Factoring In New Value Under Bankruptcy Code § 547(c)(4)

*By Arthur J. Steinberg**

Section 547(b) of the Bankruptcy Code provides a statutory framework for the bankruptcy estate representative to recover transfers made to creditors on the eve of bankruptcy. The purpose of this "avoiding power" clawback remedy is to promote equality of treatment among the debtor's creditors by ensuring that certain creditors do not receive preferential treatment just before the bankruptcy filing. A counter-veiling bankruptcy policy objective, however, is to encourage creditors to continue dealing with financially troubled businesses, else the downward spiral towards distress and potential business failure is accelerated. Section 547(c) of the Bankruptcy Code provides for exceptions to the *prima facie* preference claim which are geared towards satisfying the counter-veiling objective of encouraging creditors to continue dealing with troubled businesses prior to a potential bankruptcy filing. One of the exceptions — the so-called "new value" exception codified in Section 547(c)(4) — is intended to encourage creditors to provide value to or for the benefit of a debtor, by allowing the creditor to offset from any preference received, the new value thereafter provided by the creditor to or for the benefit of the debtor. The language "to or for the benefit" is a recognition that business transactions often involve more than two parties, and that value can be provided to a debtor as part of an integrated multi-step transaction. Significantly, the more complex the transaction, there is increased difficulty in confirming that new value was received by, or for the benefit of, the debtor as contemplated by Section 547(c)(4).

One type of multi-step financing transaction that is utilized in many industries (such as retail) is the "old line factoring arrangement," wherein the factor purchases the receivable from the vendor that supplies goods to a company, and assumes the credit risk for non-payment, including if the company ultimately files for bankruptcy. Old line factoring generally provides for a cheaper cost of financing for the vendor since the risk of non-payment by the company is split between the factor (based on the credit-worthiness of the company) and the vendor (other customer-related disputes). In turn, a lower financing cost for the vendor facilitates transactions with the company. In many respects, old line factoring is a better incentive for the vendor to continue to do business with a financially troubled company (the counter-veiling policy objective of section 547(c)) since the credit risk of the company not paying for goods shipped is assumed by the

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factor. That salutary incentive is diluted if the vendor cannot transfer the credit risk to the factor because, among other reasons, the factor is unsure whether it can avail itself of the section 547(c)(4) new value exception. A distressed business struggles to preserve trade credit from vendors (and indirectly factors). Uncertainty related to the application of section 547(c)(4) to factors only contributes to the company's financial struggle. Unfortunately, there have not been many decisions in this area, and no clear rulings as to if, and how, the new value exception will be made available for factors. A bankruptcy case from the New Jersey Bankruptcy Court, *Dots, LLC v. Milberg Factors, Inc. (In re Dots, LLC)* ("Dots"),[1] has recently weighed in on the subject, and offers another approach in analyzing various issues relating to the section 547(c)(4) new value defense in the factoring context.

Introduction

A. Factor Financing

"Old line" factoring is a form of financing that involves the purchase of accounts receivables by a factor from its client/vendor. The vendor assumes risk of nonpayment, except in the instance of the customer's inability to pay. In that circumstance, the transaction is "without recourse" to the vendor, and the factor takes the "credit risk" for the customer's failure to pay the receivable. The customer is provided with notice of the factor's receivable purchase and is instructed to make payments to the factor. The factor has the right to approve or disapprove of taking the credit risk for the sale to the customer. Unapproved sales are still purchased by the factor; they just don't assume the credit risk of the customer not paying the receivable. In that situation, the receivable purchase is full recourse to the client/vendor if the customer does not pay.

When a factor, after concluding its credit analysis of the customer, decides it no longer will purchase the vendor's receivables, that can be a "red flag" event for the customer. Often times, a factor's lack of confidence in the customer leads to a loss of vendor trade credit, which, in turn, exacerbates a liquidity problem that causes a customer bankruptcy filing. And, a factor's uncertainty as to whether it can utilize the section 547(c)(4) new value exception could be a tipping point that causes the factor not to buy vendor receivables, which then precipitates the customer's bankruptcy.

B. Preference Statute

Section 547(b) of the Bankruptcy Code sets forth the five (5) elements that must be established for a *prima facie* preference case. They are transfers made by the debtor (i) on or within ninety (90) days of the bankruptcy filing,[2] (ii) to or for the benefit of a creditor, (iii) for or on account of an antecedent debt, (iv) while the debtor was insolvent, and (v) which allowed the creditor to receive more than it otherwise would have received if the case was in Chapter 7 (liquidation).[3]

One of the preference exceptions, the section 547 (c)(4) "new value" exception (or defense), protects transfers "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."[4]

"New value" is defined in the Bankruptcy Code as:

> "money 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.[5]

Two aspects of the section 547(c)(4) new value defense are clear: the new value must be provided after the preferential transfer is made, and the new value must be unsecured. What is less clear from the sparse case law is (a) if and when new value is actually provided by the creditor, (b) if the "new value" is thereafter paid, does that still constitute new value for purposes of the section 547(c)(4) defense, and (c) whether "new value" evidenced by a factored receivable generated by Client A can be used to offset a preference payment made by the customer to the factor for a receivable generated by Client B. These issues are addressed in the *Dots* decision.

C. The New Value Defense Generally Applied in a Multi-Step Transaction

The *Dots* case discussed *In re LGI Energy Solutions*, a recent Eighth Circuit decision,[6] that illustrates how section 547(c)(4) is applied to a multi-step transaction in the non-factoring context. In *LGI*, the debtor provided billing services for its clients, who were large utility customers, such as restaurants. The restaurant paid the debtor who then paid the utility bill. Upon receipt of payment from the debtor, the utility continued to provide utility services to the restaurant who continued to pay the debtor as the middle man in this three party, multi-step transaction. After the debtor filed for bankruptcy, the debtor's trustee sued the utility to recover preference payments made to the utility, and the utility sought to invoke the section 547(c)(4) new value defense. The trustee argued that the new value provided by the utility was to the restaurant and not the debtor. The Eighth Circuit disagreed and held that in a multi-step transaction where the debtor's preferential transfer to a third party [utility] benefits the debtor's primary creditor [restaurant], "new value (either contemporaneous or subsequent) can come from the primary creditor [restaurant], even if the third party [utility] is a creditor in its own right and is the only defendant against whom the debtor has asserted a preferential liability."[7]

The Section 547(c)(4) Factoring Cases

There appear to have been only two decisions before *Dots* that analyze whether a factor provides new value to a debtor for purposes of the section 547(c)(4) new value exception. *Dots* reviewed those cases, and provides its own analytical framework as to how to address the section 547(c)(4) new value exception.

A. Country Junction Case

The first reported decision on this issue was over 30 years ago; it came from the Bankruptcy Court from the Western District of Texas in *In re Country Junction, Inc.*[8] Country Junction was a retailer that purchased apparel from vendors who sold their receivables to the defendant, Republic Factors, pursuant to a factoring arrangement. The debtor made payments to Republic Factors within the 90 day preference period. Republic Factors argued that it could avail itself of the section 547 (c)(4) new value defense for receivables purchased after the receipt of preference payments. The Bankruptcy Court rejected the factor's argument because it determined that the "new value" had to be extended by the same entity that received the preference payment.[9] And, according to the *Country Junction* court, while it was the factor that received the payment, it was the factor's client (the vendor) that provided the subsequent new value to the debtor (customer).

The *Country Junction* decision analyzed the multi-party factoring transaction in a very narrow way. It placed significant emphasis on the fact that there was no contractual agreement directly between Republic Factors and the debtor. It viewed the factoring arrangement as a form of financing between the vendor (the factor's client) and Republic Factors. Thus, the financial accommodation (i.e. new value) provided by the factor was to its client — not the client's customer (the debtor). The court also was influenced by the fact that some of the receivables purchased by Republic Factors were on a recourse basis. In other words, the credit risk for those receivable stayed with the client and not the factor. Further, there was no evidence adduced that the factor's client (the vendor) would have stopped selling goods to the debtor if there was no factoring arrangement. Bottom line: the *Country Junction* court analyzed the factoring agreement as two separate transactions, and not an integrated transaction. The court's analogy to section 553(a)(2) of the Bankruptcy Code, regarding a creditor acquiring a debt within 90 days of a bankruptcy filing for purposes of setting off a prior debt, is illustrative of the court's compartmentalized approach. The *Country Junction* decision was subsequently vacated due to a later settlement agreement amongst the parties. Generally speaking, *Country Junction* was never followed by other courts. However, it became a threat that trustees used to coerce preference settlements with factors.

B. UE Liquidating Corp Case

The second case to tackle the new value defense in the context of factoring arrangements emerged thirteen years later in *In re UE Liquidating Corp.*,[10] an unpublished decision from the Bankruptcy Court for the Western District of Virginia. The debtor, United Elastic, was a manufacturer that purchased yarn from a vendor, Unifi, which sold accounts receivable to First Factors. The factoring arrangement was done on a non-recourse basis; First Factors assumed the credit risk of non-payment by United Elastic. The *UE*

Liquidating court, unlike the court in *Country Junction*, viewed the factoring arrangement as a multi-step integrated transaction. The evidence in *UE Liquidating* showed that if the vendor "had not been able to factor the invoices, i.e., if First Factors had not approved the invoices and thereby accepted the risk of nonpayment of such invoices, the vendor would not have shipped the goods described in such invoices to [the debtor]."[11] The plaintiff made the same argument from *Country Junction* that First Factors neither extended credit nor shipped goods to United Elastic. However, the *UE Liquidating* court distinguished *Country Junction*, relying heavily on the fact that First Factors purchased all invoices without recourse and the parties stipulated that Unifi would not have shipped had First Factors not accepted the credit risk. Moreover, the court observed that the debtor knew of the factor's importance to the vendor relationship and discussed credit terms and timing of payments with the factor. Finally, the court noted that the receivable had been assigned to First Factors and therefore it stood in the shoes of the vendor who clearly could invoke the section 547(c)(4) new value defense.

The court's ruling about the integrated nature of the factoring arrangement was consistent with the policy objective of section 547(c)(4), which is to encourage creditors to continue to transact business with financially troubled companies. It noted that: "To thwart First Factors' ability to assert the new value defense in this instance would be to thwart the very type of transaction that this statutory section was meant to protect, transactions which encouraged creditors to continue to provide new value to troubled businesses".[12] The court therefore found that the factoring arrangement was an integrated transaction such that the factor could utilize the section 547(c)(4) new value defense for the invoices factored by it after the receipt of a preference payment.

The *UE Liquidating* court also addressed the issue of whether the new value had to be unpaid as of the bankruptcy filing date in order for the factor to be able to set-off that new value against the preference payment received. Like *National Lumber*, the court held that the section 547(c)(4) new value defense is available for an invoice paid after the receipt of a preferential transfer.[13]

C. Dots Case

Nineteen years after *UE Liquidating* came the *Dots* decision. In that case, the debtor was a retailer that purchased products from multiple vendors, who in turn had factoring agreements with the defendant factor on a pre-approved (without recourse) basis. Here, again, there was no debate that a *prima facie* preference case against the factor was made. The relevant issue was whether the new value defense could be utilized by the factor. The factor argued that it had provided new value to the debtor in the form of extensions of credit to the vendors who then supplied goods to the debtor. The factor pointed out that this was "old line" factoring, where it purchased the receivables and assumed the credit risk of the debtor's non-payment, as contrasted to accounts receivable financing, where the lender extends credit to the vendor and the receivables serve as collateral. The factor relied on *In re UE Liquidating* for its analysis: the value it provided to the vendor was sufficiently linked to the benefit received by the debtor such that the section 547(c)(4) defense should be available to the factor. The debtor argued *Country Junction*: that it was the vendors, not the factor, who provided the new value to the debtor.

The *Dots* court held that the factor did provide new value, but in the form of goods received by the debtor rather than, as the factor argued, new credit. The *Dots* court rejected the factor's characterization of the factoring transaction as an indirect extension of credit to the debtor, which counted as new value under section 547(c)(4) of the Bankruptcy Code. The court held that trade credit is not "new credit" for purposes of section 547(c)(4). Rather, "new credit" is akin to "a financial transaction such as a loan, credit card transaction, or provision of a credit line."[14] In *Dots*, the new value provided was the goods shipped to the debtor, and the factor provided that new value because as the assignee from the vendor, it not only obtained the account receivable generated by the sale, but also any interest in goods returned by the debtor. Thus, by virtue of the factoring arrangement and the purchase of the residual interest in the goods shipped (as well as the account receivable), the factor had provided new value directly to the debtor. Stated otherwise, as the assignee of the vendor's position, it stood in the vendor's shoes as the direct provider of new value in the form of goods shipped to the debtor.

The *Dots* court also addressed two other related section 547(c)(4) new value issues. First, like in *UE Liquidating,* the new value (for the goods shipped) did not need to be unpaid as of the bankruptcy filing date in order to qualify for the set-off contemplated by section 547(c)(4).[15] *Second,* the factor was able to use the new value provided by it through the assignment of Customer A's position against the preference payment received through its Customer B position.[16]

What This Means for Factors

It is hard to say there is a trend in the law when analyzing three cases over a thirty year span. *Country Junction* takes a narrow view of what constitutes a "benefit" to the debtor. Simply put, it did not find that an "old line" factoring agreement can be an integrated multi-step, multi-party transaction that satisfies the section 547(c)(4) new value defense. *UE Liquidating* takes a much broader view of when an integrated multi-step, multi-party transaction can occur. It views factoring as an indirect "new credit" transaction that benefits the debtor. *Dots* takes a different approach. It tries to avoid the difficulty in analyzing when a multi-step transaction is an integrated one "for the benefit" of the debtor, such that the new value defense would be available to a party that did not contract directly with the debtor. Rather, it views the factoring transaction as a bi-lateral arrangement between the factor (as the assignee from the vendor) and the debtor. In *Dots,* unlike *UE Liquidating,* it does not matter that the vendor would not have shipped but for the factoring agreement. *Dots* does not focus on the new credit provided by the factor to its client that facilitated shipments to the debtor. Rather, the focus in *Dots* is on the shipments of goods made to the debtor and the assignment of the vendor's position to the factor.

It is still not clear how future courts will analyze the section 547(c)(4) new value defense in the factoring context. Under *UE Liquidating* and *Dots,* the factor will be able to take advantage of the section 547(c)(4) new value defense, albeit under different analytical arguments. Moreover, these decisions are only persuasive authority; they are not binding precedent on other courts. So, for now, factors will continue to make all available arguments to demonstrate new value under section 547(c)(4). At some point, a clear and binding precedent will hopefully emerge.

NOTES:

[1]In re Dots, LLC, 562 B.R. 286 (Bankr. D. N.J. 2017).

[2]There is a longer preference period (one year) for a transfer to an insider (as defined in section 101(31) of the Bankruptcy Code.)

[3]11 U.S.C.A. § 547(b).

[4]11 U.S.C.A. § 547(c)(4).

[5]11 U.S.C.A. § 547(a)(2).

[6]In re LGI Energy Solutions, Inc., 746 F.3d 350, 59 Bankr. Ct. Dec. (CRR) 77, 71 Collier Bankr. Cas. 2d (MB) 474, Bankr. L. Rep. (CCH) P 82613 (8th Cir. 2014).

[7]LGI Energy Solutions, 746 F.3d at 356.

[8]In re Country Junction, Inc., 49 B.R. 708 (Bankr. W.D. Tex. 1985).

[9]Country Junction, Inc., 49 B.R. at 709.

[10]In re UE Liquidating Corp., Case No. 94-864 (Bankr. W.D. Va. Feb. 24, 1998). The *UE Liquidating* decision referenced In re National Lumber and Supply, Inc., 184 B.R. 74, 27 Bankr. Ct. Dec. (CRR) 635 (B.A.P. 9th Cir. 1995) as a case that applied the section 547(c)(4) new value defense in favor of a factor although there was no analysis therein as to how the factor provided new value to the debtor. In *National Lumber*, the section 547(c)(4) discussion was focused on whether new value needed to be unpaid as of the bankruptcy filing date in order for the setoff to be available to the factor. The *National Lumber* case answered that question by permitting the new value offset for paid invoices.

[11]In re UE Liquidating Corp., Case No. 94-864, at 4 (Bankr. W.D. Va. Feb. 24, 1998).

[12]UE Liquidating Corp., Case No. 94-864, at 11.

[13]UE Liquidating Corp., Case No. 94-864, at 13–14.

[14]In re Dots, LLC, 562 B.R. 286 (Bankr. D. N.J. 2017).

[15]Dots, LLC, 562 B.R. at 302–303.

[16]Dots, LLC, 562 B.R. at 304–305.