

**CURRENT ISSUES IN AVOIDANCE ACTIONS:  
THE NEW VALUE DEFENSE**

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The new value preference defense found at 11 U.S.C. § 547(c)(4) is one of the two preference defenses relied upon most often by defendants. Specifically, defendants who assert that they provided “unpaid new value” use that new value to counter preference avoidance actions brought by a trustee. This memorandum describes some of the current issues arising when the unpaid new value defense is asserted in preference cases.

- I. The so-called Subsequent Advance Rule, or new value defense, is set out in the statute as follows:

The trustee may not avoid under this section a transfer . . .

**(4)** 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:

**(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.

11 U.S.C. § 547(c)(4).

- a. The underlying goal of the new value defense is to encourage creditors to deal with troubled businesses by permitting payment of back debt in exchange for new goods, thus protecting creditors who replenish the estate after receiving the preferential payment. The defense is intended to ensure equitable distribution of assets among similarly situated creditors. *Allied Cos. V. Broughton Foods Co.* (*In re Allied Cos.*) 155 B.R. 739, 741 (Bankr. S.D. Ind. 1992) (citations omitted).
- b. Section 547(c)(4) is an affirmative defense. The burden of proof to show new value is on the creditor.

c. A classic example:

1. The debtor makes a preferential payment to a creditor of \$100. (Payment 1)
2. After receipt of the payment, the creditor ships to the debtor new inventory that has a value of \$50.
3. The debtor pays the creditor \$50 in payment for the shipment of inventory. (Payment 2)

If Payment 2 is also an avoidable preference, the creditor must repay it to the trustee. The creditor may use its inventory shipment as new value to reduce the repayment of Payment 1. If Payment 2 is not avoidable, the creditor keeps it but the new inventory is not counted towards the new value defense, and the creditor must return Payment 1 in its entirety. Either way, the creditor returns \$100 to the estate. *Chez Foley, Inc. v. Ramette*, 211 B.R. 25, 28 (Bankr. D. Minn. 1997).

II. What is new value? A key issue of this defense is the question of what constitutes new value given after a preferential transfer. New value defenses can lie even if cash consideration is not paid. The statute defines the term “new value” as:

[M]oney or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation.

11 U.S.C. § 547(a)(2). Courts focus on what was exchanged to determine whether new value was given by a preference defendant. Practitioners should analyze each transaction carefully to determine if new value was given. The following list summarizes some of the non-cash new value case law.

- a. Returned goods: Pre-petition returned goods will diminish the new value defense to the extent they have value at the time of delivery, even if at the time of return the product had no value. *In re Furr's Supermarkets, Inc.*, 317 B.R. 423 (10th Cir. 2004).
- b. Shipment of goods pursuant to a pre-existing obligation: Where a unified contract calls for structured deliveries over time, deliveries pursuant to this pre-existing contractual obligation do not constitute new value. *In re Globe Bldg. Materials, Inc.*, 484 F.3d 946 (7th Cir. 2007). In other words, new value must consist of the promisor giving something to the debtor that she was not already obliged to give.

- c. Delay in reporting default: Forbearance from reporting a default is not new value where the creditor does nothing to provide new value to the debtor and the creditor has no authority to revoke the debtor's use of the property at issue. *In re ABC-Naco, Inc.*, 483 F.3d 470 (7th Cir. 2007).
- d. Forbearance: Forbearance from terminating an agreement is generally not considered new value. Use of forbearance as new value would permit unsecured creditors and under-secured creditors to leverage what security they did have to force payment of unsecured debt. *Drabkin v. A.I. Credit Corp.*, 800 F.2d 1153 (D.C. Cir. 1986) (discussing disagreement in the case law).
- e. Insurance coverage: Although coverage during a paid-for period is not new value, a period of unpaid insurance coverage is new value. *In re Sharoff Food Service, Inc.*, 179 B.R. 669 (Bank. D. Colo. 1995).
- f. Use of rental property: Lessees derive new value from the rent-free use and occupancy of rented property. There is no new value where the lessee vacates and makes no use of the property. *S. Technical College, Inc. v. Graham Properties Partnership*, 89 F.3d 1381 (8th Cir. 1996); *In re Jet Florida System, Inc.*, 841 F.2d 1082 (11th Cir. 1988) (forbearance of right to terminate lease is not new value, since it is the exercise of an existing legal right).
- g. Release of a statutory lien: The release of a lien, taken alone, is too speculative in value to qualify as new value. *In re Robert*, 2007 WL 2406926 (Bankr. D. Vt.).
- h. Revolving credit: Charges on a credit card (i.e. extensions of credit) by the debtor constitute individual instances of new value, as opposed to withdrawals on a pre-existing loan. *In re Pickens*, 2008 WL 346147 (Bankr. N.D. Iowa).
- i. Services: New value is rendered on the date that services are performed, not on the date that services are billed. *In re Excel Enterprises, Inc.*, 83 BR 427 (Bankr. W.D. La. 1988).
- j. Attorney's fees: An attorney's promise to continue representation of the debtor in a litigation matter in exchange for payments towards accrued fees was not new value for purposes of the subsequent value exception, where monetary enrichment of the estate could not be directly attributed to the representation. *In re Electronic Metal Products, Inc.*, 916 F.2d 1502 (10th Cir. 1990).
- k. While substitution of one obligation for another does not constitute new value, modification of the terms of an existing obligation may be new value if the creditor can demonstrate that the modification gave the debtor new money or money's worth in new credit, goods, services or property. *In re Spada*, 903 F.2d 971 (3rd Cir. 1990).

1. Subordination of debt to equity by a creditor, as opposed to forbearance, may constitute new value if the creditor can quantify the actual amount of new value the subordination produced (in the form of reducing the debtor's liabilities or eliminating full or partial payment of the subordinated debt) versus what the creditor would receive on its equity investment. *Boston Pub. Co., Inc. v. Chase* (*In re Boston Pub. Co., Inc.*), 209 B.R. 157 (Bankr. D. Mass. 1997).
- III. How is the Subsequent Value Rule applied? A consensus appears to have developed over the mechanics of calculating new value.
- a. Net Result Rule: In former Section 60c of the Bankruptcy Act, all transfers by the creditor during the 90-day period were netted against all preferential payments. Section 547(c)(4) changed this rule and made it more restrictive for creditors, requiring that new value be given *subsequent* to preferential payments. LAWRENCE P. KING ET AL., *COLLIER ON BANKRUPTCY* 547.04[4][d] (15th ed. 2008).
  - b. Leathers Rule: New value is netted against only the immediately preceding preferential transfer and the excess preferential transfer cannot be carried forward. (Minority Rule) *Leathers v. Prime Leather Finishes Co.*, 40 B.R. 248 (D. Me. 1984). This case--while still sometimes cited in Maine cases and by trustees and given the existence of the contemporaneous exchange defense, § 547(c)(2)--in practice has limited utility since defense counsel can cite a litany of cases disagreeing with the Leathers rule. Given a central purpose of the new value defense--that a preference claim will not lie where the estate was not depleted--the rationale for cutting off new value is difficult to defend.
  - c. Garland Rule: New value may be netted against all preceding preferential transfers. (Majority Rule) *In re Thomas W. Garland, Inc.*, 19 B.R. 920 (Bankr. E.D. Mo. 1982).
    - i. Fourth Circuit: *In re Meredith Manor, Inc.*, 902 F.2d 257 (4th Cir. 1990).
    - ii. Fifth Circuit: *In re Micro Innovations Corp.*, 185 F.3d 329 (5th Cir. 1999).
    - iii. Ninth Circuit: *In re IRFM, Inc.*, 52 F.3d 228 (9th Cir. 1995).
    - iv. *In re Dependable Food Products, Inc.*, 193 BR 662 (Bankr. E.D.N.Y. 1996).
    - v. *In re Jannel Industries, Inc.*, 245 B.R. 757 (Bankr. D. Mass. 1983).
    - vi. *In re Tower Metal Alloy Co.*, 193 B.R. 273 (Bankr. S.D. Ohio 1996) (extensive discussion).
- IV. Must new value remain unpaid? One key area in which case law continues to develop relates to whether new value credit can be given where the new value is subsequently paid for by the debtor.

- a. Some circuits hold that new value must remain unpaid as of the petition date. The rationale is that a creditor should not benefit from both the new value defense and payment for the new value. These decisions note that allowing paid new value to remain as a defense would be an unfair result whereby the creditor essentially receives a windfall.
  - i. Third Circuit: *In re New York City Shoes, Inc.*, 880 F.2d 679, 680 (3rd Cir. 1989).
  - ii. Seventh Circuit: *In re Prescott*, 805 F.2d 719, 731 (7th Cir. 1986).
  - iii. Eighth Circuit: *In re Kroh Bros. Devel. Co.*, 930 F.2d 648 (8th Cir. 1991).
  - iv. Eleventh Circuit: *In re Jet Florida System, Inc.*, 841 F.2d 1082 (11th Cir. 1988).
  - v. *In re Globe Building Materials, Inc.*, 334 B.R. 416 (Bank. N.D. Ind. 2005).
  
- b. Other circuits hold that new value may be paid and still constitute a defense if the payment is *otherwise unavoidable*. These courts look to the statutory language and conclude that the question is not whether the new value remains unpaid, but, rather, whether the new value was paid “by an otherwise unavoidable transfer” under section 547(c)(4)(B). If the subsequent transfer is avoidable, the defendant may use the section 547(c)(4) defense. On the other hand, if the subsequent transfer is unavoidable, a defendant cannot satisfy the section 547(c)(4)(B) test. In effect, these cases suggest that each payment that might constitute new value under the statute must be examined to determine whether each payment is otherwise unavoidable.
  - i. Fourth Circuit: *In re JKJ Chevrolet, Inc.*, 412 F.3d 545 (4th Cir. 2005).
  - ii. Fifth Circuit: *In re Toyota of Jefferson*, 14 F.3d 1088 (5th Cir. 1994).
  - iii. Eighth Circuit: *In re Jones Truck Lines, Inc.*, 130 F.3d 323 (8th Cir. 1997) (holding that language in *In re Kroh Bros. Devel. Co.*, 930 F.2d 648 (suggesting that new value must remain unpaid, was “shorthand” for avoidable payments).
  - iv. Ninth Circuit: *In re IRFM, Inc.*, 52 F.3d 228 (9th Cir. 1995).
  - v. *In re Van Dyck*, 289 B.R. 304 (D. Conn. 2003).
  - vi. *Official Committee of Unsecured Creditors v. Travelers Indemnity Company (In re Maxwell Newspapers, Inc.)*, 192 B.R. 633 (Bankr. S.D.N.Y. 1996) (critiquing and declining to follow cases holding that new value must be unpaid).
  
- c. Published First Circuit case law is not clear on whether new value must remain unpaid: *In re Keydata Corp.*, 37 B.R. 324 (Bankr. D. Mass. 1983) (new value must “remain unpaid”); *In re Dooley Plastics Co., Inc.*, 185 B.R. 389 (Bankr. D. Mass. 1995) (discussing both views).

- d. Commentary supports the view that new value does not have to remain unpaid. There may not be as much of a conflict as first appears in the paid versus unpaid case law. That two Eighth Circuit cases are cited for both views noted above demonstrates this point. Section 547(c)(4)(B) by its terms contemplates a transfer-by-transfer avoidance analysis. The plain language of Section 547(c)(4) states that new value may be repaid if not otherwise unavoidable. Recent court opinions characterize the “remain unpaid” axiom as a judicial gloss on Section 547(c)(4) (as a way to justify what may be an emerging majority view). *In re Roberds, Inc.*, 315 B.R. 443 (Bankr. S.D. Ohio); *In re Chrysler Credit Corp.*, 312 B.R. 797 (E.D. Va. 2004); WILLIAM L. NORTON, NORTON BANKRUPTCY LAW & PRACTICE § 66.36 (2008).
  - e. If new value does not have to remain unpaid, and if a trustee does not seek to avoid the paid new value transfer, the trustee’s failure to attempt to avoid these transfers does not preclude the defendant’s claim to use the new value defense and to keep the payment based on the new value defense. *In re JKJ Chevrolet, Inc.*, 412 F.3d. 545 (4th Cir. 2005). A trustee is well-advised to seek to avoid all avoidable transfers so that she is not faced with an unfortunate result. Defendants may be able to take advantage in cases where a trustee fails to seek to avoid a transfer that pays new value.
  - f. What about payments by unrelated third parties? In some circumstances, new value defenses can lie even if third parties pay the new value. Whether the new value defense is diminished depends upon the effect on the estate. *In re Kroh Bros. Devel. Corp.*, 930 F.2d 648 (8th Cir. 1991); *In re Formed Tubes, Inc.*, 46 B.R. 645 (Bankr. E.D. Mich. 1985).
- V. Pre- and post-petition payments. Related issues involve the determination of whether post-petition new value can be used in the new value defense, and whether post-petition repayment of new value transfers diminishes a new value defense.
- a. Several cases hold that post-petition new value cannot be used to offset preferential transfers. *In re Bellanca Aircraft*, 850 F.2d 1275 (8th Cir. 1988); *In re Sharoff Food*, 179 B.R. 669 (Bankr. D. Colo. 1995); *In re Jolly “N,” Inc.*, 122 B.R. 897 (Bankr. D. N.J. 1991) (discussing post-petition new value). These cases look at the plain meaning of the term “to or for the benefit of the debtor,” reasoning that post-petition advances are made to an estate, not a debtor. These courts also reason that the defense is designed to encourage creditors to deal with troubled businesses, and conclude that allowing a credit for post-petition new value does not further this goal.
  - b. Numerous courts have discussed the question of whether payments to the creditor paid post-filing diminish the new value defense, and courts come to differing conclusions. Some courts recognize that nothing in the Code limits the new value defense to events occurring pre-petition. If a post-petition transfer to a creditor is authorized by a court, and is therefore unavoidable, courts may

reduce the new value defense by the amount of the post-petition transfer if they conclude the result would otherwise be double use of new value. Some courts recognize that post-petition transfers by the debtor-in-possession are not “otherwise unavoidable” transfers by the “debtor,” and that new value need remain unpaid only through the time of the petition.

- i. *In re Login Bros. Book Co.*, 294 B.R. 297 (Bankr. N.D. Ill. 2003) (section 547(c)(4)(B), by its terms, should not be limited to pre-petition repayments since this would allow a creditor to keep its new value defense and also receive repayment post-petition).
- ii. *In re MMR Holding Corp.*, 203 B.R. 605 (Bankr. M.D. La. 1996) (same).
- iii. *In re D.J. Mgt. Group*, 164 B.R. 831 (Bankr. W.D.N.Y. 1994) (concluding without analysis that new value defense does not apply if debt was paid post-petition in an authorized transfer).
- iv. *In re Schabel*, 338 B.R. 376 (Bankr. E.D. Wis. 2006) (analyzing cases and holding that under Seventh Circuit precedent new value must remain unpaid as of the filing date).
- v. *In re Thurman Constr. Inc.*, 189 B.R. 1004 (Bankr. M.D. Fla. 1995)
- vi. *In re Phoenix Restaurant Group, Inc.*, 373 B.R. 541 (M.D. Tenn. 2007) (post-petition payment by a debtor-in-possession was not a transfer by a debtor for purposes of section 547(c)(4)(B)).
- vii. *In re Energy Co-Op, Inc.*, 130 B.R. 781 (N.D. Ill. 1991) (holding that section 547(c)(4)(B) defense is not diminished by post-petition payment of new value).

Other cases addressing whether post-petition transfers impact the section 547(c)(4) defense focus on the lack of mutuality between the debtor and the debtor’s estate and the court’s concern that allowing this result would (1) run counter to Code provisions dealing with post-petition transfers, (2) ignore mechanisms established to protect interested parties, and (3) possibly prejudice other creditors. *In re Sharoff Food*, 179 B.R. 669, 678 (B. D. Colo. 1995) (not including post-petition transfers under section 547(c)(4) based on the distinction between the debtor and the estate and other policy considerations); *In re Jolly N. Inc.*, 122 BR 897 (D. N.J. 1991) (discussing post-petition advances of new value and holding that post-petition new value cannot be used to offset preferential transfers).

## VI. Reclamation as an unavoidable transfer.

- a. The right of reclamation eliminates the new value defense, at least in cases where the reclamation claim has value. Goods subject to reclamation are not new value because they do not replenish the estate. *In re Phoenix Restaurant Group, Inc.*, 373 B.R. 541 (M.D. Tenn. 2007); *In re Arizona Fast Foods, LLC*, 299 B.R. 589 (Bankr. D. Ariz. 2003) (goods subject to reclamation and PACA trust were not new value).