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Court: Loan Payments Outside Ordinary Course of Business Preferential

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June 24, 2010

The Legal Intelligencer

In the case of *In re Computer World Solution Inc.*, the U.S. Bankruptcy Court for the Northern District of Illinois held that loan payments by a debtor constituted avoidable preferential transfers. At trial, the lender argued that the earmarking doctrine applied to the payment it had received, that these payments were in the ordinary course of business according to ordinary business terms, and that the lender's forbearance constituted new value to the debtor.

These theories were all dismissed by the court, which found in favor of the debtor and entered judgment against the lender for $1.5 million.

The Facts

According to the court's opinion, Computer World Solution Inc. distributed flat screen televisions and computer monitors imported from Asia. As a distributor, Computer World received goods for resale to stores and also coordinated direct delivery of goods from Asia for certain of its retail clients. Computer World financed its business primarily through a $20 million loan from its lender, Fifth Third Bank.

On June 30, 2006, Computer World executed a promissory note in favor of Apple Fund L.P. and obtained a second priority loan in the amount of $2.2 million, which was to mature in one year, the opinion said. The loan represented the sole business transaction between Computer World and Apple.

On June 29, 2007, Apple and Computer World signed a Loan Modification agreement which extended the maturity date of the loan for 41 days. Apple conditioned this extension on the immediate payment of $300,000 by Computer World, and Computer World made that payment by wire transfer on June 30, 2007, the opinion said.

The parties also discussed a Second Loan Modification Agreement that would have further extended the maturity date to Aug. 31, 2007. The Second Loan Modification Agreement was never signed, although the sole managing member of Astor Partners (the general partner of Apple) testified that the parties conducted themselves as if it had been. The Second Loan Modification Agreement provided a daily interest rate, which came to $1,000, $1,750, or $3,000 depending on whether $1.2 million of outstanding principal was repaid before the 17th, before the 24th, or after the 24th, the opinion said. In addition, the Second Loan Modification Agreement increased the original per diem default rate to $5,000 for each day after Aug. 31, 2007.

On Sept. 25, 2007, Apple filed a complaint in confession of judgment against Computer World in state court. On Oct. 5, 2007, the court entered a final judgment against Computer World in the amount of $493,955, together with post-judgment interest.

Bankruptcy

On Nov. 9, 2007, three of Computer World's creditors filed an involuntary bankruptcy petition against Computer World. One week later, Computer World agreed to an order for relief under Chapter 11 of the Bankruptcy Code.

On March 25, 2008, the debtor initiated an adversary proceeding against Apple Fund L.P. and Apple's general partner, Astor Partners LLC. In the complaint, the debtor alleged that it had made preferential transfers to Apple that were avoidable under Section 547 of the Bankruptcy Code. The complaint requested the recovery of these transfers and the disallowance of any claims by the defendants against the debtor's estate. The subject transfers from the debtor to the defendants included: (i) a transfer of $200,000 on Aug. 14, 2007; (ii) a transfer of $1.2 million on Aug. 28, 2007; and (iii) a delivery of certain of the debtor's television and monitor inventory in September 2007, which Apple had been able to sell for $103,204.

Before trial in the adversary proceeding, the parties submitted a list of stipulated facts. These stipulated facts included: (i) that the transfers were made during the preference period; (ii) that the defendants did not provide the debtors with any subsequent advances of funds, goods, or services after Aug. 14, 2007; (iii) that the transfers were made to or for the benefit of Apple on account of antecedent debt owed by the debtor to Apple; (iv) that before receipt of the transfers, Apple undertook collection efforts for payment of the loan; and (v) that the defendants did not pay or otherwise return any of these transfers to the debtor.

At trial, the opinion said, the debtor presented evidence supplementary to the stipulated facts: The debtor's schedules showed assets of approximately $4 million and liabilities of approximately $37 million; the debtor presented the defendants' answer to plaintiff's statement of facts, which admitted that the debtor was insolvent during the preference period; the debtor introduced checks issued on Aug. 15, 2007, to the debtor from vendors in the total amount of about $1.6 million. The debtor argued that these checks were the source of the funds used by Computer World to pay the $1.4 million to Apple.

To corroborate its argument, the debtor also provided testimony of the Citibank assistant branch manager handling Apple's bank account there. The branch manager testified that the initial $1.2 million check the debtor issued to Apple was not honored because the vendor checks to the debtor totaling $1.6 million had not yet cleared, according to the opinion.

The debtor also provided expert testimony from Patrick O'Malley, the chief financial officer and senior consultant for the assignee of the debtor's assets since Oct. 29, 2007. According to the opinion, O'Malley testified that he discovered that the officers of the debtor had engaged in fraud: the debtor's financial statements were false; 2006 sales were overstated by $47 million; 2007 sales were overstated by $63 million; the debtor issued fraudulent invoices; and some of the debtor's listed customers were fictitious. O'Malley testified that debtor's chief operating officer had impeded his efforts to investigate reported transactions. O'Malley further testified that 10 percent of the boxes in the debtor's warehouse that purported to be filled with various items of inventory were, in fact, empty. Finally, O'Malley testified that the debtor's Citibank account had not been used for international transactions as claimed, but rather to shield transactions from the debtor's primary lender.

O'Malley went on to testify with respect to the debtor's treatment of the Apple loan. He stated that the loan was not accounted for as a loan on the debtor's books and records, but rather as a receivable from a fictitious customer. Payments to Apple were characterized as commission expenses and not as loan payments. In addition, the two cash payments to Apple totaling $1.4 million were not listed in the debtor's bank statements, but had to be verified by O'Malley through an examination of the Citibank account records, O'Malley testified.

O'Malley gave his expert opinion that it was unusual for a second priority secured lender not to file a Uniform Commercial Code financing statement or to enter into some type of subordination or intercreditor agreement with the primary lender. As a result of all of his findings O'Malley opined that "there was nothing ordinary about how the loan was treated by the debtor," the opinion said. Finally, O'Malley concluded that Apple received 75 cents on the dollar as a result of the transfers when it would have only received 9 cents on the dollar had the debtor's assets been liquidated.

The defendants provided the testimony of Robert Stein, the sole managing partner of Astor Partners, Apple's general partner. Stein testified that it was not unusual for his firm to modify loans to charge higher interest and to extend maturity dates. While claiming to be an investment management expert, Stein did not present himself as a lending expert, the opinion said. Stein further testified that Apple received debtor inventory in September 2007 and that it was not ordinary for his firm to do so. Stein was not aware that the inventory that Apple had received from Computer World was likely subject to Fifth Third Bank's blanket lien, the opinion said.

The Court's Analysis

The bankruptcy court found that several of the elements of the debtor's case were met pursuant to the stipulation of facts submitted by the parties, and that the debtor had to prove two remaining elements at trial to make its prima facie case: first, that the transfers were interests of Computer World in property; and second, that the transfers enabled Apple to obtain more than it would had the debtor liquidated its assets under Chapter 7 of the Bankruptcy Code.

In its defense, Apple asserted the earmarking doctrine, and argued that both of the cash transfers were not interests of the debtor in property. The earmarking doctrine is available to a creditor where a third party lends funds to the debtor and clearly "earmarks" those funds for payment to a designated creditor. As a result, the debtor never exercises control over the funds, and the debtor's estate is not diminished, because one creditor simply substitutes in for another. The court dismissed Apple's unsubstantiated contention that funds were given to the debtor by the family of Computer World's president and earmarked for payment to Apple.

The court also found that Apple received more through the transfers than it would have had there been a liquidation of the debtor's estate. As noted above, the debtor's expert witness testified that Apple would have received 9 percent of its claim in a Chapter 7 liquidation as opposed to the 75 percent it received through the transfers. Apple apparently submitted no evidence to refute this contention.

Apple also asserted an ordinary course of business defense under section 547(c)(2) of the Bankruptcy Code, which prohibits the avoidance of a transfer in payment of a debt incurred by the debtor if "made in the ordinary course of business or financial affairs of the debtor and transferee" or "made according to ordinary business terms."

Based on the facts outlined above, the court concluded that the loan from Apple was not incurred in the ordinary course of business or financial affairs of the parties.

It also found that the transfers to Apple were not made in the ordinary course of business of the parties, noting that the ordinary course exception only applied to payments by legitimate businesses, and Computer World's business has been conducted fraudulently for some time. Finally, the court determined that the transfers were not made according to ordinary business terms, pointing out that the defendants had not presented any evidence that the transfers were on ordinary terms in the lending industry.

The defendants also asserted a "new value" defense, arguing that their agreement to forbear on the loan constituted new value. The court dismissed this proposition and noted that several courts have already ruled that forbearance does not constitute new value under section 547(a)(2) or 547(c)(4) of the Bankruptcy Code. The court also dismissed Apple's setoff defense, noting that section 547(c) does not provide for setoff and that the defendants had not filed any claims against the debtor's estate in any case.

Final Thoughts

The defendants in this case were required to return about $1.5 million in payments they received from the debtor within 90 days of the filing of the involuntary petition. The facts of the case, coupled with a fundamental bankruptcy policy of assuring equal distributions among like-situated creditors, sealed Apple's fate in *Computer World*.

However, *Computer World* also demonstrates the pitfalls for unwary investors that might want to become involved in non-traditional lending. In our view, the testimony of the defendants suggests that they were ignorant of industry lending practice and that they either disregarded, or were unaware of, the usual practice among second lien lenders of filing UCC-1 financing statements or entering into intercreditor agreements. The court found the fact that the defendants may have been unaware of the debtor's fraudulent practices was simply not enough to put their interests before the interests of other unsecured creditors who may similarly have made a bad bet on the debtor.

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