



Expanding the Scope of the Contemporaneous Exchange for New Value Preference Defense to Multiple Party Transactions

A supplier of goods and services on a construction project enjoys special state law mechanic's lien rights that enhance the likelihood of payment of the supplier's claim. A supplier's lien rights might also protect the supplier from preference risk for payments the supplier had received within 90 days of its customer's bankruptcy filing.

The added preference protection that a supplier's mechanic's lien affords is addressed in the *In re Instrumentation and Controls, Inc.* bankruptcy case pending in the United States Bankruptcy Court for the Eastern District of Pennsylvania. A creditor had received an alleged preference payment from a debtor in exchange for the creditor's waiver of its mechanic's lien rights on two parcels of real property that were owned by non-debtors. The creditor invoked the contemporaneous exchange for new value defense to preference liability under Section 547(c)(1) of the Bankruptcy Code, arguing that it had provided contemporaneous new value to the debtor by waving its mechanic's lien rights in exchange for the alleged preference payment.

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The bankruptcy court denied the debtor's motion dismissing the creditor's Section 547(c)(1) contemporaneous exchange for new value defense. The court noted that the creditor's waiver of its lien rights on real property not owned by the debtor might still provide value to the debtor and its estate to justify invocation of the defense.

What value did the debtor, here a contractor, receive from the creditor's waiver of lien rights in non-debtor property? The answer can be found by reading further!



The Contemporaneous Exchange for New Value Defense to Preference Liability

Section 547 of the Bankruptcy Code governs preference claims. A preference defendant can reduce its preference exposure by invoking any one or more of the preference defenses contained in Section 547(c). The Section 547(c)(1) contemporaneous exchange for new value defense excuses any payment or other transfer that the debtor and creditor had intended as a contemporaneous exchange for new value and was, in fact, a substantially contemporaneous exchange. This defense, like other Section 547(c) preference defenses, encourages creditors to continue doing business with financially troubled companies. A creditor that provides new goods and/or services or other value to a debtor substantially contemporaneously with an alleged preference payment should not be forced to return the payment because the creditor had replenished the debtor and its estate.

The Instrumentation and Controls, Inc. Case

The Facts

Instrumentation and Controls, Inc. (I&C) was a Pennsylvania contractor responsible for performing cell tower retrofits. I&C worked on two parcels of certain real property (the non-debtor real property) owned by non-debtor entities (the third party owners). The third party owners had contracted work on the non-debtor real property to their contractor, who, in turn, subcon-

tracted cell tower retrofit work to I&C, who, in turn, further subcontracted certain work to Northeast Union, Inc. The third party owners and their contractor (excluding Northeast and I&C) are referred to going forward as the “third parties.”

As a result of I&C’s failure to timely pay Northeast, Northeast sent notices of intent to file mechanic’s liens on the non-debtor real property to the third party owners. That was the first step in Northeast’s imposition and perfection, under Pennsylvania law, of its mechanic’s lien rights on the non-debtor property. Northeast also commenced a lawsuit against I&C. The third party owners blocked I&C from continuing to perform under its contracts with the third parties, that Northeast asserted had a value of approximately \$750,000 to I&C, in response to Northeast’s assertion of lien rights on the non-debtor real property and the commencement of the litigation. I&C paid \$31,950.00 to Northeast (the alleged preference) in return for Northeast’s waiver of its lien rights and dismissal of the litigation.

On August 12, 2013, less than 90 days after I&C’s payment of the alleged preference, I&C filed its Chapter 11 case. On November 1, 2013, I&C filed a complaint for recovery of the alleged preference from Northeast. Northeast answered the complaint and asserted, among other defenses, a complete contemporaneous exchange for new value defense under Section 547(c)(1). In its answer, Northeast claimed that its waiver of lien rights on the non-debtor real property was new value provided in exchange for the alleged preference that benefitted I&C by inducing the third parties to allow I&C to resume work on the contracts and ultimately (at least according to Northeast) realize approximately \$750,000.

Thereafter, I&C moved for judgment dismissing Northeast’s defenses asserted in the answer. I&C rejected the applicability of the contemporaneous exchange for new value defense because Northeast had not provided any new value to I&C where: (1) Northeast had waived an “inchoate” mechanic’s lien in the non-debtor real property, that was not perfected when I&C had filed for bankruptcy; and (2) Northeast had failed to prove its actions were responsible for the “freezing” or “unfreezing” of the contracts that permitted I&C’s resumption of work on the contracts.

The Court’s Decision

The court held that Northeast would satisfy the Section 547(c)(1) contemporaneous exchange for new value defense if it could prove the facts pled in its answer. The court applied the “indirect transfer” approach in ruling that Northeast’s waiver of lien rights on the non-debtor real property would satisfy the contemporaneous exchange for new value defense if Northeast proves that it had indirectly benefitted I&C in exchange for the alleged preference.

The indirect transfer argument applies when a debtor’s payment to the creditor was in exchange for the creditor’s waiving rights against a third party that induced the third party to provide value to the debtor. As long as the debtor had received

value from the third party that is at least equivalent to the debtor’s payment to the creditor, there was no loss to the estate or detriment to other creditors. However, the third party’s actions must enhance the debtor and its estate “in real terms” and provide more than an “esoteric or intangible” benefit.

The court cited the following two examples to explain the workings of the indirect transfer approach:

Example 1: The creditor waived or otherwise did not assert its lien rights against a third party’s property in exchange for an alleged preference payment. Prior to the payment, the third party still owed sufficient sums to the debtor to permit the third party to exercise setoff rights to reduce its indemnity claim against the debtor (that would arise if the creditor had successfully asserted its lien rights) by the sums the third party owed the debtor. As a result of the alleged preference and the creditor’s waiver of its lien rights, the third party did not have to invoke its setoff rights and there was no net loss to the estate.

Example 2: Same facts as example 1, except the third party had no setoff rights because it had no indebtedness to the debtor. In this scenario, the third party was left with only a general unsecured claim against the debtor. The end result is that the third party’s indemnity rights against the debtor arising from the assertion of the creditor’s mechanic’s lien rights replaced the creditor’s claim against the debtor and the debtor and its estate were diminished by the amount of the alleged preference.

In the I&C case, the alleged preference was tendered in exchange for Northeast’s waiver of its mechanic’s liens rights on the non-debtor real property and the third parties permitting I&C to resume work under the contracts or enter into new contracts with the third parties. The court held that Northeast would satisfy the Section 547(c)(1) contemporaneous exchange for new value defense if it can prove that the third parties had provided value exceeding the alleged preference to I&C.

The court stated its willingness to apply the indirect transfer approach to support the invocation of the contemporaneous exchange for new value defense so long as Northeast could prove that it had provided I&C with at least value equivalent to the amount of the alleged preference. Just like Example 1 above, I&C had indebtedness to Northeast that was paid by the alleged preference, and Northeast had recourse against the third parties (the right to assert a mechanic’s lien on the non-debtor real property), which Northeast had ultimately waived. In short, Northeast had to prove the third parties had provided value to I&C, by permitting I&C to resume work on the contracts or enter into new contracts with the third parties, that would result in I&C’s receipt of payments equal to or in excess of the amount of the alleged preference.

The I&C court relied on another court’s holding that applied the indirect transfer approach to satisfy the contemporaneous exchange for new value defense. In *In re Great Point Intermodal, LLC* (a 2004 decision from the Eastern District of

Pennsylvania), a debtor involved in the trucking business had fallen behind in payment to a creditor that had provided the debtor access to a railyard which the debtor had used for storage and shipment of goods to its customers. After the creditor had caused the railyard owner to lock the debtor out of the railyard for failure to pay overdue charges, the debtor paid the charges and regained access to the railyard. The debtor filed for bankruptcy within 90 days of the payment. The district court held that debtor's payment to the creditor was not a preference because it was tendered in exchange for the creditor's causing the railyard owner to reopen the railyard to the debtor. The debtor thereby benefitted by regaining access to the railyard to service its customers and generate revenue and profit.

The I&C decision confirms that the Section 547(c)(1) contemporaneous exchange for new value defense goes far beyond two-party transactions.

By the same token, in the I&C case, the court held that I&C's ability to retain a potentially valuable contractual relationship with the third parties in exchange for the alleged preference may constitute a contemporaneous exchange for new value that satisfies the Section 547(c)(1) defense. However, in order for Northeast to prevail, it would have to quantify the value that I&C will realize from its resumption of work with the third parties.

Conclusion

The I&C decision confirms that the Section 547(c)(1) contemporaneous exchange for new value defense goes far beyond two-party transactions. A creditor with mechanic's and other lien rights against third parties may benefit from the contemporaneous exchange defense where they release their lien rights in return for a preference payment. However, the debtor must receive at least equivalent value in exchange for its payment to the creditor in order for the contemporaneous exchange defense to apply. In the I&C case, Northeast had to prove that I&C's anticipated realization of value from its resumption of work on the contracts or entry into new contracts with the third parties, that resulted from Northeast's waiver of lien rights against the non-debtor real property, equalled or exceeded the amount of the alleged preference. Other preference defendants might make similar arguments when a creditor receives alleged preference payments from a debtor and, in turn, causes a third party to provide value to the debtor. ▀

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