Feature

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Centralized Cash-Management and Avoidance Actions: Part II

Contemporaneous-Exchange Defense and More Headaches

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As we have written, many operating companies are part of a much larger corporate structure, and in those structures cash typically flows back and forth among its parts.[1] Many companies implement a centralized cash-management system (CCMS). Increasingly, bankruptcy opinions are addressing what happens when debtors or trustees later sue creditors for payments received by one part of the corporate structure for the contract or benefit of a separate part.

Brooke Corp. was a conglomeration of hundreds of insurance agencies that wrote general property, casualty and auto coverage for individuals and businesses. It included a franchisor corporation, a credit subsidiary and numerous other entities, including a general insurance agency. After Brooke's bankruptcy, that agency, CJD & Associates LLC, was sued by Brooke's chapter 7 trustee, who alleged that the transfers back and forth between the parent and subsidiary were preferences.[2] Because CJD sold policies and received premiums from insureds and could then wait days or weeks before remitting the premium to the carriers, it became a major source of cash for the parent, Brooke Corp.[3] For several years prior to the October 2008 bankruptcy, cash was borrowed daily from CJD.[4] In the year prior to the bankruptcy, Brooke, without consulting CJD, transferred an aggregate of $423.6 million to itself, and then returned $421.8 million, a gain of $1.8 million by the parent, Brooke.[5]

Ownership of CJD had been pledged as collateral to a lender a few months prior to bankruptcy, and in the bankruptcy, ownership had been transferred from the debtor to the lender.[6] Then, this preference suit followed. Because CJD was an "affiliate" at the time of the transfer, it was an insider and subject to the one-year reachback period.[7] Because Brooke had to transfer money first from CJD and return it later, the subsequent new value defense only provided a credit for "subsequent" payments. Because money was returned later, the "subsequent" calculation benefited the trustee, even though $1.8 million had been evaporated from CJD's accounts. Nevertheless, CJD had both (1) an ordinary course of business defense under 11 U.S.C. § 547(c)(2) (as discussed in Part I of this article) and (2) a contemporaneous-exchange defense under 11 U.S.C. § 547(c)(1).

Contemporaneous-Exchange Defense

With the application of the new value defense under § 547(c)(4), $420 million of the transfers were not subject to avoidance, and the trustee focused on a final transfer of $1.99 million on Sept. 17, 2008, some 40 days prior to the bankruptcy filing. Brooke's method of cash consolidation had it transferring the same amounts back and forth in the accounts on practically a daily basis. So the $1.99 million transferred to CJD was the result of CJD transferring to the debtor $1.99 million the day before, Sept. 16, 2008. Brooke set these transfers up in just such a fashion.

As recited by the court, § 547(c)(1) protects the transfer from attack if (1) the preference defendant extended new value to the debtor; (2) both the defendant and debtor intended the new value and reciprocal transfer by the debtor to be contemporaneous; and (3) the exchange was in fact contemporaneous. The court pointed out that the purpose of this section is to encourage creditors to continue to deal with troubled debtors without fear that they will have to disgorge payments received for value given.[8]

With the one day involved in the transfer, there was no dispute that the exchange was in fact contemporaneous, and likewise, because Brooke set up the transfer in its cash-management system, there was no question that Brooke intended it to be contemporaneous. The trustee challenged whether the subsidiary, CJD, had the common required intent.[9] Looking to the subsidiary's intent, the court noted, "'Since parties rarely testify as to their intent, the courts look to the circumstances surrounding each situation' to determine if the parties had the requisite intent."[10] Dual, common intent is critical.

1 Paul D. Sinclair and Brendan L. McPherson, "Centralized Cash-Management and Avoidance Actions (Part I): Incurrence of a Debt in the Ordinary-Course Defense," XXXV *ABI Journal* 4, 18-19, 112-13, April 2016, *available at* abi.org/abi-journal.

2 *Redmond v. CJD & Assocs. LLC (In re Brooke Corp.)*, 536 B.R. 896 (Bankr. D. Kan. 2015).

3 *Id.* at 900.

4 *Id.*

5 *Id.* at 900-01.

6 *Redmond v. CJD & Assocs. LLC (In re Brooke Corp.)*, 2012 WL 3066706 (Bankr. D. Kan. 2012).

7 *Redmond v. CJD & Assocs. LLC (In re Brooke Corp.)*, 506 B.R. 560 (Bankr. D. Kan. 2014).

8 *Redmond*, 536 B.R. at 908.

9 *Id.*

10 *Id.* The court supports this with a citation to *Silverman Consulting Inc. v. Canfor Wood Prods. Marketing (In re Payless Cashways Inc.)*, 306 B.R. 243, 249 (B.A.P. 8th Cir. 2004), which in turn relies on *Village of San Jose v. McWilliams*, 284 F.3d 785, 790 (7th Cir. 2002).

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What is the intent in a CCMS? The trustee could not challenge the parent's intent because it set up the transfer to take money out and replace the next day on a simultaneous basis. But what about the subsidiary? No one consulted the subsidiary, but the testimony was that CJD was fully aware of the practice and intended that the funds should be immediately replaced.[11] The court stated, "For several years, CJD was given notice of the transfers through accounting reports that were sent daily.... Having money in the CJD account required prompt replacement of the transferred funds — the operation of the Cash-Management System in its customary manner."[12] The court found that the subsidiary acquiesced in the continuation of the transfers and intended that any funds transferred to the parent "should be replaced the next business day."[13] Thus, the defendant sustained its burden of proof under the contemporaneous-exchange-for-new-value defense.

Cash-Management Account Issues

Preference Claims

Because it has become a common practice for companies to set up cash-management systems, if they later file bankruptcy, does this set up multiple sources of litigation for the debtor/trustee? Taking it from the creditors' perspective, there are a number of issues.

First, in the circumstance of alleged preference payments, a trustee will bring suit alleging that, during the 90 days prior to bankruptcy, the debtor paid funds from its cash-management system, to a creditor, based on an antecedent debt. The defense of such a claim would first look to the new value defense under § 547(c)(4). However, this only works if the new value is subsequent to the payment to the creditor, and if the new value is to the debtor — allegedly not to an unaffiliated subsidiary.

Second, possibly there is a contemporaneous exchange defense, as in CJD above, but only if there was the intent for an exchange, as well as the other two elements (such as a substantially contemporaneous exchange). Again, the consideration has to flow to the debtor. So for example, in *Redmond v. GMAC Insurance Management Corp. (In re Brooke Corp.)*,[14] the court rejected the § 547(c)(1) defense. In *GMACI*, Brooke used its cash-management account to make payments to GMAC for insurance policies issued to policyholders who received policies from Brooke's agents. However, the new value delivered by the creditor, GMACI, the insurance policies, was a benefit that went to the policyholders, and not in the court's view, to Brooke. Thus, the new value did not go to the "debtor."

Third, in both *Brooke* cases, GMACI and CJD, the regularity of years of practice and payments provided both of the defendants with a successful ordinary course defense under § 547(c)(2).

11 *Redmond*, 536 B.R. at 911.
12 *Id.*
13 *Id.*
14 539 B.R. 605 (Bankr. D. Kan. 2015) ("*GMACI*").

Fraudulent Transfer Claims

What happens with a cash-management account for payments received between 91 days and the two-year lookback period under 11 U.S.C. § 548 or a longer reachback period allowed by state law, such as a four-year period? If the debtor can be shown to have been insolvent during this period, can the trustee reach back to recapture funds that were paid through the cash-management account on the allegation that there was no antecedent debt paid? For example, the trustee might bring suit alleging that funds were paid by the parent or subsidiary X, when the money was owed by subsidiary Y, with which the creditor did business and sent its invoices. The trustee will contend that the payer of the check had no obligation for the product or services invoiced.

Solvency is a difficult and expensive defense, but one defense that is available is the good-faith defense under § 548(c). This good-faith defense was recently successful in a defense verdict to an $88 million claim in the *Allen Stanford* case.[15]

In constructive fraudulent transfer cases under § 548(a)(1)(B), the trustee or debtor must prove that the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation." Defendants have raised the issue of "indirect value" in several cases.

In *LandAmerica Financial Group Inc. v. Southern California Edison Co.*,[16] the debtor, LandAmerica Financial Group (LFG), operated and administered a CCMS in which it consolidated all of the funds of its subsidiaries that were in the title business and then paid all of the subsidiaries' bills, including the electrical/utility bills for its operations in California. Because the parent corporation was not on the account, it was paying its subsidiaries' obligations. However, the court noted that the parent received more than $41 million more in revenues generated by the subsidiaries than it paid out in expenses during the relevant time period.

After analyzing the lengthy history of the indirect-benefit rule, the *LandAmerica* court concluded that because LFG drew all of the money out of its subsidiaries, it had a "continuing obligation" to pay its subsidiaries' vendors through the CCMS, "in exchange for the continuing benefit of those subsidiaries up streaming their revenues to LFG."[17] The question was whether the net effect of the transaction was to deplete the bankruptcy estate. Since LFG drained its subsidiaries to a profit of $41 million, the indirect benefit was positive in the four months leading up to the bankruptcy filing, and there was no fraudulent transfer.[18] While the parties agreed that there was no direct contract (written or oral) that obligated LFG to pay for charges incurred by the subsidiaries, the court found that the bankruptcy court properly found an implied contract based on the conduct of the parties.[19]

15 *Janvey v. GMAC LLC, et al.*, Case No. 4:15-cv-00401 (U.S.D.C. N.D. Tex. Jan. 18, 2017).
16 525 B.R. 308 (E.D. Va. 2015) (Spencer, D.J. affirming Heunnekens, B.J.).
17 *Id.* at 316.
18 *Id.*
19 *Id.* at 317.

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Likewise, in both *Butler Aviation Int. Inc. v. Whyte*[20] and *In re PSN USA Inc.*,[21] the defendants were successful in raising indirect value as a defense.

Not only do common cash-management accounts present a huge issue and risk for creditors receiving payments, but they are possibly an even worse problem for lenders whose collateral is the diminishing assets of an affiliated company. Let's say the lender takes as collateral for loans the assets of a subsidiary, including all of its cash. However, as the cash is transferred to the parent corporation, the collateral can become worthless or, minimally, seriously impaired. Do lenders need to restrict such cash collateral accounts for its borrowers? While a parent corporation guarantee might somewhat help in this situation, what if the cash is concentrated at a different subsidiary level rather than at the parent corporation account level? There are limitless hypotheticals that can cause issues for both lenders and creditors dealing with companies employing centralized cash-management systems. But this has become too common a practice not to address in credit documents. abi

20 *In re Fairchild Aircraft Corp.*, 6 F.3d 119 (5th Cir. 1993).
21 615 Fed. App'x. 925 (11th Cir. 2015).

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