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Don't Settle a Preference Case on the Basis of Unpaid New Value

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The authors of this article discuss the new value defense to preference actions.

Preference actions are common in bankruptcy cases. These actions seek to claw back payments made by a debtor to a creditor during the 90 days before the commencement of a bankruptcy case.

A common defense to a preference action is the "new value" defense found in Section 547(c)(4) of the Bankruptcy Code. A creditor has a defense to the extent it provides value to the debtor *after* the creditor receives a preferential payment. To illustrate, imagine that on Day 1 of the preference period the debtor makes a payment of $100 to the creditor for goods the debtor previously received. On Day 2, the creditor delivers to the debtor $50 more in goods. The creditor has a $50 new value defense and $50 in preference exposure.

But what happens to the new value defense when, on Day 3, the debtor makes another payment of $50 for the goods the creditor delivered on Day 2? In most jurisdictions, the creditor's $50 new value defense remains unchanged, and its preference exposure increases to $100. But in three federal

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circuits that have held that new value must remain unpaid, the creditor may enjoy no new value defense and its preference exposure may increase to $150.

Why do we say that the creditor "may" enjoy no new value defense? In two of these jurisdictions, courts have been treating dicta as binding law, but now appear to be moving in the direction of the majority view. In the third jurisdiction, however, the minority view is the law and courts must follow it.

In these three circuits, a creditor facing a preference claim, and considering a proposed settlement, should carefully assess the merits of its new value defense in light of the statutory text and case law.

COMPLICATED STATUTORY TEXT

The wording of Section 547(c)(4)'s new value defense underlies the split among the courts, with three circuits indicating that the new value provided by the creditor must remain unpaid for the defense to be available. Interpretation of the requirements for the new value defense is complicated by a double negative and an ambiguous adverb, as emphasized below:

> (c) 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 a transfer to or for the benefit of such creditor.

The complicated sentence structure causes many courts to paraphrase the statute. In summarizing Section 547(c)(4)(B)'s requirement that "the debtor did not make an otherwise unavoidable transfer," the Third, Seventh and Eleventh Circuits have suggested that new value must remain unpaid. But requiring that new value remain unpaid contradicts — or at least renders superfluous — an important part of Section 547(c)(4)(B): the words "otherwise unavoidable." The minority courts have interpreted Section 547(c)(4)(B) as if

"otherwise unavoidable" were stricken from the statute:

> (c) 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 a transfer to or for the benefit of such creditor.

Rather than litigate over legislative intent or the proper interpretation of Section 547(c)(4)(B) in the minority circuits, creditors have a potentially simpler option for avoiding the requirement that new value must remain unpaid: Argue that the requirement is non-binding dicta. As discussed below, a close reading of the leading cases from the Third, Seventh and Eleventh Circuits reveals that the requirement is merely dicta in two circuits.

THE THIRD AND ELEVENTH CIRCUITS

Both the Third and Eleventh Circuits hold that new value must remain unpaid; *however*, both courts were paraphrasing Section 547(c)(4). In *In re New York City Shoes, Inc.*, the Third Circuit summarized Section 547(c)(4)'s requirements as follows:

> The three requirements of section 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 must not have fully compensated the creditor for the "new value" as of the date that it filed its bankruptcy petition.[1]

Similarly, in *In re Jet Florida System, Inc.*, the Eleventh Circuit summarized the statute:

> This section has generally been read to require: (1) that the creditor must have extended the new value after receiving the challenged payments, (2) that the new value must have been unsecured, and (3) that the new value must remain unpaid.[2]

In neither opinion was the "remains unpaid" issue considered on the merits. Indeed, in both cases the parties conceded that the new value had not been paid. In both the Third and Eleventh Circuits, discussion of issues not before the court is dicta and not binding precedent.[3] Thus, the requirement that new value remain unpaid—repeatedly applied by lower courts in the Third and Eleventh Circuits[4]—is only non-binding dicta.

Courts that have carefully analyzed *New York City Shoes* and *Jet Florida System* also have concluded that the holdings are dicta. The U.S. Bankruptcy Court for the District of Delaware, as well as others, have explained,

> [M]ost of the courts that are cited as requiring that subsequent new value be "unpaid," have not actually held as much, but, like *Jet Florida*, have only repeated that requirement in dicta. This explains those courts' employment of the term "unpaid" not as a statement of law, but rather as a "shorthand description of § 547(c)(4)(B)."[5]

Lower courts in the Third and Eleventh Circuits have expressly rejected the dicta set forth in *New York City Shoes* and *Jet Florida System*. In *In re Pillotex Corp.* and *In re Frey Mechanical Group, Inc.*, the Delaware and Eastern District of Pennsylvania bankruptcy courts applied the new value defense even though the new value had been paid.[6] Similarly, in *In re Winter Haven Truss Co.*, the Bankruptcy Court for the Middle District of Florida rejected the argument that new value must remain unpaid under Eleventh Circuit precedent:

> Plaintiff asserts that *Jet Florida* stands for the proposition that new value credit is available only for amounts which remain unpaid. This Court does not agree.

> While the Jet Florida opinion recites that the non-payment of a subsequent advance is a necessary prerequisite to new value credit, that statement is quoted from a case out of another jurisdiction, and is not necessary to the decision of the court in *Jet Florida*. Thus, the statement is purely dictum. *Jet Florida* stands for no more than the proposition that a lessor's forbearing to terminate a lease after default did not constitute the giving of new value under § 547(c)(4). Even that proposition may be too broad, since it is clear from the opinion that the debtor in that case did not continue to use the leased premises, and that the result might well have been different had the debtor not abandoned the premises.[7]

In *In re TI Acquisition, LLC* the Bankruptcy Court for the Northern District of Georgia similarly questioned whether the "remains unpaid" requirement was binding precedent in the Eleventh Circuit.[8]

WHAT ABOUT THE SEVENTH CIRCUIT?

In *In re Prescott*,[9] the Seventh Circuit directly addressed the issue of whether new value must remain unpaid. A few observers have characterized the "remains unpaid" requirement in *Prescott* as dicta too, though such characterization is questionable.[10] There are, however, reasons to question the opinion. The *Prescott* Court failed to explain how the statutory text requires (or even implies) that the value must remain unpaid or give any reason for deviating from the statutory text. In addition, the court quoted a bankruptcy court opinion from outside of its jurisdiction when it paraphrased Section 547(c)(4).[11] Despite *Prescott*'s shortcomings, the "remains unpaid" requirement appears alive and well in the Seventh Circuit. More than a decade after *Prescott*, the Seventh Circuit applied the "remains unpaid" requirement again in *In re P.A. Bergner & Co.*[12]

SO WHAT?

Most preference cases settle. The parties engage in a process of negotiations over the strengths and weaknesses of the alleged preference liability, based on the particular facts and the available defenses. By comparison to

other defenses (such as the "ordinary course of business" defense in Section 547(c)(2)), the subsequent new value defense is relatively straight-forward to develop, as it is based on the flow of value to and from the debtor during the relevant period. However, depending on the circuit in which the case is pending, the defense may be substantially weaker based on the "remains unpaid" requirement.

If you are a preference defendant in the Third, Seventh, or Eleventh Circuits who provided new value that was subsequently paid for by the debtor, consider holding out for a more favorable settlement than you might otherwise expect. The plaintiff may argue that the "remains unpaid" requirement poses a substantial obstacle to invoking the Section 547(c)(4) subsequent new value defense. However, as demonstrated above, at least in the Third and Eleventh Circuits preference defendants should argue in their negotiations that the "remains unpaid" requirement is dicta, and rely on the lower court decisions holding as much. Even in the Seventh Circuit, where "remains unpaid" appears to be the law, your case may warrant the fight based on the statutory text and the current trend.[13] If negotiations fail and you end up in litigation, the bankruptcy community will be eagerly watching for a ruling in those c ircuits on the viability of the "remains unpaid" gloss on the statutory defense.

NOTES

[1] *N.Y.C. Shoes, Inc. v. Bentley Int'l, Inc. (In re N.Y.C. Shoes, Inc.)*, 880 F.2d 679, 680 (3d Cir. 1989).

[2] *Charisma Inv. Co., N.V. v. Airport Sys., Inc. (In re Jet Fla. Sys., Inc.)*, 841 F.2d 1082, 1083 (11th Cir. 1988).

[3] *See, e.g.*, *Great Lakes Dredge & Dock Co. v. Tanker Robert Watt Miller*, 957 F.2d 1575, 1578 (11th Cir. 1992) (because what is said in a prior opinion about a question not presented is dicta, and dicta is not binding precedent, a later panel is "free to give that question fresh consideration"); *McGurl v. Trucking Emps. of N. Jersey Welfare Fund, Inc.*, 124 F.3d 471, 484 (3d Cir. 1997) (issue not considered on the merits was dicta and not binding). Other circuits have adopted similar views on dicta. *See, e.g.*, *Espinosa v. United Student Aid Funds, Inc.*, 553 F.3d 1193, 1199 n.3 (9th Cir. 2008).

[4] *See, e.g.*, *Braniff, Inc. v. Sundstrand Data Control, Inc. (In re Braniff, Inc.)*, 154

B.R. 773, 783–85 (Bankr. M.D. Fla. 1993); *Burtch v. Masiz (In re Vaso Active Pharm., Inc.)*, No. 10-10855, 2013 WL 5631025, at *8 (Bankr. D. Del. Oct. 15, 2013).

[5] *Official Committee of Unsecured Creditors of Maxwell Newspapers, Inc. v. Travelers Indem. Co. (In re Maxwell Newspapers, Inc.)*, 192 B.R. 633, 639–40 (Bankr. S.D.N.Y. 1996) (citations omitted); *Am. & Efrid, Inc. v. Xymid, LLC (In re Pillotex Corp.)*, 416 B.R. 123, 127 (Bankr. D. Del. 2009); *see also TI Acquisition v. S. Polymer, Inc. (In re TI Acquisition, LLC)*, 429 B.R. 377, 383–84 (Bankr. N.D. Ga. 2010).

[6] *In re Pillotex Corp.*, 416 B.R. at 127–31; *Shubert v. Mull (In re Frey Mech. Grp., Inc.)*, 446 B.R. 208, 217–19 (Bankr. E.D. Pa. 2011).

[7] *Hyman v. Stone Lumber Co. (In re Winter Haven Truss Co.)*, 154 B.R. 592, 596 (Bankr. M.D. Fla. 1993); *but see In re Braniff, Inc.*, 154 B.R. 773 (relying on *Jet Florida System* and applying the "remains unpaid" approach). Notably, *Winter Haven Truss* was decided by a judge sitting by designation.

[8] *In re TI Acquisition, LLC*, 429 B.R. at 383–84.

[9] *In re Prescott*, 805 F.2d 719 (7th Cir. 1986).

[10] *See, e.g.*, *New Value Defense to Preference Payments the Circuits Divided*, Am. Bankr. Institute, Annual Spring Meeting (April 2003) *available at* http://www.abiworld.org/AM/Template.cfm?Section=Home&Template=/MembersOnly.cfm&ContentID=28445&FusePreview=Falsehttp://www.abiworld.org/AM/Template.cfm?Section=Home&Template=/MembersOnly.cfm&ContentID=28445&FusePreview=False; *but see McKloskey v. Schabel (In re Schabel)*, 338 B.R. 376, 381 (Bankr. E.D. Wis. 2005) ("Since that was *Prescott's* holding, not just a set of extraneous remarks, it cannot be dismissed as mere dicta.").

[11] In *Prescott*, the Seventh Circuit quoted the U.S. Bankruptcy Court for the District of Maine for Section 547(c)(4)'s requirements, "Section 547(c)(4) establishes a subsequent advance rule whereby a preferential transfer is insulated from a trustee's avoiding powers to the extent that a creditor extends new value, which is unsecured and *remains unpaid*, to a debtor after the preferential transfer." The court then noted, "The district court determined that Marine failed to meet this burden because it never showed that any overdrafts went unpaid." *In re Prescott*, 805 F.2d at 728. The Court did not discuss the "remains unpaid" requirement further.

[12] *P.A. Bergner & Co. v. Bank One, Milwaukee, N.A. (In re P.A. Bergner & Co.)*, 140 F.3d 1111, 1121 (7th Cir. 1998) ("Bank One's alternative new value defense, under § 547(c)(4), fails as well…since Bank One gave no subsequent unsecured

credit which remained unpaid."). Arguably, the *Bergner* Court's comment on the "remains unpaid" requirement is dicta.

[13] *See, e.g.*, *Hall v. Chrysler Credit Corp. (In re JKJ Chevrolet, Inc.)*, 412 F.3d 545, 552 (4th Cir. 2005); *Jones Truck Lines, Inc. v. Central States, Se. & Sw. Areas Pension Fund (In re Jones Truck Lines, Inc.)*, 130 F.3d 323, 329 (8th Cir. 1998); *Mosier v. Ever-Fresh Food Co. (In re IRFM, Inc.)*, 52 F.3d 228, 231–32 (9th Cir. 1995); *Laker v. Vallette (In re Toyota of Jefferson, Inc.)*, 14 F.3d 1088, 1092–93 (5th Cir. 1994); *see also* 5-547 COLLIER ON BANKRUPTCY ¶ 547.04[4][e] ("With increasing consistency, more modern decisions have rejected the notion that the new value must remain 'unpaid,' as representing an oversimplification of the proper application of section 547(c)(4).").