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When is Contemporaneous (as in Exchange) Not Contemporaneous

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Citation

Cases Discussed

Journal Article:

In a recent liquidation, a series of preference claims brought by the estate representative were met with creditors asserting that the payments received from the debtor were a contemporaneous exchange and therefore not a preference. Bankruptcy Code §547(c)(1) provides that the trustee may not avoid under this section a transfer to the extent that such transfer was "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 the debtor and in fact a substantially contemporaneous exchange."[1]

Contemporaneous exchange is when products, goods or services are provided to a debtor in exchange for payment from the debtor for those services. This defense is separate and distinct from the application of new value, designed to encourage a creditor to ship a new product as a reduction to any exposure to receipt of payment(s) from a debtor. Creditors who apply the payment received to antecedent debt risk the loss of the contemporaneous exchange defense.

An example is when a creditor refuses to ship goods to a debtor unless payment is made at the time the goods are delivered. Instead of invoicing the debtor for a COD or CIA transaction, the invoice reads normal credit terms (*i.e.,* net 30, etc.). Then, when the payment is received, the creditor applies the check to an outstanding invoice rather than the present shipment. Creditors will justify this application because they feel the need to reduce their exposure by applying the check to (typically) the oldest outstanding invoice and using the new invoice as collateral under its revolving line of credit. This enables the creditor to borrow on the new invoice and not lose the older invoice from its collateral base. But this is not "in exchange" for the new shipment.

One of the few cases addressing this issue is *Contempri Homes Inc. (In re Contempri Homes Inc.),* 269 B.R. 124 (M.D. Pa. 2001). That case reviews the requirements of contemporaneous exchange and states that "three requirements must be met. First, the creditor must have extended new value to the debtor. Secondly, the parties must have intended that the new value and the transfer by the debtor be contemporaneous. Finally, the exchange must in fact be a substantially contemporaneous exchange."[2] If a debtor reflects on its remittance advice that the check is in payment of outstanding invoices and not the present shipment, the intention is inferred that the payment is not to be contemporaneous with the new shipment.

When a creditor requires the payment for the release of new goods and in fact applies that payment to outstanding invoices, the payment can be construed as not being contemporaneous. *Contempri* also states that "furthermore, payments made to a supplier of goods as a prerequisite to the shipping of more goods to the debtor are not *intended* (emphasis added) by the parties as a contemporaneous exchange for new value even though the payments roughly correspond to the value of the new goods shipped."[3]

This case can be distinguished from the position in *Jannel Industries Inc. (In re Jannel Industries Inc.),* 245 B.R. 757 (Bankr. D. Mass. 2000). In the *Jannel* case, the court stated that the applicability of the contemporaneous exchange defense turns on whether the exchanges were made with the intent required by §547(c)(1)(A).[4] The court added that the defense limits the application of the defense to transfers "intended by the debtor and the creditor...to be a contemporaneous exchange for new value given the debtor."[5] Again, this should also not be confused with the application of the "new value" defense available under §547(c)(4). Application of a payment against outstanding invoices in exchange for the release of a new shipment of goods is not a contemporaneous exchange, but rather a credit transaction in exchange for the shipment of new goods.

The practical implication here is that when a creditor is facing a distressed debtor and wants to limit its exposure to that debtor, requiring payment "in exchange for new product" is not a safe harbor to prevent an allegation of a preference if that debtor goes into an insolvency proceeding within

90 days of that transaction. The ultimate test will be how the payment *is applied* by the creditor. If the payment is applied to the released shipment, then the contemporaneous exchange defense will be upheld. But if the payment is instead applied to an outstanding invoice, the defense is likely to be lost.

It will also be hard to defend this transaction as being in the "ordinary course of business." Where a creditor changes the terms of its relationship with a debtor because of a debtor's distress, subsequent transactions will be hard to defend as being in the ordinary course as the "ordinary" terms will have changed.

Creditors should therefore make a determination as to how the new transaction is to be documented. If it is in fact a COD-type transaction, then record the transaction on the invoices as a COD to further evidence the intention that the transaction is in exchange for that payment. If the payment is only to exchange a product for the reduction of an outstanding invoice, then the creditor should be prepared to defend the payment as a preference if the debtor fails shortly after receipt of the payment.[6]

Footnotes

1 11 U.S.C. §547(c)(1)(A) and (B). Return to article

2 *In re Contempri Homes Inc.,* 269 B.R. 124, 128 (Bankr. M.D. Pa. 2001). Return to article

3 *Id.* at 129; *also citing In re Fasano/Harriss Pie Co. (Remes v. Acme Carton Corp.),* 71 B.R. 287 (W.D. Mich. 1987). Return to article

4 *In re Jannel Industries Inc.,* 245 B.R. 757, 759 (Bankr. D. Mass. 2000). Return to article

5 *Id.* at 760. Return to article

6 This is separate from the defense that the new value shipped fully eliminates the payments received in the preference period, a distinct defense available to the creditor when a preference allegation is made. Return to article

Bankruptcy Rule:

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