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Potential Pitfalls in Subsequent Bankruptcies of Reliance on Joint Check Agreements

By Al Lurey

Under title 11 of the United States Code (the "Bankruptcy Code"), generally speaking, payments by insolvent debtors to an unsecured or undersecured creditor on pre-existing indebtedness (so-called "antecedent debt") made during the 90-day period before the debtor's bankruptcy filing (the "Preference Period") are vulnerable to claw-back in the debtor's bankruptcy case as voidable preferences. This is the case if the payments allowed the creditor to receive more than it would receive in a chapter 7 liquidation of the debtor, if the payments had not been made and the creditor received payment on its debt in the chapter 7 liquidation to the extent provided by the Bankruptcy Code. For example, if an unsecured creditor owed $100,000 receives a $50,000 payment from an insolvent debtor 50 days before the debtor goes into bankruptcy and the projected recovery in a chapter 7 liquidation of the debtor for creditors of its class is five cents on the dollar, the creditor's position will have been improved substantially by receipt of the $50,000 payment, if that payment is not required to be disgorged as a voidable transfer.

If the $50,000 payment stands, the creditor would recover a total of $52,500 on its $100,000 claim , consisting of the $50,000 paid before bankruptcy and a 5% distribution in the chapter 7 liquidation on the $50,000 balance remaining on its claim. If the pre-bankruptcy payment had not been made, the creditor would receive only 5% of its $100,000 claim, namely, $5,000. Under such circumstances, unless one of the recognized defenses to a preference claim is applicable, the $50,000 payment made during the Preference Period can be recovered from the creditor by the representative of the debtor's bankruptcy estate. Even if the debtor filed a chapter 11 case and is continuing in business as a going concern, the test is applied as if the case were a chapter 7 liquidation case.

The upshot of the foregoing is that, in order to promote (among other things) the bankruptcy policy of equality of distribution among similarly situated creditors, a payment made during the Preference Period on a perfectly legitimate debt may be recoverable from the creditor in the debtor's bankruptcy case.

A recent decision by the United States District Court for the Eastern District of Virginia, arising out of the *Truland* bankruptcy cases, involved a $2.1 million preference claim brought by a chapter 7 trustee in bankruptcy for a defunct subcontractor against a supplier that had provided electrical equipment (the "Equipment") to the subcontractor in connection with a large construction project. *See* Myers Controlled Power, LLC v. Gold (*In re* Truland Grp., Inc.), No. 1:18-cv-979 (LMB/IDD), 2019 WL 2251704 (E.D. Va. May 24, 2019). In particular, the bankruptcy trustee alleged that, during the 90-day period preceding the subcontractor's bankruptcy filing, the supplier received, by means of a check from the general contractor on the project made jointly payable to the subcontractor and the supplier, $2.1 million in payment of antecedent debt owed to the supplier by the subcontractor. The trustee contended that, notwithstanding the joint check procedure employed to effectuate payment to the supplier, the transaction constituted a transfer to the supplier of property of the insolvent subcontractor during the Preference Period. He further alleged that this transfer enabled the supplier to recover more than it would have recovered in the subcontractor's chapter 7 case, if (i) the transfer had not been made, and (ii) the supplier had received payment in the chapter 7 case to the extent provided by the provisions of the Bankruptcy Code.

According to the trustee, all of the elements of a voidable preference were satisfied regarding the $2.1 million transfer, and the supplier therefore should be required to disgorge to the subcontractor's bankruptcy estate the $2.1 million it had received, through the joint check arrangement, in payment of indebtedness owed to it for Equipment delivered to the project. After a bench trial before the bankruptcy judge, the bankruptcy judge ruled in favor of the trustee and entered judgment against the supplier for $2.1 million plus prejudgment interest. *See* Gold v. Myers Controlled Power, LLC (*In re* Truland Grp., Inc.), 588 B.R. 447 (Bankr. E.D. Va. 2018). The supplier appealed to the district court but to no avail. The district court agreed with the bankruptcy court that all of the elements of an avoidable preference under section 547(b) of the Bankruptcy Code had been proven and that no defense to preference avoidance under section 547(c) had been established by the supplier. It therefore affirmed the judgment of the bankruptcy court.

This case is significant because it reveals pitfalls to which a lower tier supplier or subcontractor ("lower tier party" or "lower tier parties") dealing with a financially challenged subcontractor may be exposed when a joint check arrangement is employed to ensure that payments from the general contractor (inclusive of funds for materials supplied to, or work performed for, a subcontractor by lower tier parties) are not diverted by the debtor/subcontractor to other uses. It also illustrates that when a joint check agreement is first entered into at a time that turns out to fall within the Preference Period applicable to a subsequently filed bankruptcy of the debtor/subcontractor, the agreement itself may be vulnerable to preference avoidance. If the agreement itself can be avoided, then it cannot serve as a basis for a determination that the proceeds of joint checks issued in accordance with the agreement are "trust funds" for the benefit of lower tier parties that are immune from claw-back as voidable preferences.

<u>Relevant Facts and Judicial Resolution</u>

The project in question in the *Truland* case consisted of a $273 million renovation of the Orange/Blue Line – Armory to National Airport -- to be performed for the Washington Metropolitan Area Transit Authority ("WMATA"). WMATA entered into a contract with Clark Construction Group, LLC (the "GC") to serve as general contractor for the project. The GC, in turn, entered into a contract with a Truland entity ("TWST") to serve as the electrical subcontractor for the project. According to the court, this subcontract contained a "flow-down" provision requiring TWST to pay its subcontractors and suppliers such that they would not make claims on the sureties "that guaranteed TWST's performance." *Truland Group*, 2019 WL 2251704 at *1. In connection with this subcontract, TWST caused its sureties to issue performance and payment bonds.

TWST decided to use Myers Controlled Power, LLC ("Myers") to supply the Equipment required by TWST to fulfill its contract with the GC. It did not contract directly with Myers, however, because a disadvantaged business enterprise (the "DBE") was inserted into the mix between TWST and Meyers. Though the parties disputed whether there was ever a written subcontract between TWST and the DBE, the bankruptcy court concluded that no signed, written contract between TWST and the DBE existed. On the other hand, a written contract between the DBE and Myers was prepared, under which Myers was to supply about $17 million of equipment to the project. Though this contract apparently was not signed by either party, no one disputed that the parties acted as though it was in full force and effect during the relevant time period.

In connection with its performance under this contract, Myers submitted all but one of its invoices to the DBE rather than to TWST, but Myers took direction exclusively from TWST in supplying the Equipment. The DBE invoiced TWST from time to time for the Equipment provided by Myers. While the opinion does not state explicitly that TWST, in turn, invoiced the GC, the bankruptcy court's opinion states that when it came time to pay for Equipment, the GC would issue checks that were jointly payable to TWST and the DBE. The opinions do not disclose how these jointly payable checks were handled as between TWST and the DBE. Because, as described below, TWST became "out of trust" with respect to such payments, TWST apparently was able to obtain dominion and control over these checks and their proceeds.

The method employed by the GC in issuing checks in payment of invoices submitted by TWST changed after TWST began to experience serious financial difficulties in the spring of 2014. By April of that year, TWST was "out of trust" with its suppliers and lower tier subcontractors, in that it had received payment from the GC for material supplied or work performed by those parties but had failed to pay them for such material or services. As a result, unpaid invoices for Equipment provided by Myers had accumulated to the point that Myers notified TWST and the GC that it was suspending delivery of Equipment until old invoices were paid. This notification posed a threat to the schedule for the overall project and resulted in communications among the GC, TWST and Myers. Based on an email of May 1, 2014 from an employee of TWST, it appears that TWST, by that time, had requested that the GC pay Myers by checks made jointly payable to TWST and Myers.

Myers proposed instead that it be paid directly by the GC (via one-party check) and that the GC guarantee payment for Equipment provided by Myers. The GC rejected that approach. It advised instead, on May 13, 2014, that future checks would be issued payable jointly to TWST and Myers; that they would be sent to TWST for endorsement and then delivered to Myers, which would collect them. The DBE, apparently, no longer would appear as a co-payee on the checks. The opinions do not reveal whether Myers was to have any obligation to TWST or the DBE for any portion of the collections on these checks. The preference claim ultimately asserted, however, seems to indicate that Myers retained all proceeds of the check that was issued under the new procedure.

Ultimately, under the newly-instituted procedure, Myers collected approximately $2.1 million, within the 90-day period before TWST filed its chapter 7 petition, for Equipment it had delivered during that period. As previously described, the chapter 7 trustee eventually sued Myers to recover the $2.1 million as a voidable preference.

As gleaned from the opinions, in addition to TWST's acknowledgement on May 1, 2014 that it had requested that, going forward, payment be made to Myers by joint check issued by the GC, the timeline relevant to the trustee's claim was as follows:

1. On May 13, 2014, the GC communicated the new joint check procedure that would be followed in issuing checks in respect of Equipment supplied by Myers.

2. During May 2014, Myers began exploring the process of making a claim on the surety bond. The bankruptcy court found, however, that Myers had not produced, on a timely basis, evidence that it actually made a claim on the bond and then released it based on the new payment procedure or the payment it received under the new procedure.

3. On May 27, 2014, apparently satisfied with the GC's representations that it would enter into a joint check agreement as indicated, Myers released approximately $1.8 million more of Equipment to the project without requiring immediate payment for this Equipment. This resulted technically in the creation of antecedent debt for the amount to which Myers was entitled for this Equipment.

4. A draft of a joint check agreement was circulated on June 11, 2014.

5. A written joint check agreement dated June 9, 2014 (the "JCA") was executed among the GC, TWST and Myers on or about June 16, 2014 (about 20 days after Myers had released the $1.8 million of Equipment). The bankruptcy court found June 16, 2014 to be the effective date of the JCA. The surety had been consulted regarding the JCA, and, according to the bankruptcy court, the surety "signed off" on the JCA.

6. On June 18, 2014, Myers released approximately another $260,000 of equipment without requiring immediate payment, resulting in the creation of an additional $260,000 of antecedent debt.

7. On July 11, 2014, the GC delivered a check for $2,107,039.86 made jointly payable to TWST and Myers, apparently, as payment for the Equipment that had been released by Myers on May 27 and June 18.

8. TWST endorsed the check and returned it to the GC, which then delivered it to Myers.

9. Myers collected the check. The opinions indicate that the proceeds were applied to pay for the Equipment released on May 27 and June 18, 2014, rather than applied to the previously accumulated unpaid invoices.

10. TWST filed its chapter 7 petition on July 23, 2014.

11. On July 21, 2016, the chapter 7 trustee sued Myers in the bankruptcy court to avoid and recover the approximately $2.1 million payment that had been made on July 11, 2014 as a voidable preference under section 547(b) of the Bankruptcy Code.

12. Though Myers did not file a proof of claim in the bankruptcy case (which would have waived its right to a jury trial), it apparently did not demand a jury trial in the preference action or assert that the bankruptcy judge lacked constitutional authority to enter final orders or final judgment on the preference claim.

13. After evidentiary hearings on February 1 and March 29, 2018, the bankruptcy court entered judgment on July 25, 2018 in favor of the trustee against Myers, avoiding the July 11, 2014 payment as a voidable preference and awarding the trustee $2,107,039.86, plus pre-judgment interest at the federal judgment rate from July 21, 2016, the date the trustee filed suit.

14. On May 24, 2019, the district court affirmed the judgment of the bankruptcy court.

<u>The Courts' Rejection of the Defenses Asserted by the Supplier</u>

<u>Creditor Status</u>

To be subject to avoidance as a preference, a transfer, among other things, must be made by a debtor to or for the benefit of a creditor. Myers argued that because its contract was with the DBE, not TWST, TWST was not indebted to it and it, therefore, was not a creditor of TWST when the challenged payment was made. (Whether that contention would be consistent with a claim on the surety payment bond TWST had posted is an open question, but it may be that a claim on the bond no longer was feasible by the time the preference action was filed.). The bankruptcy court and the district court rejected the argument of non-creditor status on the grounds that, under applicable non-bankruptcy law, even if privity of contract did not exist between TWST and Myers, Myers at least had a claim in *quantum meruit* against TWST, at the time the subject payment was made, for the value of the Equipment delivered on May 27 and June 18, 2014.

Property of the Debtor

To be potentially eligible for avoidance as a preference, a transfer must be a transfer of an interest of the debtor in property. Myers argued that TWST had no interest in the joint check or its proceeds for two reasons. First, it contended that the "flow-down" provision in the GC/TWST subcontract resulted in a trust relationship between TWST, as trustee, and Myers, as beneficiary, with respect to the joint check. Because any interest of TWST was purely as trustee, the joint check was not its property under section 541 of the Bankruptcy Code. This argument was rejected on grounds that the flow-down provision did not satisfy the requirements for creation of a trust under applicable non-bankruptcy law. Among other things, there was no requirement in the GC/TWST subcontract that any portion of remittances by the GC be segregated by TWST for the benefit of Myers (or, presumably, the DBE).

Myers second argument on the property of the debtor issue was that the JCA created a trust relationship between TWST and Meyers with respect to the joint check. The courts circumvented this argument by holding that the JCA, itself, was a voidable preference through which TWST transferred, on account of antecedent debt, its interest in future receivables from the project. According to the district court, the bankruptcy court correctly concluded that the JCA and the check issued under the JCA constituted an inseparable two-part process in which TWST agreed to transfer its interest in the check to Myers. Accordingly, the JCA itself was avoidable as a preference, having been entered into within 90-days before bankruptcy. It therefore could not serve as a basis for a trust relationship between TWST and Meyers with respect to the jointly payable check and its proceeds.

In an effort to avoid that conclusion, Myers argued that, by May 13, 2014, TWST and the GC effectively had committed to a joint check arrangement and that, in reliance on that commitment, Myers delivered Equipment of a value in excess of $1.8 million on May 27, 2014 (and $260 million more on June 18, 2014). Consequently, that commitment (to enter into a JCA) was not made on account of antecedent debt but instead as a part of a contemporaneous exchange for new value, which Myers provided when it delivered the Equipment. As the argument continued, because the JCA was simply a memorialization of a commitment on which Myers had relied in delivering valuable Equipment post-commitment to accommodate the project schedule, and because the jointly payable check was applied to pay for that Equipment, the JCA was not a transfer on account of antecedent debt that would be subject to preference avoidance. Accordingly, the JCA could serve as a basis for the creation of a trust relationship that would immunize the jointly payable check from characterization as property of the debtor for preference purposes.

This argument apparently was first made by Myers on appeal to the district court. The district court rejected it because it had not been made in the bankruptcy court and also because of the bankruptcy court's finding that the JCA did not become effective until June 16, 2014 and that actions taken before that date were merely in anticipation of the execution of a joint check agreement. Thus, the lesson for parties dealing with financially challenged counter-parties is to refrain, if practicable, from making accommodations to such counter-parties based on assurances of later payment by third-parties like the GC that do not equate to legally binding guaranties that can be enforced against creditworthy third-parties, in the event that a payment is deemed to have been made from property of a debtor and is clawed back in a subsequent bankruptcy of the debtor as a voidable preference.

The Contemporaneous Exchange Argument That Was Made in Both Courts

Under section 547(c)(1) of the Bankruptcy Code, a transfer that technically may be made on account of antecedent debt is nevertheless shielded from preference avoidance if (i) the parties intended that the transfer by the debtor be a contemporaneous exchange for new value given to the debtor, and (ii) the exchange *in fact* was a substantially contemporaneous exchange. In assessing whether section 547(c)(1) was applicable in this case, the bankruptcy court found that the parties indeed had intended that the delivery of the Equipment at issue and the payment for it be a contemporaneous exchange for new value. The bankruptcy court found further, however, that the exchange was not substantially contemporaneous, given that payment did not occur until 45 days after the May 27 Equipment delivery and 23 days after the June 18 Equipment delivery. In reaching this conclusion, the bankruptcy court rejected the argument that it should consider the date the parties entered into the JCA (June 16, 2014), rather than the date the joint check was issued (July 11, 2014), in determining whether the exchanges were substantially contemporaneous.

If the relevant exchange had been found to be the entry into the JCA in return for delivery of the Equipment, given that the JCA was entered into, at the latest, by June 16, a much stronger argument that the exchange was substantially contemporaneous would have been presented. In the case of the May 27 release of Equipment, the spread would have been only 20 days. In the case of the June 18 release of the Equipment, the JCA already had been entered into before the Equipment was released.

The district court found that it was within the bankruptcy court's discretion to adopt the July 11 payment date, rather than the June 16 JCA date, for purposes of determining whether the exchange was substantially contemporaneous. In that regard, it found that the bankruptcy court's treatment of the execution of the JCA and the delivery of the July 11 check as parts of an inseparable transaction in assessing whether the exchange was substantially contemporaneous was not clearly erroneous or contrary to law. The district court, incidentally, also observed that even if the execution date of the JCA, rather than the date the check was issued, was chosen as the proper measuring point, a determination that the 20-day gap between the May 27 Equipment delivery date and the JCA date was lengthy enough to support a finding that the exchange was not substantially contemporaneous under existing case law would not be clearly erroneous. No mention was made of the temporal relationship between the JCA date and the June 18 Equipment delivery in upholding the ruling that the entire transfer was subject to preference avoidance.

Myers also attempted to sustain the section 547(c)(1) contemporaneous exchange for new value defense by arguing that it released its bond claim against the surety contemporaneously with the transfers the trustee was seeking to avoid. Based on the evidence that was admitted on this issue, the bankruptcy court held that Myers never made a claim on the bond that could have been released and that, based on Fourth Circuit authority, the release of an inchoate right to make a bond claim could not qualify as "new value." The district court did not mention Myers' defense based on the surety bond.

Perhaps, it was not pressed on appeal. Such an argument would be difficult to sustain in any event because, to support a new value defense, the release of a claim against a third-party must result in new value flowing to the debtor, such as the release of a letter of credit issued by a debtor's bank for the benefit of a creditor that results in a release to the debtor of collateral it pledged to the bank to secure its reimbursement obligation to the bank in the event of a draw on the letter of credit. *See, e.g.,* Gulf Oil Corp. v. Fuel Oil Supply & Terminaling, Inc. (*In re* Fuel Oil Supply & Terminaling, Inc.), 837 F.2d 224 (5th Cir. 1988).

<u>Conclusion</u>

There are several takeaways from a lower tier party's perspective that can be gleaned from the *Truland* case.

First, when the decision has been made that it is imprudent to extend further credit, the lower tier party needs to make sure the arrangement going forward does not inadvertently result in a further extension of credit to the debtor. If a joint check arrangement is to be implemented, the JCA should be fully-executed and clearly in effect before additional material is supplied or work performed. From a preference exposure point of view, the lower tier party should be resistant to accommodating pleas about the delay in the schedule of the project that will ensue if further work or supply must await a fully-executed JCA.

While the *Truland* case may be subject to the interpretation that a JCA entered into during the preference period is a transfer by the debtor that is itself subject to avoidance as a preference, that interpretation only makes sense if, and to the extent that, checks to be issued in accordance with the JCA are to be in payment of indebtedness incurred by the debtor before the JCA was executed. In that sense, the debtor's entry into the JCA likely would be deemed a transfer of property of the debtor on account of antecedent debt and subject to preference avoidance. If, instead, the JCA is to apply solely to the payment for material supplied or work performed after the JCA is executed, the JCA should not be held to be a transfer of property of the debtor *on account of antecedent debt* and should not be exposed to preference avoidance, even if entered into during the preference period.

If the JCA is not exposed to preference avoidance, then jointly payable checks issued under the JCA during the preference period for material supplied or work performed after the execution of the JCA should not constitute a transfer of property of the debtor for purposes of preference exposure. This is the case, because, as a consequence of the unavoidable JCA, the debtor has no equitable interest in the proceeds of the checks intended for the lower tier party. *See* Mid-Atlantic Supply, Inc. of Virginia v. Three Rivers Aluminum Co., 790 F.2d 1121 (4th Cir. 1986). The JCA should provide that jointly payable checks will be delivered by the general contractor, in trust for the benefit of the lower tier party, to the subcontractor solely for endorsement by the subcontractor and then delivered to the lower tier party, who shall be entitled to negotiate the check and retain its proceeds.

Another takeaway is to leverage surety bonds the debtor has posted to the extent business considerations allow. As long as a bond was not issued by a surety and collateralized by a debtor during the preference period, recourse to the surety does not result in preference exposure. This is the case because payment by the surety is not a transfer of property of the debtor, even though the surety may be subrogated to the payee's rights against the debtor to the extent of the payment. Thus, if a debtor/subcontractor is experiencing significant financial difficulties and is in default on its obligations to a lower tier party that is a beneficiary of a bond, it is safer to obtain payment from the surety rather than from the debtor, from the perspective of preference exposure. It is important to understand that the fact that a surety bond existed under which a lower tier party could have obtained payment in full if it had not been paid by the debtor during the Preference Period is not a shield from a later preference attack on payments on account of antecedent debt that were made by the debtor during the Preference Period. *See, e.g., In re* Powerine Oil Co., 59 F.3d 969 (9th Cir. 1996). As alluded to above, however, an exception to that conclusion applies, if payment by the debtor results in the release by the surety to the debtor of a corresponding amount of collateral the debtor pledged to secure its obligations to the surety. It seems unlikely, however, that this exception would apply under the facts of most cases.

For the reason discussed immediately above, it is unlikely that granting a release to a surety in exchange for a payment by a debtor during the preference period would suffice, without more, to insulate the recipient from a preference attack in the debtor's subsequent bankruptcy. Under the definition of "new value" in section 547(a)(2) of the Bankruptcy Code, it appears that, to constitute new value given to the debtor for purposes of the contemporaneous exchange defense, a release of a surety in exchange for a payment by the debtor would have to result in the release to the debtor of a corresponding amount of collateral it had pledged to the surety to secure the debtor's reimbursement obligation to the surety. Whether the claw-back of a payment as a voidable preference (which might not occur until several years after the payment was made) would resurrect a claim on a payment bond that was in force when the preferentially-paid obligation arose is beyond the scope of this memorandum.

Finally, in the event a lower tier party has received substantial payments on antecedent debt during the preference period from a subcontractor that has subsequently landed in bankruptcy, unless these payments clearly would be shielded from a preference attack by an applicable defense, serious consideration should be given to refraining from filing a proof of claim for still outstanding invoices. If the outstanding invoices are covered by a surety bond, the decision not to file a proof of claim may be an easy one, if such a filing is not a prerequisite to having recourse to the surety.

Even if recourse to a surety is unavailable, however, the best course still may be not to file a proof of claim. The projected recovery to unsecured creditors in the bankruptcy case very well may be minimal. Filing a proof of claim results in a waiver of the right to a jury trial in a proceeding seeking the recovery of allegedly preferential payments and forecloses the argument that the bankruptcy judge lacks constitutional authority to finally adjudicate a preference claim seeking the recovery of money. When a proof of claim has not been filed, a timely demand for a jury trial will preserve that right. Similarly, a timely expression of no consent to final adjudication by the bankruptcy judge will preserve the argument that the bankruptcy judge lacks constitutional authority to make a final adjudication of the preference claim. Though a jury trial may be more expensive, given that jurors may be skeptical about why a party that received payment on a legitimate debt should be required to disgorge it and may be more inclined than a bankruptcy court to find that asserted defenses have merit, may justify the additional expense. In addition, bankruptcy trustees are not enamored of trying preference cases to juries and may be more inclined to accepting a settlement the defendant can stomach to avoid a jury trial.

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