



AVOIDANCE ACTION REPORT

*A Report on the Latest
Case Law on Bankruptcy
Avoidance Actions*

1 Late Payments Are Not Ordinary Even Without Collection Pressure

2 Contemporaneous Exchange Defense Requires That Both Parties Intended For Exchange To Be Contemporaneous

3 Funds Must Be Specifically Designated For “Earmarking” Defense To Apply

4 No Preference Liability For Debtor’s Insider Guarantor That Validly Waived Its Indemnification Rights

5 Prior Payment Plans Do Not Automatically Entitle A Defendant To The Ordinary Course Of Business Defense; Cutoff Date For New Value Calculation Is Petition Date

Late Payments Are Not Ordinary Even Without Collection Pressure

Davis v. Clarklift-West, Inc. (In re Quebecor World (USA) Inc.), 518 B.R. 757 (Bankr. S.D.N.Y. 2014)

In *Davis v. Clarklift-West*, the trustee for the Quebecor World Litigation Trust commenced an action to recover certain preferential transfers from the defendant pursuant to Bankruptcy Code Section 547. Under this section, a trustee may recover payments made by the debtor to or for the benefit of a creditor, on account of antecedent debt, made within the 90 days prior to the petition date, provided the debtor was insolvent at the time of the transfers and the defendant recovered more than it would have under a Chapter 7 liquidation of the debtor’s assets. The trustee bears the burden of establishing these elements of the action; once the trustee has established the elements of its case in chief, the burden shifts to the defendant to establish any affirmative defenses to reduce or eliminate its preference liability.

The defendant in the adversary proceeding did not dispute that the trustee met its initial burden. Additionally, the trustee and the defendant agreed on the amount of “subsequent new value” that could be used by the defendant to reduce its net preference exposure under Section 547(c)(4) of the Bankruptcy Code, which states that a defendant can reduce its net preference exposure to the extent it provided goods and services to the debtor subsequent to a preferential transfer. The only legal issue in dispute

between the parties was whether the “subjective” ordinary course of business defense under Section 547(c)(2)(A) of the Bankruptcy Code applied to further diminish the net preference amount. Under this affirmative defense, a defendant may assert that the transfers are protected from avoidance because they were both incurred and paid for in the ordinary course of business between the defendant and debtor. The subjective ordinary course of business analysis requires the court to look at the circumstances surrounding the payments during the preference period and compare them to the historical transactions of the parties, presumably when the debtor was financially healthy. As the court noted, “[t]he starting point—and often ending point—[of an ordinary course analysis] involves consideration of the average time of payment after the issuance of the invoice during the pre-preference and post-preference periods, the so-called ‘average lateness’ computation theory.” Under this theory, courts examine the average time it took the debtor to pay its invoices during the historical dealings of the parties as compared to the preference period. If there is a significant change in timing, courts will often find the payments were not made in the ordinary course of business.

The defendant and debtor had been conducting business with each other from at least 2005 through the debtor’s bankruptcy in January of 2008. The trustee conducted a statistical analysis to compare the timing of the preference payments with the parties’ previous dealings, and asserted that during the preference period, payments were made later. Specifically, in the historical

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AVOIDANCE ACTION REPORT

period, 83% of payments to the defendant were made between 45-65 days after the invoice date. In contrast, only 6% of payments during the preference period were made in that time frame. Instead, over 70% of payments during the preference period were made between 76-85 days after invoice date. The trustee also asserted that the weighted average in days to payment increased from 50.29 days in the historical period to 77.79 days in the preference period, or an increase of 27.5 days in payment.

The defendant did not dispute the trustee's analysis based upon the foregoing figures. Instead, the defendant noted a lack of other factors used to determine whether payments are unordinary, such as whether the amounts or methods of payment changed, and whether there was any collection pressure. The defendant argued that because the manner of payment and general amounts of payment did not change, and there was no identified collection pressure, the payments were ordinary.

The court rejected the defendant's assertions, noting that courts do not count the number of factors present against the number of factors not present to determine if a payment is ordinary. Instead, courts place significant emphasis on whether payments were late in determining whether they are ordinary. The court further stated that the lack of some factors that would make a payment unordinary could not compensate for the lateness of the payments in question and somehow make them ordinary. The court determined that the payments made during the preference period were made substantially later

than during the historical period, and held that the defendant did not meet its burden as to the subjective ordinary course of business defense. Accordingly, the court granted summary judgment in favor of the trustee.

COMMENTARY

Practitioners either prosecuting or defending preference actions should be aware of all circumstances surrounding a transfer, including whether the timing, manner, or method of payment changed from the parties' earlier dealings. However, while evidence of collection pressure is extremely important, the lack of any pressure from the defendant in and of itself does not protect a late payment from avoidance.

Contemporaneous Exchange Defense Requires That Both Parties Intended For Exchange To Be Contemporaneous

Dietz v. Calandrillo (In re Genmar Holdings, Inc.), 776 F.3d 961 (8th Cir. 2015)

In *Dietz v. Calandrillo*, the Chapter 7 trustee for the Genmar Holdings, Inc. bankruptcy estate commenced an action to recover a single payment made by the debtor to the defendant during the 90-day period prior to the debtor's petition date (known as the "preference period"). The payment received by the

defendant during the preference period was on account of a settlement agreement entered into between the debtor and defendant regarding a boat the defendant purchased from one of the debtor's subsidiaries in 2007. The defendant claimed the boat was defective, and the parties engaged in mediation to resolve their dispute. On February 19, 2009, the parties agreed to settle on the following conditions: the defendant agreed to convey the boat back to the debtor's subsidiary free of any liens or encumbrances, and the debtor's subsidiary agreed to pay defendant \$205,000. The debtor's payment was broken into two portions. First, the debtor would pay a portion to the bank holding a lien on the boat, and receive a lien waiver from the bank. Second, once the lien waiver was obtained, the debtor was to pay the remainder into the defendant's attorney's trust account "no sooner than 15 days after [the debtor] receives the lien waiver" from the bank and it received title to the boat from the defendant.

On February 20, 2009, the debtor paid the funds to the bank, and the bank issued the lien waiver. On February 25, the defendant executed a bill of sale conveying the boat to the debtor, and on March 4, the defendant sent the title documents to the debtor. On March 23, 19 days after the defendant sent the title documents, the debtor sent the remaining settlement payment to the defendant. The debtor filed a bankruptcy petition on June 1, 2009, and sought to recover the March 23 payment through the preference action.

The defendant asserted that the contemporaneous exchange for new value



AVOIDANCE ACTION REPORT

defense under Section 547(c)(1) of the Bankruptcy Code applied to the payment to protect it from avoidance. The contemporaneous exchange for new value defense protects a transfer to the extent that a defendant gives the debtor new value at the time payment is received or soon thereafter. Unlike credit transactions where a vendor gives the debtor a certain time period to pay, the contemporaneous exchange protects the immediate or near-immediate exchange of goods for value. Importantly, Section 547(c)(1) of the Bankruptcy Code requires that two elements be met. First, both parties must intend for the transaction to be a contemporaneous exchange. Second, the exchange must in fact be contemporaneous. Under Section 547(g) of the Bankruptcy Code, the defendant bears the burden of proof to establish this defense.

The bankruptcy court and the bankruptcy appellate panel both determined that the defendant did not meet its burden of proof to establish a contemporaneous exchange for new value, and the defendant appealed to the Eighth Circuit Court of Appeals. The Eighth Circuit affirmed the lower courts, determining that the defendant failed to establish the intent requirement of the defense. Specifically, the defendant argued that intent could be found in the settlement agreement itself, as it provided that the debtor's final transfer of money to it would occur within a matter of days after the boat was re-conveyed to the debtor, effectuating an essentially contemporaneous transfer. However, contrary to the defendant's argument, the settlement agreement actually provided that the funds would

be transferred "no sooner than" fifteen days after title was transferred. The court noted that the mandatory delay (for which the defendant offered no explanation) evidenced intent to enter into a credit transaction rather than a contemporaneous exchange.

COMMENTARY

While many practitioners focus on the timing element of the contemporaneous exchange defense, courts place a strong emphasis on the intent of the parties. Some courts have found that language evidencing contemporaneous intent can protect a transaction even where there is a somewhat significant delay in the exchange. Conversely, even when the payment timing is less than 20 days after new value is provided, language evidencing intent to the contrary can destroy the contemporaneous exchange defense.

Funds Must Be Specifically Designated For "Earmarking" Defense To Apply

The Official Comm. Of Unsecured Creditors of Cox & Schepp, Inc. v. Palmer Elec. Co. (In re Cox & Schepp, Inc.), 523 B.R. 511 (Bankr. W.D.N.C. 2014)

In *In re Cox & Shepp*, the unsecured creditors' committee of the debtor sued the defendant for the return of payments made during the preference period. In order for a plaintiff to meet its initial burden for a preference action, the plaintiff must prove that the debtor

made a transfer of the debtor's property to the defendant within the ninety days prior to the preference period. A plaintiff cannot sue to recover transfers of something other than property of the debtor.

A specific defense utilizing this debtor-property requirement is the "earmarking" defense. To successfully assert this defense, a defendant must establish that the debtor borrowed funds from a new creditor for the specific purpose of extinguishing the debt owed to the defendant. In other words, if the funds were "earmarked" by this new creditor to pay the debt owed to the defendant, the debtor's estate has not been diminished by the transfer. Instead, one creditor has simply substituted itself for another.

The debtor in the instant case was a general contractor on certain building projects for Quest Diagnostics Clinical Laboratories, Inc. (Quest) in Florida. Quest contracted with the debtor as general contractor on three projects, and the debtor in turn hired the defendant as a subcontractor to complete the electrical wiring elements of the project. On two of the three projects, the debtor agreed to pay the defendant within seven days of being paid by Quest. On the third project, the debtor agreed to pay the defendant within 25 days of being paid by Quest. The debtor made two payments to the defendant under their subcontracting agreements within the 90 days prior to bankruptcy, which the committee sought to avoid.

The main thrust of the defendant's arguments was that the funds paid from



AVOIDANCE ACTION REPORT

Quest to the debtor were either (i) held in a constructive trust for the benefit of defendant and thus not property of the estate, or (ii) earmarked by Quest for payment to the defendant. In bankruptcy, a party's rights to property are determined under applicable state law, which in this case was Florida.

Under Florida law, several elements must be met before a court will impose a constructive trust, including (i) a promise, (ii) a transfer based on that promise, (iii) a confidential relationship, and (iv) unjust enrichment. Additionally, a constructive trust will only be applied when the party asserting the trust can specifically trace the funds. The court found that the defendant did not meet several of the trust requirements and did not trace the funds. The court therefore held that the defendant did not establish a trust.

As to the earmarking defense, the court first noted that the earmarking defense, as a judicially created exception, was to be "narrowly construed." In order to establish this defense, a defendant must establish that the debtor did not have the right to disburse funds from the new creditor as it chose, but instead was limited to paying a particular old creditor under the agreement with the new creditor. The court noted that the defendant did not demonstrate the existence of a requirement that the Quest funds be used by the debtor to pay it. The court also noted that the funds came from the debtor's general operating account, evidencing that they belonged to the debtor to use as it wished, and that they were not "earmarked" by Quest for any specific purpose. Accordingly,

the court denied the defendant's motion for summary judgment on this basis.

While the defendant also argued that the payments were protected by the ordinary course of business defense and the contemporaneous exchange for new value defense, the court found there were material issues of fact in dispute and denied both parties' motions for summary judgment on those grounds.

COMMENTARY

The earmarking defense to an avoidance action is a difficult defense to prove. If a defendant wishes to proactively insulate itself from a financially weak debtor through this method, it should ensure that any agreement that the debtor has with a new creditor spells out that the new funds are to be used specifically to pay the debt to the potential defendant and that the debtor segregates the funds for such purpose.

No Preference Liability For Debtor's Insider Guarantor That Validly Waived Its Indemnification Rights

Stahl v. Simon (In re Adamson Apparel, Inc.), 785 F.3d 1285 (9th Cir. 2015)

In *In re Adamson Apparel, Inc.*, the debtor took out a multimillion dollar loan in 2002, which its CEO guaranteed. Towards the end of 2003, one of the

debtor's customers paid the money it owed to the debtor directly to the lender, per the instruction of the debtor. The debtor filed for Chapter 11 bankruptcy nine months later, and the creditors' committee utilized 11 U.S.C. § 547(b)(4)(B)'s one-year look-back period for preference actions against insiders to try and recover the amount paid by the customer to the lender from the debtor's CEO. The committee argued that the CEO received a preference to the extent the debtor's liability, and by extension, the CEO's personal guarantee obligation, was reduced. The bankruptcy court entered judgment in favor of the CEO, finding that the CEO was not a creditor of the debtor by virtue of having waived his right to indemnification under the loan agreements. Since Bankruptcy Code Section 547(b)(1) requires that a transfer of assets must be "to or for the benefit of a creditor" in order for preference liability to attach, the CEO was exempt from preference liability.

On appeal, the trustee that was substituted for the creditors' committee posited decisions by a number of bankruptcy courts which subjected an insider guarantor to preference liability even where the insider waived all claims against the debtor. These cases held that indemnification waivers could be a sham, because the insider could just as easily have purchased the lender's note rather than pay on the guarantee, in which case the insider would step into the shoes of the lender and be a creditor of the debtor. The CEO countered with case law holding that indemnification waivers by insiders are valid and protect the insider from preference liability.



AVOIDANCE ACTION REPORT

The Ninth Circuit determined that instead of focusing on what could happen, a better approach was to focus on what actually did happen, and in this case, the CEO did not purchase the lender's claim. The Ninth Circuit therefore affirmed the bankruptcy court's ruling that the indemnification waiver in the case was valid. The court acknowledged that the possibility of a sham waiver is a public policy concern that "is far from frivolous," but concluded that "that concern is more properly addressed to Congress, which has the ability to amend the Bankruptcy Code."

COMMENTARY

This decision could pave the way for courts in other circuits to approve the use of indemnification waivers as shields against preference liability for insider guarantors. Parties seeking to assert the waivers as defenses, however, should be ready to demonstrate that such waivers are valid, and that the parties took no subsequent actions that would negate the economic impact of the waivers, such as filing a proof of claim or purchasing the lender's note.

Prior Payment Plans Do Not Automatically Entitle A Defendant To The Ordinary Course Of Business Defense; Cutoff Date For New Value Calculation Is Petition Date

Prudential Real Estate and Reloca-

tion Services, Inc. v. Burtch (In re AE Liquidation, Inc.), Civ. Nos. 13-1504, 13-1505, 2015 WL 5301553 (D. Del. Sept. 10, 2015)

In May of 2006, the debtor entered into an agreement with Prudential Real Estate and Relocation Services, Inc. and Prudential Relocation, Inc. (Prudential) under which Prudential would perform relocation services for the debtor's employees. The debtor agreed to pay Prudential for services within 30 days of receiving an invoice, and did so for the first year and a half of the parties' agreement. Toward the end of 2007, however, the debtor fell behind on payments, leading Prudential to place the debtor on a payment plan. The debtor complied with the terms of the plan, and by January 18, 2008, Prudential terminated the plan and the parties resumed operating under their original payment structure. In August of 2008, the debtor fell behind on payments once again, and so Prudential placed the debtor on a second payment plan which was substantially similar to the first payment plan.

After the debtor filed for Chapter 7 bankruptcy on November 25, 2008, the trustee commenced an adversary proceeding against Prudential to recover 12 payments totaling \$781,702.61 that the debtor made to Prudential under the second payment plan during the preference period. Following trial, the bankruptcy court awarded judgment in favor of the trustee for \$653,323.20, representing \$781,702.61 of preferential transfers, reduced by \$128,379.40 of new value that Prudential provided.

Prudential appealed, arguing that the bankruptcy court erred in rejecting its

ordinary course of business defense of 11 U.S.C. § 547(c)(2). The trustee cross-appealed, claiming that the bankruptcy court overcalculated the new value Prudential provided.

Specifically, Prudential argued that the bankruptcy court improperly rejected its "subjective" ordinary course of business defense under Bankruptcy Code Section 547(c)(2)(A), which prohibits a trustee from avoiding a transfer "to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was made in the ordinary course of business or financial affairs of the debtor and the transferee." Prudential insisted that the second payment plan on which it placed the debtor during the preference period was the same as the first payment plan it had instituted earlier in the parties' relationship. Prudential therefore maintained that it did not act any differently during the preference period than it did during the "historical" period.

The trustee disagreed and also contended that Prudential's new value defense should be reduced, arguing that 21 of the invoices posited by Prudential as new value actually represented services rendered after the debtor's petition date. According to the trustee, the petition date was the final cutoff point for calculating new value under the new value defense.

The district court sided with the trustee on both issues. With respect to Prudential's subjective ordinary course of business defense, the district court cited the Third Circuit's decision in *In re Hechinger Inv. Co. of Delaware*,



AVOIDANCE ACTION REPORT

Inc., 489 F.3d 568, 576 (3d Cir. 2007). There, the Third Circuit rejected the same argument made by Prudential in this case, noting that the pre-preference period payment plan was the “result of an unusual dispute regarding some past due invoices and w[as] not the terms employed by the parties during the rest of their fifteen year relationship.” The facts here were similar, in that the parties established a baseline relationship on terms that continued for more than 18 months before Prudential placed the debtor on the first payment plan after the debtor fell behind on its payments. Moreover, when the debtor caught up on its payments, Prudential reinstated the baseline payment terms for another eight months until the debtor fell behind again and Prudential instituted the second payment plan. The court therefore concluded that the bankruptcy court did not err in denying Prudential’s 11 U.S.C. § 547(c)(2)’s ordinary course of business defense.

Turning to Prudential’s new value defense, the district court cited the case of *In re Friedman’s Inc.*, 738 F.3d 547 (3d Cir. 2013), in which the Third Circuit analyzed whether a debtor’s post-petition payment to a creditor could reduce that creditor’s new value defense. The discussion in *Friedman’s* related to Section 547(c)(4)(B) of the Bankruptcy Code, which provides a carve-out to the new value defense by crediting a transferee for new value only “on account

of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.” The majority of circuit courts interpret this section to mean that a creditor can only benefit from new value credit for goods or services the creditor provided subsequent to the preferential payment when those goods or services remain unpaid for by the debtor. A minority of circuit courts holds that the subsequent advance of goods or services need not remain unpaid; rather, a creditor may receive new value credit for goods or services it subsequently provided even if the debtor paid for those goods or services, but only if such payment is potentially avoidable.

In *Friedman’s*, the Third Circuit established that the cutoff date for assessing whether the debtor made “an otherwise unavoidable transfer” to the creditor under this section was the debtor’s petition date. The Third Circuit made this determination after observing that Bankruptcy Code Section 547 is entitled “Preferences,” suggesting that that the section only concerns transactions during the pre-petition preference period. The Third Circuit also noted that the “hypothetical liquidation test” to be performed under a preference analysis must be performed as of the petition date, supporting the conclusion that the cutoff date for determining new value be the same date. The Third Circuit additionally pointed out that the statute of limitations

for preference actions generally begins on the petition date, suggesting that the calculation of preference liability should remain constant post-petition. Although the holding in *In re Friedman’s Inc.* pertained to 11 U.S.C. § 547(c)(4)(B)’s specific carve-out to the new value defense, the district court found that its logic applied to 11 U.S.C. § 547(c)(4)’s new value defense in general. The court accordingly remanded the new value amount calculated by the bankruptcy court to that court to determine whether that calculation erroneously included post-petition services.

COMMENTARY

This decision cautions defendants that they cannot establish the subjective ordinary course of business defense by merely pointing to previous payment plans they implemented with the debtor where those payment plans were implemented under unusual circumstances. This decision also reaffirms that the cutoff date for calculating the new value provided under the new value defense is the petition date. Services rendered or goods provided by a defendant to a debtor after that date will not serve to reduce the defendant’s preference liability.

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