Unpaid Product May Not Always Qualify as New Value

By

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The silver lining to having an unpaid balance upon a bankruptcy filing is that the vendor usually has at least some new value defense to a preference demand. However, as the Court of Appeals for the Seventh Circuit recently determined, that is not always the case, even when the unpaid is delivered after receipt of the preferential transfer.

In *In re Globe Building Materials, Inc.*, the Chapter 7 debtor had a contract with an equipment supplier, which consisted of a unified multi-million dollar contract for delivery of a single complex equipment manufacturing line. The line used a number of component machines which resulted in an overall machine suitable for making the debtor's product. The debtor was to pay the vendor in stages according to a schedule set forth in the contract, and the payment obligation was not tied to the vendor's delivery of any specific system components. Instead, the contract obligated the vendor to deliver parts as they became available. Except for the final payment of the last 10% and final delivery, the payment schedule and delivery schedule were not coordinated, and no payments were tied to specific deliveries.

The alleged preferential transfer was for $419,891.08, which represented approximately 10% of the contract price of the equipment line and was supposed to be the second to the last scheduled payment under the contract. After it received the alleged preferential transfer, the vendor completed its production of the equipment line and offered to ship the rest of the equipment. The parties stipulated that the vendor had fulfilled its delivery obligations by making the components available to the debtor even though the debtor never physically took possession of the full line.

The vendor asserted a new value defense to the preference action, and the trustee asserted that the vendor's delivery during the preference period of equipment components that it was obliged to furnish did not constitute new value. The trustee argued, and the court agreed, that Congress intended the definition of "new value" to codify the principle of consideration from contract law. Consideration must be something that the promisor is not already obliged to give to the promisee, that is, something additional or new. The performance of a legal duty owed to a promisor is not consideration.

The court found that the vendor already had an obligation to deliver the portion of the line equipment to the debtor that it delivered to the debtor after it received the transfer, and the debtor already had an obligation to make its scheduled payment on the contract. As a result, both the debtor's obligation to pay and the vendor's obligation to deliver the product were anything but "new" when it made the delivery and finished production. Further, as defined under the Bankruptcy Code, "new value" does not include an obligation substituted for an existing obligation.

The court found that the contract was a unified contract for the delivery of a single complex equipment manufacturing line, and that just because the parties structured both payment and delivery obligations under the contract to extend over a period of time do not transform each payment, or each delivery of goods, into an independent transaction. As a result, neither the product delivered nor the product specially produced did not qualify as new value. On a bright note for vendors, the court recognized that its analysis would have been different if the vendor and the creditor had agreed to an installment contract, and not one single contract for the payment and delivery of the equipment.