is bound by the fundamental principle of United States law that a court must follow applicable precedent including, with respect to the *Calumet* court, the holdings of the Seventh Circuit where the court is located. Unfortunately, the *Calumet* case will not provide an opportunity for the Seventh Circuit to reconsider and possibly join the majority view, as the bankruptcy court's decision was not appealed.

Due to the division among the United States Circuit Courts of Appeal over whether a creditor can include paid new value as part of its subsequent new value defense, it will be left to the United States Supreme Court to resolve the competing interpretations of the subsequent new value defense. Alternatively, Congress can provide clarity on the issue in future bankruptcy legislation.

Until then, trade creditors would be wise to continue to assert both paid and unpaid new value as part of their subsequent new value defense, regardless of the jurisdiction in which they find themselves defending against preference exposure. The *Calumet* decision could only go one way, following the Seventh Circuit's minority view allowing only unpaid new value as part of a creditor's subsequent new value defense. However, the recent trend in court decisions following the majority view allowing paid new value, that even the *Calumet* court has acknowledged, should make any bankruptcy trustee wary enough of a potential adverse ruling to be incentivized to settle preference claims.