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Double Counting New Value – A New Ruling Increases the Value of the New Value Defense for Creditors

One of the concerns for creditors dealing with a distressed company is the possibility of bankruptcy, and the risk that payments to the creditor on account of previously incurred debt will be avoided as a "preference" in the debtor's bankruptcy proceeding. Generally speaking, a "preference" is a transfer of the debtor's property on the eve of bankruptcy to satisfy an old debt. The Bankruptcy Code allows a bankrupt company to reach back 90 days and avoid any transfers made to creditors during that time, subject to certain defenses. One of the more important defenses for creditors is the "new value" defense, which allows creditors to "net out" any preference liability against the value of goods or services subsequently provided to the debtor. A First Circuit District Court recently issued a creditor-friendly ruling which expansively interprets the “new value” defense to allow creditors to net out “new value” against preference liability, even if the creditor was paid for the subsequent "new value." *Bogdanov v. Avnet Inc*. (D.N.H., No. 10-cv-543, September 30, 2011) (Avnet). Although the court's ruling in *Avnet* is the minority view, it establishes a valuable precedent for creditors with exposure to the risk of preference liability.

In *Avnet*, the creditor, Avnet Inc., was a supplier of software to Amherst Technologies LLC, an information technology company. Just prior to the debtor's bankruptcy filing, the debtor was behind on its payments to Avnet, an important supplier. The debtor sought to purchase an additional $4 million in goods. Knowing that the debtor was distressed, the creditor required an upfront payment of $4 million. From that payment, the creditor applied $1.1 million to the new order, and applied $2.9 million to previous invoices.

The debtor filed for bankruptcy soon thereafter, and the bankruptcy trustee claimed that the $4 million payment, along with other smaller payments, was a preference and sought to reclaim those amounts from Avnet on behalf of the bankruptcy estate. Avnet responded, along with other defenses, that the $4 million in goods it provided was "new value" under the Bankruptcy Code and could be netted out against the preference liability. The bankruptcy trustee, in turn, argued that the "new value" could not be netted out to the extent that Avnet was paid for the "new value," including the $1.1 million payment that was applied

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to the shipment of goods. The Bankruptcy Court, and then the District Court, agreed with Avnet, and found that all of the new value which Avnet provided to the debtor could be netted out against Avnet's preference liability, including "new value" for which Avnet was paid.

The issue turns on the interpretation of section 547(c)(4) of the Bankruptcy Code, which provides that the trustee may not avoid a transfer that was followed in time by "new value" given by the creditor "to or for the value of the debtor." 11 U.S.C. § 547(c)(4). However, the "new value" defense is not applicable to the extent that the "new value" was "otherwise unavoidable" by the debtor. 11 U.S.C. § 547(c)(4)(B). That is, the creditor cannot both shield a prior preference payment by offsetting it with “new value,” and also keep the payment for such "new value" on account of some other defense (such that it would be "otherwise unavoidable”).

At issue in *Avnet* is the interpretation of "otherwise unavoidable" in Bankruptcy Code section 547(c)(4)(B). The creditor argued that "otherwise" refers to all theories of avoidability other than section 547(c)(4); whereas the trustee for the debtor argued that “otherwise” in this context refers to all theories of avoidability including section 547(c)(4). The District Court in *Avnet* found the word "otherwise" to be ambiguous, and therefore chose to adopt the interpretation which best serves the purposes of the Bankruptcy Code.

The *Avnet* court sided with the creditor, finding that the creditor's interpretation of Bankruptcy Code section 547(c)(4)(B) creates a valuable incentive for creditors to continue to deal with debtors by reducing their potential preference exposure. The court acknowledged, but rejected, the alternative view that allowing a creditor to net out "new value" for which the creditor has been paid appears to be double-dipping, by allowing the "new value" to count against two separate preference payments.

Unfortunately for creditors to debtors in Wisconsin, the Seventh Circuit Court of Appeals has ruled the opposite way, holding that "new value" must remain unpaid to be applicable to a "new value" defense under Bankruptcy Code section 547(c)(4)(B). *In the matter of Prescott*, 805 F.2d 719, 728 (7th Cir. 1986). However, in the First Circuit, and in other circuits in which the issue has not been decided, the *Avnet* decision provides creditors with a new and valuable defense against preference liability.

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