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A Bi-Annual Report on the Latest Case Law Relating to Avoidance Actions and Other Bankruptcy Issues

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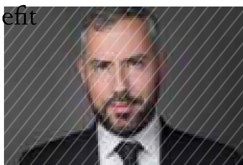

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Payments With Insurance Proceeds Are Property Of The Estate and Avoidable Preferential Transfers

In re Magellan E & P Holdings, Inc., 654 B.R. 98 (Bankr. S.D. Tex. 2023)

Magellan E & P Holdings ("Magellan"), an owner of the working interest in an offshore well that blew out, filed a voluntary bankruptcy petition under Chapter 7 of the Bankruptcy Code. Ronald J. Sommers was appointed as Chapter 7 trustee. Magellan received insurance payments as a result of the blown out well and used those insurance proceeds to pay certain of its creditors. One of those creditors was Offshore Marine Contractors, Inc. ("Marine") who was paid $269,995.67 with the insurance proceeds within 90 days prior to the bankruptcy filing. The trustee sued Marine to avoid the payment as a preference under 11 U.S.C. § 547.

Marine argued that the payment of $269,995.67 could not be avoided because it was not made with property of the estate because the insurance proceeds were not an "interest of the debtor in property" under 11 U.S.C. § 547(b). Marine further argued that the transfer at issue was "earmarked" for payment to Marine only and, therefore, could not be avoided. The earmarking doctrine applies when the funds transferred by the debtor were received from the third party with the direction to pay a specific recipient to extinguish a specific designated, existing debt based on the previous agreement between the debtor and the third party. Marine further argued that the transfer was not avoidable as it was made in the ordinary course of business between Magellan and Marine under 11 U.S.C. § 547(c)(2)(A).

The trustee argued that $269,995.67 could indeed be avoided as a preferential transfer under 11 U.S.C. § 547 even though it was made with insurance proceeds because the insurance proceeds were property of the estate. The trustee also pointed out that Magellan used the insurance proceeds to pay certain creditors, such as Marine, while the vast majority of creditors were not paid at all.

The bankruptcy court sided with the trustee and concluded that the transfer of $269,995.67 was avoidable as preferential transfer. The court opined that the transferred insurance proceeds were "an interest of the debtors in property" because Magellan controlled the insurance proceeds, commingled these funds with other funds in its bank account, and made the decision of who to pay, when to pay, and how much to pay. The court further rejected Marine's earmarking defense because Magellan's insurers did not direct that any of the insurance proceeds be paid to Marine. The court also rejected Marine's subjective ordinary course of business defense because there was no historical data for transactions between Magellan and Marine and the transfer was not made pursuant to any payment terms. In concluding, the court emphasized that bankruptcy should stand for the proposition that all creditors are treated fairly and equally, and, therefore, it was antithetical to the bankruptcy process that Marine was paid while other creditors were not.

COMMENTARY

In re Magellan emphasizes that a payment made from insurance proceeds within 90 days prior to the bankruptcy filing is made

from an interest of the debtor in property. The basis for this holding was that the insurance proceeds were commingled in the debtor's account with other funds and that the debtor exercised discretionary control over the use of the insurance proceeds. Preference prosecutors and defendants should be mindful of whether the debtor had control over the funds used to make an alleged preference in determining whether the payment was made with property of the estate. In re Magellan is currently on appeal in the District Court for the Southern District of Texas.

Earmarking Defense Applies If The Transfers Satisfy The Dominion/Control And The Diminution Tests

In re Chuza Oil Co., No. 22-2073, 2023 WL 8588589 (10th Cir. Dec. 12, 2023)

Chuza Oil Company ("Chuza"), a petroleum production company, filed for bankruptcy under Chapter 11 of the Bankruptcy Code with a Chapter 11 plan being confirmed shortly after the filing. Under the plan, unsecured creditors were to be paid in full before insiders with unsecured claims. After the confirmation, Chuza had to rely on new insider loans to continue operating and to pay creditors under the confirmed plan. Repayment of the insider loans was subordinated to payment to general unsecured creditors under the plan. In contradiction to the plan, Chuza used some of the insider loan money to pay off $46,885 owing to insiders on their unsecured claims, even though not all non-insider claimants had been paid by then. Chuza failed to stay afloat after the confirmation, and an involuntary Chapter 7 petition was filed against Chuza. Phillip Montoya was appointed the chapter 7 trustee. The trustee sued the insiders to avoid the $46,885 as preferential transfers under 11 U.S.C. § 547(b), as actual fraudulent transfers under 11 U.S.C. § 548(a)(1)(A), and as constructive fraudulent transfers under 11 U.S.C. § 548(a)(1)(B).

The insiders raised a variation of the "earmarking" defense, arguing that the transfers were not transfers of estate property because the transferred funds were loaned by a third party (the insiders) and "earmarked" to be used for specific purposes (to pay the insider in question), and the debtor could not do as it wished with the funds. The bankruptcy court agreed with the insiders and held that the transfers did not constitute a transfer of an interest of the debtors in property. The trustee appealed to the BAP and the BAP reversed the bankruptcy court's ruling finding that Chuza had an interest in the funds because the transfers diminished the estate by impairing the interests of a preferred class of creditors established by the Chapter 11 plan. The insiders appealed to the Tenth Circuit.

The insiders argued that Chuza did not have full control over the insider loan money because these loans had a valid condition that some of the funds be used only in accordance with certain guidelines. The trustee argued that Chuza did have an interest in the transferred funds and that the transfers diminished the bankruptcy estate because they allowed Chuza to replace debt subordinated by the Chapter 11 plan with unsubordinated debt, i.e. it did not simply replace one creditor with another creditor of equal priority.

The Tenth Circuit sided with the insiders and held that Chuza did not control the earmarked funds and the transfers did not diminish the estate. The Tenth Circuit opined that earmarking doctrine applies if the transfers can satisfy both the dominion/control and the diminution tests. The Tenth Circuit pointed at the uncontradicted trial evidence showing that Chuza could only use the insider loan money to pay a certain insider on the unsecured claims, and concluded that Chuza did not control the funds under the dominion/control test. The Tenth Circuit further pointed out that every alleged preferential transfer to the insider had come right after other insiders loaned larger amounts to Chuza which was eight times more than the total amount of preferential transfers. Viewing the economic realities of Chuza's situation, the Tenth Circuit concluded that the preferential transfers did not diminish Chuza's estate. Therefore, the Tenth Circuit disagreed with the BAP and affirmed the bankruptcy court's holding that the preferential transfers were not avoidable because Chuza did not have an interest in the earmarked funds and the transfers did not diminish the estate.

COMMENTARY

In re Chuza Oil Co. emphasizes that the debtor's lack of full control over funds along with the absence of the diminution of the estate shields a creditor from a preference action. In re Chuza Oil Co. also underscores that the diminution of the estate is assessed based on the transaction as a whole including a new creditor's infusion of funds to the debtor that are used to repay debtor's old creditors.

AVOIDANCE ACTION REPORT

Avoidance Actions Are Estate Property and Can Be Sold

In re Simply Essentials, LLC,
78 F.4th 1006 (8th Cir. 2023)

An involuntary petition under Chapter 7 of the Bankruptcy Code was filed against Simply Essentials, LLC, an operator of a chicken production and processing facility ("Essentials"). Larry S. Eide was appointed as Chapter 7 trustee. The trustee filed a motion to sell the Chapter 5 avoidance actions to ARKK Food Company ("ARKK"), a creditor of Essentials under 11 U.S.C. § 363(f). Pitman Farms, a creditor of Essentials, objected arguing that Chapter 5 avoidance actions are not part of the bankruptcy estate because they are not listed as property of the estate under 11 U.S.C. § 541, and, therefore, could not be sold. The bankruptcy court sided with the trustee and granted the motion finding Chapter 5 avoidance actions were part of the bankruptcy estate and, therefore, could be sold. Pitman Farms filed a motion to appeal the decision. The bankruptcy court certified Pittman Farm's motion to appeal, and the Eighth Circuit granted permission to appeal. Pitman Farms appealed to the Eighth Circuit.

Pitman Farms argued that avoidance actions belong to the creditors, or to the trustee to pursue solely for the benefit of the creditors, and are not property of the estate that could be sold. Pitman Farms further noted that allowing the sale of avoidance actions would violate the trustee's fiduciary duty and undermine the purpose of avoidance actions, which is to recover money for creditors.

The trustee argued that Chapter 5 avoidance actions are part of the bankruptcy estate under 11 U.S.C. § 541(a)(1) which says that "all legal or equitable interests of the debtors in property as of the commencement of the case" are property of the estate, and under 11 U.S.C. § 541(a)(7), which says "[a]ny interest in property that the estate acquires after the commencement of the case" is estate property. Therefore, the avoidance actions could be sold as such.

The Eighth Circuit agreed with the trustee and affirmed the bankruptcy court's decision approving sale of the avoidance actions. The court noted that Section 541(a) was written broadly enough to include avoidance actions as property of the estate. The court emphasized that the trustee's fiduciary duty is to "maximize the value of the estate" which could be achieved by sale of the avoidance actions when the estate cannot afford to pursue the avoidance actions on its own. The court further pointed out that the courts across the country are in consensus that avoidance actions are property of the estate by citing the opinions from the First, Fifth, and Seventh Circuits. Thus, the court agreed with the bankruptcy court's conclusion that Chapter 5 avoidance actions are property of the estate and affirmed the order approving the trustee's motion to sell them.

COMMENTARY

In re Simply Essentials underscores that Chapter 5 avoidance actions are property of the estate that can be sold. However, some courts hold that outright sales of avoidance actions are impermissible, especially when the creditor who purchased avoidance claims would pursue these claims on its own behalf. *See* Briar Cap. Working Fund Cap., LLC v. Remmert, No. 4:18-CV-2867, 2022 WL 4137840 (S.D. Tex. Sept. 12, 2022).

Subjective Ordinary Course Defense May Be Satisfied Even With Persistent Email Requests to Collect

In re Diversified Mercury Commc'ns, Inc.,
646 B.R. 403 (Bankr. D. Del. 2022)

On April 3, 2019, an involuntary Chapter 7 petition was filed against Diversified Mercury Communications, LLC ("DMC"), a full-service direct response media agency, with the Delaware bankruptcy court. On May 23, 2019, DTR Advertising, Inc. ("DTR" and together with DMC, the "Debtors") filed a voluntary petition under Chapter 7 of the Bankruptcy Code. The Debtors' Chapter 7 cases were jointly administered, and George L. Miller was appointed as the Chapter 7 trustee. The trustee sued Direct Results Radio, Inc. ("Direct Results"), a marketing company that provided services to the Debtors' clients on behalf of the Debtors, to avoid and recover the payment of $493,349.34. Direct Results would collect all invoices incurred in a month and issue one invoice to the Debtors each month for the aggregate invoices plus its commission. This reconciliation process generally took 45 days. Direct Results then emailed the invoice to the Debtors with payment due in 30 days. During the historical period, all but one of 20 payments that the Debtors made to Direct Results were made by check. All checks were cleared within a week of Direct Results' receipt. Before the fall of 2018, the Debtors became financially distressed and failed to timely pay the August invoice. The bookkeeper of Direct Results sent several emails to DMC's ac-

counts payable representative, asking for an update on the payment. The account director of Direct Results also emailed the senior director of DMC to follow up on the collection request. DMC finally issued a check for the August invoice (the "Check") on November 30, in the amount of $493,349.34. Direct Results received the Check on December 3 but waited to cash the Check until January 2, for "financial management and tax purposes." The Check cleared DMC's bank account on January 3, ninety days prior to the petition date, falling within the preference period.

Direct Results claimed that the transfer was made within the ordinary course of business pursuant to section 11 U.S.C. § 547(c)(2) and was therefore unavoidable. They further argued that both the "subjective test" (§ 547(c)(2)(A)) and "objective test" (§ 547(c)(2)(B)) were satisfied.

The trustee argued that the transfer could be avoided even though the amount and the manner of payment was consistent with prior dealings, because the length of time between the date of the August invoice and the date the Check was honored, which was 130 days, is clearly different from the ranges and averages of the historical period. The trustee also pointed out that some courts have determined that deposit delays affect the ordinariness of a payment. Moreover, the trustee argued that Direct Results pressured the Debtors for payment and took advantage of their financial condition.

The court held that although Direct Results failed to satisfy its burden with respect to objective test because it neither offered an expert report nor other satisfactory evidence to establish relevant industry standard, the transfer was unavoidable under the subjective test. The court looked to the 20 transactions between parties during the 2-year historical period and found that the transfer was similar to previous transactions. During the historical period, Direct Results received payments between 28 to 74 days after invoices were sent, averaging 45.81 days. The Check for the transfer was received 49 days after the August invoice was sent, squarely within that historical range, and the three days difference was insufficient to overcome the ordinariness of the transfer. The court also opined that the date the Check was honored was not material, because the date the creditor receives the check – not the clear date – is relevant for the purposes of analyzing payment timing for the ordinary course of business defense. Furthermore, the court disagreed with the trustee's claims relating to unusual collection efforts. Although Direct Results emailed DMC regarding past-due invoices, the emails were polite inquiries, and the follow up emails were consistent with Direct Results' past practice when confronted with late client payments. The court also found no evidence to suggest that Direct Results was aware of the Debtors' deteriorating financial condition, further supporting that their action was simply motivated by the desire to timely pay their own clients and maintain healthy relationships with them, rather than to receive payments out of fear for the Debtors' inability to pay. In conclusion, the court ruled in favor of Direct Results, that the transfer was made in ordinary course of business and thus cannot be avoided.

COMMENTARY

In re Diversified Mercury Communications underscores that a creditor's collection pressure, such as persistent email requests for payment, may not be sufficient to defeat subjective ordinary business defense if such action is consistent with their past practices. The court will also take into account the creditor's awareness of the debtor's financial status in determining the intent and purposes behind such collection efforts. Nevertheless, creditors should always be mindful of the consequences of collection pressures against a financially distressed party.