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Fireworks, Hot Dogs, and Bankruptcy?

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As the townsfolk of Lubbock, Texas readied for the annual Fourth on Broadway Independence Day fireworks show and celebration, local car dealer Reagor-Dykes wanted to be front of mind. So as it had the previous year, it sponsored the event by donating $25,000 to Broadway Festivals, the charitable organization that hosted the event.   Only this year, soon after the last bottle rocket burst, Reagor-Dykes filed Chapter 11. This sparked a dispute between the Liquidating Trustee and Broadway about whether the sponsorship was a preferential transfer under the Bankruptcy Code.

Preference Claims

To avoid unequal treatment and a free-for-all in the run-up to bankruptcy, a bankruptcy court can reverse certain "preferential" transfers with these characteristics:

- The transfer was made to benefit a creditor.
- The transfer was made to pay a prior debt owed by the debtor before the time of the transfer.
- The transfer was made while the debtor was insolvent.
- The transfer was made on or within 90 days before the date of the bankruptcy.
- The transfer enables the creditor to receive more than it would receive if the bankruptcy case were a Chapter 7 liquidation if the transfer had not been made and if the creditor received payment of the debt to the extent provided by § 547 of the Bankruptcy Code.

Broadway was a creditor of Reagor-Dykes that received money within 90 days of the bankruptcy. Reagor-Dykes was presumed insolvent. The $25,000 was more than Broadway would receive under Chapter 7. So at first blush, it appeared that Broadway would need to return the money to the Trustee.

Antecedent Debt

Broadway advanced several arguments to keep the money. First, it argued that the sponsorship was not for a prior, or antecedent, debt. Antecedent debt is debt incurred before the alleged preferential transfer. Debt is incurred when the debtor becomes obligated to pay it, and a debtor becomes obligated to pay a debt when it has received its consideration, or the creditor has performed services for the debtor. Broadway contended that the debt was not an antecedent debt because Reagor-Dykes paid for the sponsorship on July 13, 2018, and received some consideration following the July 4th event.

The Court rejected this argument. The primary consideration for Reagor-Dykes was the pre-event advertisements, VIP tickets to the event, and the opportunity to address the crowd and advertise at the celebration. Any subsequent consideration was incidental. Moreover, Broadway admitted that Reagor-Dykes became obligated to pay on July 4th.

The "New Value" Exception

Broadway then argued that the sponsorship was a contemporaneous exchange for new value and, therefore, could not be avoided. The "new value" exception encourages creditors to continue to deal with debtors experiencing financial distress, so long as these transactions involve exchanges of equally-valued consideration. To succeed on a new value defense, the creditor must prove: (1) intent, (2) contemporaneousness, and (3) new value.

The court determines intent by examining the parties' mutual understanding of the payment arrangement, including evidence of how payments were reflected in the parties' books. Broadway billed local businesses before the July 4th event, with no requirement that the sponsors pay the bill before July 4th. Because of the gap between the payment and consideration received, the court determined the parties did not intend for a contemporaneous exchange.

The court also determined there was no contemporaneousness or new value. A transfer need not be simultaneous to be substantially contemporaneous, and what is substantially contemporaneous will be evaluated case-by-case. But delays in payment not caused by unexpected or uncontrollable circumstances will not amount to substantially contemporaneous transfers.

Proving the element of new value is simple: the creditor must show that the debtor received some new value through the transfer. Broadway argued that because Reagor-Dykes benefited from the sponsorship after the July 4th event, and that benefit equaled the sponsorship payment, it received new value. The court disagreed.

The "Ordinary Course of Business" Defense

Finally, Broadway asserted the ordinary course of business defense. There are two approaches to the ordinary course of business defense -- an objective test and a subjective test. The objective test evaluates what is ordinary in the industry. The subjective test evaluates what is ordinary, given the party's respective practices.

Broadway argued that the sponsorship was a transfer made in the ordinary course of business under the subjective test. The subjective test involves a fact-intensive analysis of the parties' historical business practices. To determine if a transaction is ordinary under the subjective test -- would the transaction have occurred the way it did absent the debtor's impending bankruptcy -- courts generally ask:

- What is the length of time the parties engaged in the transaction (or transactions)? Essentially, what is the history of the business relationship between the parties?
- Does the amount or form of tender in the transaction differ from past practices?
- Is the payment by the debtor unusual, or were the collection efforts of the creditor unusual?
- Under what circumstances was the payment made?
- Did the creditor-transferee take advantage of the debtor's known deteriorating financial condition?

Some courts have determined that a single transfer is enough to establish what is ordinary between the parties, while others have expressed the need for a longer transaction history. A first-time debt may be ordinary when compared to past practices of the parties with other similarly-situated counterparties or when the agreement between the parties outlines the business terms. Although Broadway had a limited history with Reagor-Dykes, the court determined the sponsorship was within the ordinary course of business under the subjective test.

The court found the timing of Reagor-Dykes' payment -- nine days after the event -- normal when compared to other large sponsors of the fireworks show and celebration. The court also noted that Broadway never demanded payment, and the manner, amount, and form of Reagor-Dykes' payment were normal under the circumstances. Because Reagor-Dyke's sponsorship payment was in the ordinary course of its business with Broadway in anticipation of the annual fireworks show and celebration, the court declined to avoid the preferential transfer, and Broadway did not have to return the $25,000 to the Trustee.

Conclusion

Creditors who engage with customers on the brink of bankruptcy must know their transaction history with the debtor will be scrutinized by the court. Creditors should educate themselves on the elements of a preferential transfer and the available defenses and structure their behavior to put themselves in the best position to avoid having their payments avoided.

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 For further information regarding the issues described above, please contact Lilian L. Faulconer or Lance P. Martin.