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New Value Must Remain Unpaid? It's Time to Resole *New York City Shoes*

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Although Delaware has sported one of the busiest preference dockets of any venue over the past 10 years or more, it may come as a surprise that one of the greatest controversies surrounding preference litigation—whether subsequent new value need remain unpaid under 11 U.S.C. §547(c)(4)—has not been settled there. The applicability of the sole Third Circuit opinion that even mentions the issue—*New York City Shoes Inc. v. Bentley Int'l*



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Inc. (In re New York City Shoes), 880 F.2d 679 (3d Cir. 1989)—is hotly debated, while only one opinion out of Delaware's bankruptcy court,¹ *Hechinger Inv. Co. of Del. Inc. v. Universal Forest Prods. Inc. (In re Hechinger Inv. Co. of Del.)*, has addressed this issue head-on and, in the process, found that there was no binding precedent on that exact question.

As discussed in this article, while the early trend following the enactment of the Bankruptcy Code in 1978 suggested that there may be a requirement that new value must remain unpaid for a preference defendant to use the defense of 11 U.S.C. §547(c)(4), the recent

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overwhelming trend is for courts to reject that approach in favor of a plain-meaning, textually based approach to that statute. Moreover, it appears that Delaware—and perhaps the Third Circuit—may well be on track to weigh in on this issue.

In the chapter 11 case of the *Pillowtex Corp. et al.* (Case No. 03-12339 (PJW)), there are two adversary proceedings brought by the Official Committee of Unsecured Creditors of *Pillowtex Corp.*

meaning of the statute requires that new value remain unpaid.

Instead, the committee primarily ties its fortunes to the viability of *Shoes* as binding authority on the bankruptcy court for this issue. This reliance may well prove to be ill-advised in view of



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the statement by Judge Carey at a status conference in the *Pillowtex* adversary proceedings that “there’s no controlling law in the circuit on that issue.” *Tr. of Status Conf.*, Aug. 22, 2006, 5:23-24 [Docket No. 2505].

Subsequent new value is “money or money’s worth in goods, services, or new

Feature

(the “committee”) with pending motions for partial summary judgment on this precise issue: *Committee v. Xymid LLC*, (Adv. Pro. No. 05-30238 (KJC)), and *Committee v. American & Efrid and Wellman Inc.*, (Adv. Pro. No. 05-52131 (KJC) (collectively, the “*Pillowtex* adversary proceedings”) (the defendants in the *Pillowtex* adversary proceedings are collectively referred to herein as the “*Pillowtex* defendants.”) Each of these motions are pending before Bankruptcy Judge **Kevin J. Carey**, who is one of the four bankruptcy judges added to the court’s roster this year.

While the *Pillowtex* defendants each articulate a number of rationales for the position that new value need not remain unpaid, many of which are mirrored in the arguments set forth in this article, the committee does not argue that the plain

credit”² extended after the time that the creditor receives a transfer from the debtor. While normally a straightforward calculation, plaintiffs assert in some preference actions in Third Circuit districts that “all new value must remain unpaid” and that this is the “established law” of the circuit under *Shoes*. This assertion derives from the following *dicta* in that case:

The three requirements of §547(c)(4) are well established. First, the creditor must have received a transfer that is otherwise voidable as a preference under §547(b). Second, *after* receiving the preferential transfer, the preferred creditor must advance “new value” to the debtor on an unsecured basis. Third, the debtor

¹ Adv. Pro. No. 01-3170 (PBL), 2004 WL 3113718 (Bankr. D. Del. Dec. 14, 2004).

² 11 U.S.C. §547(a)(2)

must not have fully compensated the creditor for the “new value” as of the date that it filed its bankruptcy petition.

Id. at 680.

However, *New York City Shoes* neither supports nor establishes that new value must remain unpaid. In *Shoes*, the Third Circuit addressed when a post-dated check given by a debtor to a creditor should be considered transferred for the purpose of the new value defense—*i.e.*, when the transfer was made, *not* whether there was subsequent new value.

Unlike §60(c) of the Bankruptcy Act, the statutory language of §547(c)(4) does not provide that new value must remain unpaid. Instead, the critical language of §547(c)(4)(B) requires that after receiving the new value “the debtor did not make an *otherwise unavoidable* transfer to or for the benefit of such creditor” (emphasis added). This section says nothing about new value remaining unpaid; rather, what it says is that the new value cannot be paid by an *otherwise unavoidable transfer*. Thus, it is not the fact of payment that undermines the new value, it is the nature of the payment itself that determines whether the value constitutes new value within the meaning of §547(c)(4).

Perhaps an extreme example would help. Presume a vendor provides goods to the debtor on a regular basis. Each shipment constitutes \$1 million in goods and after each shipment, but before the next shipment, the debtor pays the vendor \$1 million. During the preference period the debtor receives and pays for five shipments for a total of \$5 million. The chart of shipments and payments might look like this:

Shipment 1: \$1 million
Payment 1: \$1 million
Shipment 2: \$1 million
Payment 2: \$1 million
Shipment 3: \$1 million
Payment 3: \$1 million
Shipment 4: \$1 million
Payment 4: \$1 million
Shipment 5: \$1 million
Payment 5: \$1 million

Assuming this vendor had no other defenses, the new value chart under some plaintiffs’ version of *New York City Shoes* might look like this:

Shipment 1
Value: \$1 million; **Net Preference:** 0
Payment 1

\$1 million; \$1 million
Shipment 2
\$1 million; \$1 million (this new value was paid)
Payment 2
\$1 million; \$2 million
Shipment 3
\$1 million; \$2 million (this new value was paid)
Payment 3
\$1 million; \$3 million
Shipment 4
\$1 million; \$3 million (this new value was paid)
Payment 4
\$1 million; \$4 million
Shipment 5
\$1 million; \$4 million (this new value was paid)
Payment 5
\$1 million; \$5 million

In some plaintiffs’ view of *New York City Shoes*, this defendant would have \$5 million of preference exposure. Worse yet, this vendor, not only liable for \$5 million, would also be out \$5 million in goods that it shipped to the debtor. This result, however, makes no sense, either in the context of the language of §547(c)(4) or in the context of a preference defense’s purpose being to protect creditors and encourage them to do business with debtors in distress. *See, e.g., Mosier v. Ever-Fresh Food Co. (In re IRFM Inc.)*, 52 F.3d 228, 232 (9th Cir. 1995) (“the new value exception encourages creditors to continue to do business with financially troubled debtors, with an eye toward avoiding bankruptcy”); *see also Williams v. Agama Sys. Inc. (In re Micro Innovations Corp.)*, 185 F.3d 329, 332 (5th Cir. 1999) (“by limiting the risk of loss incurred by suppliers who continue ordinary credit arrangements with troubled companies, the rule encourages transactions that may allow the debtor to stave off bankruptcy”); *Laker v. Vallette (In re Toyota of Jefferson Inc.)*, 14 F.3d 1088, 1091 (5th Cir. 1994) (citations omitted) (“the limited protection provided by the subsequent advance rule encourages creditors to continue their revolving credit arrangements with financially troubled debtors, potentially helping the debtor avoid bankruptcy altogether”). Indeed, if “new value must remain unpaid” were the rule, no savvy credit manager would advocate providing further goods or services to a troubled customer, and the policy behind this preference defense would be eviscerated.

However, strict application of the

statutory language would result in potential preference liability of only \$1 million relating to the last payment—all other payments being netted out by the subsequent extensions of new value:

Shipment 1
Value: \$1 million; **Net Preference:** 0
Payment 1
\$1 million; \$1 million
Shipment 2
\$1 million; \$0
Payment 2
\$1 million; \$1 million
Shipment 3
\$1 million; \$0
Payment 3
\$1 million; \$1 million
Shipment 4
\$1 million; \$0
Payment 4
\$1 million; \$1 million
Shipment 5
\$1 million; \$0
Payment 5
\$1 million; \$1 million

This result stays true to the statute, underscores the policy behind the defense and is arguably fair to both the debtor and the creditor. Conversely, *Shoes* is not true to the statute, undermines the policy behind the defense and rewards the debtor with a double recovery at the defendant’s expense. For these reasons, *Shoes* has been roundly criticized.

For example, as one bankruptcy court noted, *New York City Shoes* “lack[s] any meaningful analysis of why the ‘remains unpaid’ element should be read back into a statute that expresses no such requirement. In *New York City Shoes*, the court did not analyze the defense in terms of a series of new advances repaid by preferential payments that were in turn the basis for more new advances.” *Liberty Livestock Co. v. Ellis County Abstract & Title Co. (In re Liberty Livestock Co.)*, 198 B.R. 365, 377 (Bankr. D. Kan. 1996); *see also IRFM*, 52 F.2d at 231 (discussing “absurd results” that arise from a “shorthand” reading of the statute urged by *New York City Shoes* and other cases that require new value to remain unpaid).

Since *New York City Shoes*, many courts have been more amenable to applying the clear language of the statute when directly addressing the issues of whether new value must remain unpaid. Perhaps the most detailed of these is *Boyd v. Water Doctor (In re Check Reporting Servs. Inc.)*, 140 B.R. 425 (Bankr. W.D. Mich. 1992). *Check Reporting* put the

New York City Shoes dilemma this way:

(1) Common sense would dictate that a creditor should not be able to assert a new value transfer as a defense to a preference if the transfer was paid for by the debtor because the estate was not made whole by the new value transfer. But (2) by the same token, the trustee should not be able to assert the new value was paid if the trustee is asserting that the paying transaction was in fact a preference which the trustee can avoid. By doing so the trustee will be able to eliminate the effect of the payment for the new value when he recaptures the preferential transfer.

Check Reporting, 140 B.R. at 433.

In *Check Reporting*, the court closely analyzed the case law relevant to the question of whether new value must remain unpaid, and the language of §547(c)(4)(B). Addressing the trustee's argument that the court should adopt a requirement that new value remain "unpaid," the *Check Reporting* court dissected the failure of earlier courts to read §547(c)(4) properly. That failure was attributed in part to "[t]he statutory language, [which] consists of several layers of negatives." *Id.* at 431. The court observed that, "[a]lthough the provision at issue in this case does contain a double negative, this fact makes the statute *complicated*, not ambiguous." *Id.* at 434. Once the statute is comprehended, "it does effectuate the...policy concerns expressed by its drafters." *Id.* at 437. The court therefore concluded that there is no requirement that new value remain unpaid.

Every court recently considering the question of whether new value must remain unpaid, when not bound by *stare decisis*, has rejected the proposition that it must remain unpaid.³

In Delaware, at least one court has distinguished *New York City Shoes* and followed *Check Reporting*. See *Hechinger*, Adv. Pro. No. 01-3170 (PBL), 2004 WL 3113718 (Bankr. D. Del. Dec. 14, 2004). In *Hechinger*, plaintiff Hechinger sued defendant Universal Forest Products (UFP) under §547(b) of the Code to avoid a series of allegedly preferential transfers worth

\$16,703,604.57. *Id.* at *1. Visiting Judge Paul B. Lindsey found that *New York City Shoes*, where there was one transfer, was distinguishable on the facts, explicitly rejecting the notion that *New York City Shoes* was applicable in a "rolling credit" scenario, and adopting the reasoning of *Check Reporting*, based on the plain language of §547(c)(4) and the policy reasons underlying that section of the Code. *Hechinger*, 2004 WL 3113718 at *5.

As long as plaintiffs and their counsel continue to insist that new value must remain unpaid, *New York City Shoes* will be used as their support in the Third Circuit. However, that requirement, which was expressly a requirement of the new-value defense until 1978, was thereafter written out of the Code. Unfortunately, *New York City Shoes* merely provided a shorthand statement of the new value defense. Moreover, *New York City Shoes* itself did not consider whether new value needs to remain unpaid, so it is, at best, faulty reasoning that leads plaintiffs to continue to claim that it establishes such a requirement in the Third Circuit.

Because plaintiffs habitually sue defendants for every payment made to them in the 90 days prior to the petition date, those plaintiffs and counsel who continue to argue that new value must remain unpaid are either relying on the same "shorthand" form of §547(c)(4) that appears to doom *New York City Shoes*, or perhaps they are implicitly admitting that the payments that paid the alleged new value are "otherwise unavoidable" and are therefore not subject to avoidance and recovery at all. In any event, with BAPCPA arguably loosening the requirements for proving the "ordinary-course-of-business" defense in preference actions,⁴ plaintiffs will likely raise the paid new-value argument more vigorously. However, the outcome of the summary judgment motions in the *Pillowtex* adversary proceedings may do much to determine whether plaintiffs in Delaware—and perhaps ultimately the Third Circuit overall—will be able to continue to do so. ■

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³ See, e.g., *Hall v. Chrysler Credit Corp.* (In re J&J Chevrolet Inc.), 412 F.3d 545 (4th Cir. 2005); *IRFM*, 52 F.3d 228 (9th Cir. 1995); *Toyota*, 14 F.3d 1088; *Phoenix Rest. Group v. Denny's* (In re Phoenix Rest. Group Inc.), Case Nos. 301-12036, 303-573A, 2005 WL 114327, *8 (Bankr. M.D. Tenn. Jan. 10, 2005); *Hechinger*, 2004 WL 3113718 at *5; see also *McKloskey v. Schabel* (In re Schabel), 338 B.R. 376, 380-81 (Bankr. E.D. Wis. 2006) (noting that although bound by *stare decisis* to follow the holding in *Prescott*, 805 F.2d 719 (7th Cir. 1986), new value must remain unpaid, "[i]n recent years...many courts have favored a different approach that comports with the statutory language and does not require that the new value remain unpaid" (citations omitted)); *Matter of Kroh Bros. Dev. Co.*, 930 F.2d 648, 653 (8th Cir. 1991).

⁴ Section 547(c)(2), which formerly required that preference defendants prove that the subject transfers were both made in the ordinary course of business or financial affairs of the debtor and transferee, and made according to ordinary business terms (the so-called "industry standard"), now posits those elements in the disjunctive, perhaps making the defense easier to prove.

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