Valuation of Returned Inventory as a Preference Claim

By

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Preference claims are one of the more frequently litigated issues in bankruptcy, and the typical preference claim is based on a debtor's payment of antecedent debt. However, sometimes a preference claim is based on the debtor's return of inventory to the creditor in return for a reduction of the creditor's claim. The few reported decisions concerning return-of-inventory preference claims have addressed the determination of the value of the inventory returned by applying various methods. The most recent case from the U.S. District Court for the Western District of Virginia in *Active Wear Inc. v. Parkdale Mills Inc.* applies yet another method of valuation, limiting a chapter 11 debtor's recovery on a return-of-inventory preference claim to the amount the debtor would have realized from a liquidation sale of the inventory.

The debtor, Active Wear Inc., turned yarn into cloth and purchased substantial amounts of yarn from Parkdale Mills Inc. During its period of operation, the debtor purchased substantial quantities of yarn on open account from the creditor, Parkdale Mills, Inc. When the debtor ceased operations, it had unused yarn in its possession which it had purchased from the creditor, at which time it owed on its account with the creditor at least $2 million.

When the debtor ceased operating, the creditor sent a reclamation demand to the debtor for recovery of yarn having the value of $11,428.88. Thereafter, the creditor picked up all of the unused yarn it had previously sold to the debtor, and the debtor credited $134,849.50 against its outstanding indebtedness to the creditor for the returns.

An involuntary chapter 7 petition was filed against the debtor within 90 days of the creditor's recovery of the yarn. An order for relief was entered, and the debtor converted the case to chapter 11. Thereafter, the debtor commenced a lawsuit against the creditor for avoidance of the debtor's pre-petition return of the creditor's yarn and recovery of the value of the yarn. The bankruptcy court held that the returns to the creditor were an avoidable preference for which the debtor was entitled to recover the liquidation value of the returns in an amount equal to $27,459. The debtor appealed the bankruptcy court's order, arguing that the creditor should have been directed to pay the fair market value of the returns equal to the amount the creditor could have realized from reselling the returned yarn.

The district court limited recovery on the debtor's return-of-inventory preference claim to the sums the debtor could have realized from a liquidation sale of the returns. The district court, relying on the pre-Bankruptcy Code decision of the U.S. Court of Appeals for the Fourth Circuit in <u>Virginia Nat'l. Bank v. Woodson (In re Decker), 329 F.2d. 836 (4th Cir. 1964)</u>, noted that the recovery from the debtor should be based on the extent to which the return had depleted the debtor and its bankruptcy estate. The yarn's value to the debtor was the amount the debtor could have realized from a liquidation sale of the yarn. The court refused to give the debtor any credit for any greater recovery the debtor derived from its disposition of the returned yarn, which the court attributed to the creditor’s expertise, time, goodwill and advertising.

As indicated, it is important to recognize that courts have employed several other methods to determine the recovery on a return-of-inventory preference claim. For example, the bankruptcy court from the District of Massachusetts in *In re First Software Corp*. entered a judgment in the amount of $1,500,026 against the creditor on a return-of-inventory preference claim. The court simply relied on a credit memorandum in the above amount issued by the creditor in reduction of its claim. The credit memorandum was deemed the creditor's contemporaneous determination of the market value of the returns.

Another commonly cited case is from the bankruptcy court in the Middle District of North Carolina in *In re American Furniture Outlet USA Inc. (American Furniture Outlet USA Inc. v. Woodmark Originals Inc.)*, which refused to base the recovery on a return-of-inventory preference claim on a credit the creditor had issued for past-due invoices owing by the debtor. Instead, the court limited recovery to the net amount, after deducting expenses, that the creditor had realized from its commercial resale of the returned inventory.

Other courts dealing with a return-of-inventory preference claim have ordered the creditors to return the inventory, when conflicts arise as to the valuation of the inventory and no clear valuation can be made.

Unfortunately, there is very little case law on the application of the ordinary course of business and new value defenses in return-of-inventory preference cases. As such, to creditors faced with such preference demand, the decision from *Active Wear Inc. v. Parkdale Mills Inc.* may provide those creditors with the only way to reduce their preference exposure.