The Preference Action, the Trade Vendor, and the <u>Contemporaneous Exchange Defense</u>

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Here's a scenario that may be all too familiar. A key customer has been steadily falling further and further behind on its account. You delicately begin to enforce existing credit limits, walking the fine line between trying to spur collections and keeping the customer happy. Still, your aging report continues spiraling out of control. You reduce -- or even expand -- the customer's credit limit, but accounts payable continues to report large balances on old debt. You check with a few of the credit agencies and learn that despite a recent large infusion of capital from its lenders the customer is experiencing significant cash flow problems. Slowly it dawns on you. Your key customer is becoming the albatross around your neck. If it goes under, it might even drag you down with it.

The situation calls for drastic measures. You flat out refuse to continue shipping product unless the customer remits payment sufficient to come within its credit limit. The customer assures you that a sizable payment is in the mail and requests that you continue to ship on credit. You agree. In anticipation of receipt of payment, product is released from credit hold and ships that very day. The next day, the payment is received as promised and you apply it to the customer's oldest outstanding balance. The situation seems to have stabilized.

Next thing you know, the customer has filed for bankruptcy protection and you're left holding the bag. The customer's account is well into the red. Then, adding insult to injury, the bankruptcy trustee sues your company on a preference theory to recover the payment you worked so hard to obtain.

You've been around the block with bankrupt customers a few times before. You realize that once the trustee proves that the payment was made on account of old debt it's going to be up to you to prove your defenses or you'll have to give the payment back. You are aware of your three main statutory defenses: new value, ordinary course of business, and contemporaneous exchange. You worry that you won't be able to mount a new value defense because the shipment was released before the payment was received. You suspect that adjusting credit limits as a debtor slides into bankruptcy would undermine an ordinary course of business defense. And you didn't ship C.O.D., so you think there's no contemporaneous exchange defense available to you either. You get that sinking feeling when you realize that you have no statutory defenses. What is a businessperson to do?

All is not lost. The U.S. Bankruptcy Court for the District of Massachusetts has rendered a decision in a case called <u>In re Jannel Industries, Inc.</u> that throws a lifeline in just such a situation.[1] The relevant facts follow.

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[1] <u>In re Jannel Industries, Inc.</u>, 245 B.R. 757 (Bankr. D. Mass. 2000).

In October of 1997, Jannel Industries filed for protection under Chapter 11 of the Bankruptcy Code. Unable to reorganize its business, Jannel's case was converted to a liquidation under Chapter 7. The Chapter 7 Trustee brought a preference action against Draper Knitting Company seeking to recover 59 payments totaling $121,750 that Jannel had paid to Draper during the 90-day preference period leading up to Jannel's bankruptcy. It turns out that about eight months before Jannel filed for bankruptcy, Draper had attempted to put Jannel on C.O.D. status. Since then, the parties' practice was that when Jannel picked up goods at Draper's shipping dock, Jannel would tender payment for the approximate amount of the goods provided on that day. Although the payments at issue during the preference period were remitted immediately upon receipt of the goods, not all of the payments were made in the amounts of the corresponding shipping invoices. Some payments were high (by as much as $6,000) and some were low (by as much as $1,800). None of the payments were really C.O.D. because Draper applied all of the payments to pay down old debt rather than to pay for the goods delivered on any particular day.

The matter came before the Court on the parties' cross-motions for summary judgment. Draper argued that it should be permitted to keep the payments it received during the preference period because, in accordance with the Bankruptcy Code's contemporaneous exchange provision, the payments were intended by the parties to be contemporaneous exchanges for new value (that is, goods) and the payments were made contemporaneously (that is, at about the same time the goods were delivered).[2]

The Chapter 7 Trustee argued that if Draper intended to apply the payments to old debt rather than to the goods for which the payments had been exchanged (which indeed is what Draper did), then the exchanges could not have been intended to be contemporaneous as required by the Bankruptcy Code.

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[2] Section 547(c)(1) states: "The trustee may not avoid ... a [preferential] transfer ... to the extent that such transfer was -- (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and (B) in fact a substantially contemporaneous exchange."

According to the Bankruptcy Code, "'new value' means 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." 11 U.S.C. § 547(a)(2).

The Court stated that in the context of a contemporaneous exchange defense to a preference action the term "new value" meant "money or money's worth in goods, services, or new credit." As applied here, lopping off the second half of the definition appears to be appropriate. In re Spada, 903 F.2d 971, 976 (3d Cir. 1990) (finding "new value" definition to codify the usual rules of consideration).

At first it appeared that the Court was going to deny Draper's motion for summary judgment because the Court determined that it was unclear just what the parties had intended. Therefore, the Court was prepared to conduct a trial. But then the Court determined that whatever else the parties may have intended, they clearly intended to exchange the payments for the goods. Despite the fact that Draper applied the payments to old debt, the Court held that the intention to exchange payments for goods satisfied the requirements of the Bankruptcy Code. The Court granted Draper's motion for summary judgment to the extent of the value of the goods delivered.

The Court reasoned that it was simply irrelevant that Draper applied the payments to old debt rather than to the goods on account of which the payments had been made. The Court noted that the Bankruptcy Code's contemporaneous exchange provision says nothing about how payments may or may not be applied. It simply requires the parties to intend to exchange payment for goods contemporaneously, and that the exchange actually occur "substantially contemporaneously," as happened here. The Court reasoned that all of the statutory defenses to a preference action (for example, new value, ordinary course of business, and contemporaneous exchange) only come into play once a trustee has established that the payments he seeks to recover have been made on account of old debt. Therefore, the Court concluded, if the contemporaneous exchange defense is to have any usefulness in defending against a preference action, the defense must apply in the context of payments used to pay old debt.

But, you say, "How does this help me? I released the goods the day before I got the payment." Not to worry, a number of other courts have held that it doesn't matter which half of the exchange occurred first, only that the exchange was "substantially contemporaneous."[3] So long as the parties intended to make a contemporaneous exchange, the fact that the payment came in the day after the goods went out doesn't mean that the exchange wasn't "substantially contemporaneous."

You may just get to keep that payment after all.

[3] See, In re Payless Cashways, Inc., 306 B.R. 243 (8th Cir. BAP 2004); see, HLI Creditor Trust v. Hyundai Motor Co. (In re Hays Lemmerz Int'l, Inc.), 329 B.R. 136, 139 n.3 (Bankr. D. Del. 2005).