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Delaware Bankruptcy Court's *Pillowtex* Decision Favors Preference Defendant Relying on Subsequent New Value Defense

The October 15, 2009 decision of the US Bankruptcy Court for the District of Delaware in *In re Pillowtex* opens the door for creditors in the Third Circuit to increase their "new value" preference defense under the "subsequent advance" approach. *In re Pillowtex,* No. 03-12339 (Bankr. D. Del. filed Oct. 15, 2009).

A trustee's power to avoid preference payments is circumscribed by the statutory defenses set forth in section 547(c) of the Bankruptcy Code. The "subsequent new value" defense set forth in section 547(c)(4) has three well-established elements:

> *First, the creditor must have received a transfer that is otherwise avoidable 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.*

New York City Shoes, Inc. v. Bentley Int'l, Inc. (In re New York City Shoes, Inc.), 880 F.2d 679, 680 (3d Cir. 1989).

While the elements of the new value defense are well established, the circuit courts of appeal have split in

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Contacts:

Stephen D. Lerner
Practice Chair
+1.513.361.1220
+1.212.872.9800

Sean T. Cork
+1.602.528.4035

Craig D. Hansen
+1.602.528.4085

Jordan A. Kroop
+1.602.528.4024

Jeffrey A. Marks
Alert Editor
+1.513.361.1242

Sandra E. Mayerson
+1.212.872.9899

G. Christopher Meyer
+1.216.479.8692

Thomas J. Salerno
+1.602.528.4043

Robert A. Wolf
+1.212.872.9850

their interpretation and application of the new value defense. The Third, Seventh and Eleventh Circuits have been cited for the "remains unpaid" interpretation, which requires that the new value provided by the creditor must remain unpaid at the end of the preference period in order to be effectively used by the creditor to offset its preference liability. Conversely, the Fourth, Fifth, and Ninth Circuits have determined that the new value defense does not mandate a "remains unpaid" requirement and have instead applied the more pragmatic and broader "subsequent advance" approach.

What is the difference between the "remains unpaid" and "subsequent advance" approaches and why is it important? The "remains unpaid" approach significantly increases the preference exposure for creditors whose prepetition dealings with a debtor were done on a "running" or "rolling" account basis because that creditor loses the ability to use any provisions of new value that are made between avoidable preference payments by the debtor. Under the "remains unpaid" approach, the creditor gets credit for new value that is provided only after the last avoidable preference payment received from the debtor. That is, under the "remains unpaid" approach, the creditor simply loses the ability to offset any new value the creditor may have provided during the "sandwich period" – the period sandwiched between two preferential payments by the debtor. By contrast, the "subsequent advance" does not deny the creditor credit for new value provided during the sandwich period. The "subsequent advance" approach recognizes the reality of a rolling account relationship by offsetting the aggregate payments received by the creditor by the aggregate new value given by the creditor during the preference period. Therefore, the "subsequent advance" approach prevents a trustee from eliminating the effect of the new value defense when the new value is provided by the creditor during the sandwich period. As shown in the following chart, the "subsequent advance" approach significantly reduces a creditor's preference exposure in rolling account situations.

Date	Alleged Preference Pmt.	New Value Given	Preference Exposure (Subsequent Adv.)	Preference Exposure (Remains Unpaid)
1/10/09	$1,000		$1,000	$1,000
1/20/09		$1,000	-	-
1/30/09	$1,000		$1,000	$2,000
2/10/09		$1,000	-	$1,000
2/20/09	$1,000		$1,000	$3,000
3/1/09		$1,000	-	$2,000

Bradley A. Cosman
Alert Author
+1.602.528.4032

Preference defendants in the Third Circuit have generally been without the benefit of the "subsequent advance" approach as the Third Circuit has historically been considered to be in the "remains unpaid" camp. The *Pillowtex* decision, however, demonstrates that the "subsequent advance" approach is in fact viable in the Third Circuit. The *Pillowtex* court distinguished *New York City Shoes,* the Third Circuit opinion relied upon to place the Third Circuit in the "remains unpaid" camp, on several bases. First, the *Pillowtex* court noted that *New York City Shoes* was concerned only with the second element of the new value test and did not consider the third element that a creditor not be fully compensated for any new value provided. Second, the *Pillowtex* court, citing *Hechinger Inv. Co. of Del., Inc. v. Universal Forest Prod., Inc. (In Re Hechinger Inv. Co. of Del., Inc.),* 2004 WL 3113718 (Bankr. D. Del. 2004), distinguished *New York City Shoes* on its facts because *New York City Shoes* involved only one transfer during the preference period as opposed to the series of transfers contemplated by a rolling account situation. Finally, the *Pillowtex* court concluded that the "subsequent advance" approach furthered the two interrelated purposes of the new value defense: (1) to encourage trade creditors to continue dealing with troubled companies and (2) to treat fairly a creditor who has replenished the estate after having received a preference.

The *Pillowtex* opinion is welcome news to creditors facing preference actions in the Third Circuit as it may provide a roadmap for significantly reducing their preference exposure. Squire Sanders has significant experience assisting creditors in preference defense actions. If you have any questions regarding this alert or preference actions, please feel free to contact a member of the Squire Sanders Bankruptcy & Restructuring group listed on the right.
