# Extending the Contemporaneous Exchange for New Value Preference Defense

July/August 2005

Sean P. Byrne and Mark G. Douglas

The ability of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to invalidate asset transfers made during the period immediately preceding a bankruptcy filing that unfairly prefer one or more creditors over the rest of the creditor body is one of the most important powers created by the Bankruptcy Code. It promotes the fundamental goal of achieving equality of distribution among similarly situated creditors. However, not every payment made by a debtor on the eve of a bankruptcy filing can be successfully challenged on the grounds that it is preferential. One important exception to a DIP or trustee's avoidance powers was the subject of a decision recently handed down by the United States Court of Appeals for the Eighth Circuit. In *In re Payless Cashways, Inc.*, the recipient of pre-petition payments made for goods shipped to the debtor under a "destination contract" successfully defended a preference action by asserting that the payments constituted "contemporaneous exchanges for new value" under section 547(c)(1) of the Bankruptcy Code.

## Equality of Distribution and Avoidance of Preferential Transfers

One of the fundamental goals underlying U.S. bankruptcy law is the equitable distribution of assets. To that end, the automatic stay generally prevents an individual creditor from pursuing its claim against a debtor after the initiation of a bankruptcy case, in part, to prevent one creditor from recovering a greater proportion of its claim relative to other similarly situated creditors. In addition, the Bankruptcy Code recognizes that the goal of providing equal treatment to similarly situated creditors would be thwarted if debtors, voluntarily or otherwise, had an unfettered ability to pay certain favored creditors more than they would otherwise receive in a bankruptcy case. Accordingly, Bankruptcy Code section 547 provides that a transfer made by an insolvent debtor within 90 days of a bankruptcy filing (or up to one year, if the transferee is an insider) to a creditor who, by reason of the transfer, receives more than it would have received if, assuming the transfer had not been made, the debtor were liquidated in chapter 7, may be "avoided" (invalidated and recovered) by a bankruptcy trustee or DIP.

Whether a transfer satisfies these basic elements, however, does not end the inquiry. While some transfers may be preferential in the literal sense, not all transfers are avoidable and recoverable. Section 547(c) contains eight distinct exceptions (nine, when the newly enacted bankruptcy legislation becomes effective in October of 2005) to the trustee's ability to avoid a transfer that is otherwise preferential. Of these, the three defenses most commonly invoked by creditors are the ordinary course payment defense, the subsequent new value defense and the contemporaneous exchange defense. The first shields from avoidance payments that are made on ordinary business terms and in accordance with the ordinary business practice of the debtor and the creditor. The second protects payments to the extent that, after the transfer, the creditor gave new value to the debtor that is not secured by an otherwise unavoidable security interest, and on account of which the debtor did not make an otherwise unavoidable transfer to the creditor.

## The Contemporaneous Exchange for New Value Defense

The "contemporaneous exchange for new value" defense permits creditors to continue to do business with troubled counterparties by excepting from avoidance transactions involving exchanges of valuable consideration. To successfully assert the defense, the recipient of a challenged transfer must demonstrate that: (i) the parties intended the transfer to be a contemporaneous exchange; (ii) the exchange was actually contemporaneous; and (iii) the exchange was for new value.

"New value" is defined by the Bankruptcy Code as "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." Most courts require that "new value" confer a "material benefit" upon the debtor and thus enhance the bankruptcy estate. A transferee invoking the protection of the defense bears the burden of proving by a preponderance of the evidence that each part of the exception applies. Whether the recipient of an allegedly preferential transfer satisfied that burden was the subject of the Eighth Circuit's ruling in *Payless Cashways*.

## Payless Cashways

Payless Cashways, Inc. was a home improvement product retailer. Before filing for chapter 11 protection for the second time in less than five years on June 4, 2001, Payless purchased lumber from Canfor Corporation, the largest producer of lumber in Canada. At the inception of its relation with Payless, Canfor had required prepayment for orders by electronic fund transfer ("EFT") and by check, but over time the parties negotiated less stringent payment terms.

The contracts between Canfor and Payless provided for the shipment of lumber to Payless by truck and by rail. Lumber sent by rail took on average 12-14 days following shipment, and lumber sent by truck took on average 3-5 days following shipment to arrive at Payless' facilities. Canfor generally gave Payless terms which would correlate the due date for payment with the delivery date. However, at times Canfor was exposed to a credit risk because lumber would arrive before payment was made.

On January 24, 2001 — less than sixth months before Payless filed for bankruptcy — Canfor's concern about its credit exposure led it to convene a meeting with Payless executives to negotiate terms for continued lumber shipments. The parties agreed to terms designed to correlate delivery dates with payments. For rail shipments expected to arrive in 12-14 days, payment was due in 12 days. For truck deliveries expected to arrive in 3-5 days, payment was due in 3 days. The parties also agreed that all payments would be made by EFT. Canfor prepared the invoices at the time the shipment was made and then calculated the due dates by working from the shipment date.

Between May 14, 2001 and May 18, 2001, Payless made four payments to Canfor totaling over $800,000 and involving 25 shipments. Of these, 22 shipments were by rail, all of which were paid for between 11 days and 15 days of shipment. The remainder were by truck, all of which were paid for in either five or six days of shipment. Payless may have received some of the truck-shipped lumber prior to paying for it, but Payless and Canfor considered truck shipments to be the same as cash transactions because of the short payment terms. Payment for at least eight of the 22 rail shipments was made by EFT prior to delivery of the lumber.

After Payless filed for bankruptcy, the chapter 11 trustee appointed in the case sought to avoid the $800,000 in payments. Canfor argued, among other things, that the transfers were insulated from avoidance because they involved contemporaneous exchanges for new value. The bankruptcy court ruled that the four transfers were not avoidable under section 547(c)(1) of the Bankruptcy Code. The trustee appealed that determination to the bankruptcy appellate panel.

The appellate panel prefaced its analysis by explaining that, in accordance with established precedent in the circuit, a preference defendant can successfully rely on a defense under section 547(a)(1) only if it establishes by a preponderance of the evidence that: (i) the parties intended the transfer to be a contemporaneous exchange; (ii) the exchange was actually contemporaneous; and (iii) the exchange was for new value. Addressing the first element, the appellate panel noted that the bankruptcy court made the following findings on the issue of intent: (1) the January 24, 2001 meeting changed the nature of the parties' transactions; (2) Canfor sought new terms to reduce its credit risk by assuring that it would be paid prior to delivery; (3) each of the contracts gave Canfor the right to refuse to complete delivery if payment was not made; and (4) Canfor received payment on the documented rail shipments between 7 and 21 days prior to delivery. The appellate panel agreed with the bankruptcy court's conclusion, based upon these findings, that the parties intended the transfers to be contemporaneous exchanges.

Next, the appellate panel considered whether the exchange of lumber for the transfers was in fact substantially contemporaneous. It concluded that they were, explaining that the agreement between Payless and Canfor structured shipments, deliveries and payments in such a way that the exchanges would be contemporaneous, and that the EFT payments were in fact made prior to delivery of the lumber.

Finally, the appellate panel concluded that Canfor gave "new value" to Payless in exchange for the payments. The governing agreements, the court explained, did not create a credit transaction even though the kind of contracts involved — a "destination contract" — is ordinarily viewed as creating a debt at the time of shipment rather than delivery of goods. Here, the appellate panel noted, under both the express terms of the contracts and applicable non-bankruptcy law, a right to payment for the lumber did not arise until delivery, and therefore, value was given when the lumber was delivered rather than when the lumber was shipped. According to the appellate panel, the dealings between Payless and Canfor were essentially cash on delivery transactions that qualified as exchanges for new value under section 547(c)(1).

The trustee appealed again. However, it fared no better before the Eighth Circuit. The Court of Appeals affirmed in a brief opinion adopting the reasoning articulated in the bankruptcy appellate panel's ruling below.

## Analysis

Vendors dealing with a customer they know is financially troubled commonly revise or restructure the terms of payment or credit in an effort to limit their exposure in the event of a meltdown. *Payless Cashways* illustrates one approach to the problem — ensuring that payment is received contemporaneous with or prior to delivery of goods. In effect, the parties restructured their course of dealing to establish a series of pre-paid transactions at a discount.

The ruling may create opportunities for savvy creditors. Even though Payless and Canfor recorded the transaction at the time of shipment, leading the bankruptcy appellate panel to conclude that an antecedent debt was created at the time of shipment, the transfers were not treated as credit transactions. If destination contracts are not treated as credit transactions, contract parties may have an opportunity to use these kinds of contracts strategically to extend payment terms while maintaining a contemporaneous exchange for new value preference defense. Creditors could incorporate credit terms into such contracts by measuring the "contemporaneous exchange for new value" from delivery when title is transferred and not from the time of shipment.

---

*Silverman Consulting, Inc. v. Canfor Wood Products Marketing et al. (In re Payless Cashways, Inc.)*, 394 F.3d 1082 (8th Cir. 2005), *affirming* 306 B.R. 243 (B.A.P. 8th Cir. 2004).