New Take on New Value? Recent Seventh Circuit Decisions Limit the "New Value" Defense to Bankruptcy Preference Liability

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The United States Court of Appeals for the Seventh Circuit recently issued two decisions narrowly construing the so-called "new value" exception to "preference" exposure—the potential liability a creditor may face to repay to the bankruptcy estate payments it received from the debtor shortly before the debtor went into bankruptcy. The decisions are binding only in bankruptcy cases filed in Illinois, Wisconsin and Indiana (the three states that make up the Seventh Circuit). But, if these decisions are followed by courts outside the Seventh Circuit, especially if they are broadly construed, they may significantly restrict the utility of the new value defense and make creditors less willing to continue to extend credit and do business with companies in pre-bankruptcy financial distress.

Background

Under the Bankruptcy Code, a debtor-in-possession or trustee may generally seek to "avoid" and recover payments of debt made by an insolvent debtor to an unsecured creditor within 90 days before the debtor goes into bankruptcy (or within one year before that filing if the creditor is an "insider" of the debtor) (11 U.S.C. § 547(b)). But the Code also provides several exceptions to this potential liability. One of the most significant is the "new value" defense. It provides that the debtor-in-possession or trustee may not recover such a payment "to the extent that, after such transfer, [the] creditor gave new value to or for the benefit of the debtor not secured by an otherwise unavoidable security interest … and on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor" (11 U.S.C. § 547(c)(4)). The new value exception is designed to encourage a creditor to continue to extend credit, on an unsecured basis, to a debtor in financial distress. The new value exception does so by providing that, to the extent the creditor does extend credit, the creditor will receive dollar-for-dollar credit against any prior payment that would otherwise be recoverable as a preference. To this end, the Bankruptcy Code defines "new value" broadly to include "money or money's worth in goods, services or new credit"; the only express carve-out from the definition is for "an obligation substituted for an existing obligation" (11 U.S.C. § 547(a)(2)).

In both of the recent Seventh Circuit cases, a creditor that had been sued for recovery of a payment on a preference claim asserted that it had provided the debtor with new value after it had received the payment. In both cases, the Court of Appeals held that what the creditor had done—forbearance in one case and contract performance in the other—was not “new value” within the meaning of the Code, notwithstanding the broad statutory definition of that term.

The *ABC-NACO* Case

In the first case, *In re ABC-NACO, Inc.*, 483 F.3d 470 (7th Cir. 2007), the debtor, ABC-NACO, entered into a purchase agreement with the creditor, Softmart, to acquire 700 computers and licenses for Microsoft software installed on the computers. In connection with the purchase agreement, ABC-NACO granted Microsoft the right to revoke the software licenses if ABC-NACO failed to pay Softmart for the computers. After initially defaulting, ABC-NACO paid Softmart approximately $100,000 within the 90 days before it finally succumbed to its financial difficulties and filed for bankruptcy. Thereafter, its unsecured creditors’ committee obtained authority to sue Softmart to recover those payments for the bankruptcy estate as a preference. Softmart argued that, after it had received the payments, it had provided subsequent “new value” by refraining from notifying Microsoft of ABC-NACO’s defaults and by thereby enabling ABC-NACO to retain its software licenses and to continue to use the computers. The Seventh Circuit rejected this argument on the ground that only Microsoft, not Softmart, had the right to revoke the licenses. And, while it expressly did not decide the issue, the court intimated that even if Softmart had been the licensor of the software and had the right to revoke the licenses for non-payment, such “forbearance” might not constitute “new value” in any event (*Id.* at 473-74 & n.2). Accordingly, the Court of Appeals held that Softmart had not provided new value and therefore had to repay the approximately $100,000 in “preferential payments” it had received.

The *Globe Building* Case

The second case, *Gouveia v. RDI Group (In re Globe Building Materials, Inc.)*, 484 F.3d 946 (7th Cir. 2007), may be even more significant. Globe had contracted with RDI to purchase a custom-built equipment line for use in manufacturing laminated roofing shingles. Globe was to pay RDI approximately $4 million pursuant to a fixed payment schedule set forth in the contract. RDI, in turn, was to deliver the parts of the equipment as they became available. Except for the final payment—the final 10% of the purchase price was to be made by Globe within 90-days of shipment by RDI—the payment schedule and the delivery schedule were not coordinated.

In November 2000, Globe paid RDI about $420,000. Including that payment, Globe had by that time paid about 90% of the total contract price, and by that time RDI had complied with about 55% of its delivery obligations. Following receipt of the $420,000 payment, RDI fulfilled the remaining 45% of its delivery obligations to Globe at a cost to RDI of approximately $250,000. Soon thereafter, Globe filed for bankruptcy, and its chapter 7 trustee sued RDI to recover the $420,000 as a preference. Not surprisingly, RDI argued that it was entitled to keep the payment on the ground that it had provided subsequent “new value” to Globe by delivering the equipment components after it had received the allegedly preferential payment.

Again, the Seventh Circuit rejected the new value defense, albeit for a somewhat different reason than in *ABC-NACO*. It held that there was nothing “new” about the value RDI had given because RDI had been contractually obligated to deliver the equipment even before it had received the payment. Without engaging in much analysis of the statutory language, the Court of Appeals concluded that Congress had intended the definition of “new value” to “codify the principle of consideration from contract law.” *Id.* at 949. The Seventh Circuit thus suggested that, just as the “‘performance of a legal duty [already] owed to a promisor . . . is not consideration’”, “new value” cannot come from “something that the promisor is … already obliged to give to the promisee.” *Id.* (citation omitted). In so holding, the Court of Appeals rejected RDI’s “plain meaning” argument that the Code defines “new value” to be “money or money’s worth in goods, services or new credit,” without specifying that the goods must be ones the creditor is not already obligated to deliver. Accordingly, the Court of Appeals ruled that RDI had received an avoidable preference and was legally obligated to pay the $420,000 it had received within the 90-day preference period.

To be sure, the decision may be limited to its facts. The Seventh Circuit made clear that its conclusion would likely have been different had RDI agreed to provide goods or services for which it had no pre-existing obligation. “If RDI had decided to furnish something outside the confines of the contract to Globe, within the preference period … we could have a different case” (*Id.* at 950). And, the Seventh Circuit also suggested that the result might have been different had RDI and Globe agreed to a “straightforward installment contract” under which each installment could be deemed a “new” transaction.

But, even within its apparent confines, the decision could have serious implications. Take, for example, a standard committed revolving credit facility. Imagine that the debtor owed $5 million and makes a payment of $1 million; thereafter, the debtor reborrows the $1 million amount and then files for bankruptcy within 90 days of the payment. Does the Seventh Circuit mean to suggest that the $1 million in reborrowed funds is not “new value” and that the debtor’s estate therefore gets **both** to keep that $1 million **and** to sue the lender for the $1 million it paid, simply because the lender had a preexisting contractual obligation under the loan agreement to make the $1 million in reborrowed funds available (assuming, of course, that there was not a covenant or other default such that the lender was not contractually obligated to make the new credit available)? If so, the decision is contrary to what many practitioners believe is well-established law.

The Bottom Line

It is too soon to know how significant these two cases will be. Will they be broadly construed? Will they be followed outside the Seventh Circuit? Only time will tell.

But, in the interim, there are some lessons for creditors. While the Seventh Circuit reserved on the issue, the *ABC-NACO* case might have come out differently had Softmart been entitled as a matter of contract to revoke the software licenses. And the *Globe* case almost surely would have been decided differently had the arrangement between Globe and RDI been a series of individual contracts for distinct parts of the equipment line under which RDI had no preexisting obligation to finalize or perform any “new” contract. In that event, RDI’s voluntary entry into one such contract, after receiving an allegedly preferential payment on a prior such contract, would likely have been deemed “new value,” even by the Seventh Circuit. But the result would not be as certain if there were one contract with multiple shipments, where the contract provided that future shipments were conditioned on timely payments of prior amounts due. In short, creditors may wish to pay particular attention to the way they structure their contracts to minimize the preference exposure that Softmart and RDI all too painfully experienced in these two cases.

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