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Column

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***32 THE VERSATILE "CONTEMPORANEOUS EXCHANGE" PREFERENCE DEFENSE**

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Perhaps the most versatile preference defense is the contemporaneous exchange exception embodied in §547(c)(1) of the Bankruptcy Code. The beauty of § 547(c)(1) is that it prevents preference recovery to the extent of *any* substantially contemporaneous new value given to the debtor in exchange for the preference. The subject of the new value can be almost anything (other than forbearance) that benefits the debtor—goods, services, release of security interest, etc. The cases construing the contemporaneous exchange exception demonstrate that the defense is used in a wide variety of situations to help protect preference defendants.

Section §547(c)(1) states:

(c) The trustee may not avoid under this section a transfer-

(1) 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;...

The legislative history of §547(c)(1) states:

The first exception [§547(c)(1)] is for a transfer that was intended by all parties to be a contemporaneous exchange for new value, and was in fact substantially contemporaneous. Normally, a check is a credit transaction. However, for the purpose of this paragraph, a transfer involving a check is considered to be "intended to be contemporaneous," and if the check is presented for payment in the normal course of affairs,...that will amount to a transfer that is "in fact substantially contemporaneous."

R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977) [hereinafter cited as H.R. 595], U.S. Code Cong. & Admin. News 1978, pp. 5787, 6329.

By enacting the contemporaneous exchange exception Congress recognized that if a creditor provides new value in exchange for a preferential transfer, the estate has not been diminished and therefore that creditor is entitled to protection to the extent of the new value provided. Section 547(c)(1) also codifies those decisions under the Bankruptcy Act, which held that when a cash sale was intended, the acceptance of a check (rather than cash) did not change the character of the transaction to a credit sale *if* the check was cashed within a reasonable period of time. *See, e.g., Engstrom v. Wiley*, 191 F.2d 684 (9th Cir. 1951).

In order to invoke the contemporaneous exchange defense, the preference defendant must prove that: (1) the parties intended that the exchange be substantially contemporaneous, and (2) the exchange was, in fact, sub-substantially contemporaneous, and (3) the exchange was for new value. “New value” is defined in 11 U.S.C. §547(a)(2) as follows:

“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 on substituted for an existing obligation; ...

Forbearance does not constitute “new value.” See, e.g., *In re Allegheny International Inc.*, 145 B.R. 823 (W.D. Penn. 1992); *In re Drabkin v. A.I. Credit Corp.*, 800 F.2d 1153 (D.C. Cir. 1986); *Superior Toy & Manufacturing Company*, 183 B.R. 826 (Bankr. N.D. Ill. 1995). The burden of proving the contemporaneous exchange defense rests upon the creditor/preference defendant. 11 U.S.C. §547(g).

Case law has evolved to help clarify the statutory language. In *In re Jet Florida Systems Inc.*, 861 F.2d 1555 (11th Cir. 1988) the preference defendant argued that §547(c)(1) only requires proof that the debtor and the creditor intended that the debtor would receive some new value in the exchange: the actual amount of new value that the debtor received at the time of the exchange was irrelevant. The Eleventh Circuit rejected this argument and held that the preference defendant needs to prove the specific amount of the new value that the debtor received, because §547(c)(1) expressly protects preferential transfers only to the extent of the new value which the debtor received. In *In re Adelphia Automatic Sprinkler Co.*, 184 B.R. 224 (Bankr. E.D. Penn. 1995), the district court affirmed the bankruptcy court's finding that the landlord's lease extension constituted “new value,” but remanded the case so that the bankruptcy court could make a finding as to the *amount* of the new value. In its ruling, the district court held that the purpose of §547(c)(1) is to ensure that the debtor receives at least as much in new value as it transfers away. Therefore, “new value” does not consist of esoteric or intangible benefits but, instead, must actually enhance the worth of the debtor's estate so as to offset the reduction in the estate caused by the preferential transfer.

In order to prove the intent element of §547(c)(1), the preference defendant must present evidence showing that the parties knew about what each side was exchanging in the transaction. In *In re Gateway Pacific Corp.*, 205 B.R. 164 (Bankr. E.D. Mo. 1997), the defendant claimed to have a security interest in some of the debtor's assets and claimed that its release of that security interest constituted a contemporaneous exchange for new value under §547(c)(1). However, the debtor's representative testified that he was not aware of the creditor's purported security interest, or that a release of that alleged security interest was intended in exchange for the preferential transfer. The court found that the creditor failed to prove the requisite intent for a contemporaneous exchange, and thus failed to meet its burden of proof under §547(c)(1).

It is not necessary that the new value flow directly to the debtor: All that is necessary is that the debtor actually benefit from the new value. In *In re Jones Truck Lines Inc.*, 130 F.3d 323 (8th Cir. 1997), the debtor sued to recover alleged preferences consisting of nearly \$6 million in employee benefit payments made to benefit funds. The defendant argued that the debtor received new value in exchange for the employee benefits in the form of continued employee service. Both the bankruptcy and the district courts rejected *33 this argument and held that the payments were recoverable preferences because no benefit flowed from the pension funds to the debtor. The Eighth Circuit Court of Appeals reversed, holding that the lower courts erred in requiring that the new value flow directly from the pension funds to the debtor because the word “directly” does not appear in §547(c)(1), and because the lower courts' interpretation would effectively rewrite the statute. Consequently, the Eighth Circuit Court found that the debtor received new value in exchange for its payment of benefit contributions, namely continued employee service. The fact that the new value came from the employees and not from the benefit funds, did not affect the contemporaneous exchange exception. The case was ultimately remanded to the bankruptcy court with instructions to recalculate the pension fund's preference liability in accordance with the circuit court's opinion. A similar result was reached in *In re Fuel Oil Supply & Terminating Inc.*, 837 F.2d 224 (5th Cir. 1988), when the debtor paid a creditor, and the creditor released letters of credit. The bank that had issued the letters of credit then released its lien in collateral which the debtor had given the bank. Thus, the debtor received new value in exchange for its payment of the creditor, namely release of a security interest against its property,

but the new value came from the bank, not from the creditor who had received the debtor's payment. The Fifth Circuit held that the payment to the creditor was exempt from preference recovery because §547(c)(1) does not require that the new value come directly from the creditor who received the preference, but may be provided by a third party.

Case law has also evolved to illustrate the situations in which the contemporaneous exception will, and will not, work. For example, all of the circuit courts that have considered this issue have concluded §547(c)(1) will not shelter a purchase money security interest that is not perfected within the time limit set forth in 11 U.S.C. §547(c)(3), and that purchase money security interests may only be sheltered under §547(c)(3). See *In re Locklin*, 101 F.3d 435 (5th Cir. 1996); *Wachovia Bank & Trust Co. v. Bringle (In re Holder)*, 892 F.2d 29, 31 (4th Cir. 1989); *Erie v. Baker (In re Tressler)*, 771 F.2d 791, 794 (3d Cir. 1985); *Gower v. Ford Motor Credit Co. (In re Davis)*, 734 F.2d 604, 607 (11th Cir. 1984); *Valley Bank v. Vance (In re Vance)*, 721 F.2d 259, 262 (9th Cir. 1983). However, in the case of non-purchase money security interests, courts are split on the issue of whether lenders who fail to timely perfect may take advantage of §547(c)(1). In *In re Arnett*, 731 F.2d 358 (6th Cir. 1984) the Sixth Circuit ruled that a secured creditor who did not timely perfect as required by §547(c)(3) cannot use §547(c)(1) to protect the transfer from preference recovery. However, other courts have adopted a more flexible standard. In *In re Pinetop Insurance Company v. Bank of America National Trust and Savings Association*, 969 F.2d 321 (7th Cir. 1992) the court noted that the modifier "substantial" in §547(c)(1) indicates that contemporaneity is a flexible concept that requires inquiry into the relevant circumstances, such as the length of the delay, the reason for the delay, the nature of the transaction, the intentions of the parties and possible risk of fraud. See 969 F.2d at 328. And, in *In re Marino*, 193 B.R. 907 (9th Cir. BAP 1996); aff'd. 117 F.3d 1425 (9th Cir. 1997), the Bankruptcy Appellate Panel (BAP) held that the untimely recording of a non-purchase money security interest in the debtor's property did not automatically render the contemporaneous exchange exception inapplicable. In *Marino* the creditor had promptly completed all acts required to perfect his lien and had no reason to believe that the security interest would not be timely recorded; the fact that it took the clerk longer than usual to record the security instrument was a matter beyond the creditor's control. The BAP ruled that it would contradict the policy underlying both the preference statute and the contemporaneous exchange defense if a transfer was avoided simply because a recording clerk did not timely record the security interest. Thus, the court ruled: "We hold then that the view that best comports with the policies of §547 is that when the delayed perfection of a security interest can be satisfactorily explained, the transfer may still be characterized as substantially contemporaneous in fact." 193 B.R. at 915.

Based on the legislative history of §547(c)(1), the contemporaneous exchange exception cannot be used as a preference defense in connection with a dishonored check that is subsequently honored or replaced with another payment instrument. See, e.g., *In re Lee*, 179 B.R. 149 (9th Cir. BAP 1995); *In re Standard Food Service Inc.*, 723 F.2d 820 (11th Cir. 1984). These cases note that the dishonor of a check changes the nature of a transaction from *41 one intended for a contemporaneous cash exchange to a credit transaction, which is not protected under §547(c)(1).

Attorneys have tried, unsuccessfully, to use §547(c)(1). In *In re Investment Bankers Inc.*, 136 B.R. 1008, 1021 (D. Col. 1990), the court ruled that the contemporaneous exchange defense did not apply because the client became legally obligated to pay his attorney as soon as the law firm rendered services, irrespective of the billing date. Thus, any payment that the law firm received on services previously rendered constituted payment on an antecedent debt rather than a contemporaneous exchange of value. See, also, *In re Electronic Metal Products Inc.*, 916 F.2d 1502 (10th Cir. 1990).

Section 547(c)(1) has also been used to try to protect settlement payments from recovery as preferential payments. In *In re Upstairs Gallery Inc.*, 167 B.R. 915 (9th Cir. BAP 1994), the trustee sued to avoid a lease termination payment that was made on November 20, 1990, in connection with a Lease Termination Agreement that released and discharged all parties to the lease. The defendant argued that the lease termination payment was exempt from recovery under §547(c)(1). The BAP rejected this argument and found that the Lease Termination Agreement did not create a new obligation, but settled an antecedent obligation, namely the tenant's obligation under a 1988 lease, therefore §547(c)(1) did not apply. However, in *In re Lewellyn & Co. Inc.*, 929 F.2d 424 (8th Cir. 1991) the debtor's transfer of 425,000 shares of stock to a securities broker was held to be a contemporaneous exchange in lieu of a cash settlement for the \$8 million in purchases that the debtor made through that same securities broker before filing bankruptcy. Because the 425,000 shares were transferred to the broker consistent with both

applicable regulations (which required that all cash stock purchases be settled within seven business days) and with the prior course of conduct between the parties, the court held that the exchange within seven days after the broker made the \$8 million in stock purchases for the debtor was substantially contemporaneous and that § 547(c)(1) would prevent preference recovery of the value of the 425,000 shares.

Conclusion

The broad, conceptual focus of the contemporaneous exchange defense is what makes it so versatile. The cases discussed in this article provide a general framework of the parameters of §547(c)(1); within those parameters lies an opportunity for the lawyer's creativity to protect his or her client from preference liability.

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