

AVOIDANCE CLAIMS ARISING OUT OF THE USE OF CONSOLIDATED CASH MANAGEMENT SYSTEMS

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In today's global economy, the financial affairs of large multiple-entity businesses are extremely complex and require the collection, disbursement and movement of funds through numerous bank accounts on a world-wide basis. Often, the parent corporation will require all its subsidiaries and affiliates – both within the United States and in Canada, Mexico and abroad – to participate in a consolidated cash management system in which all of the funds generated by the operations of the subsidiaries and affiliates are swept into one master bank account owned, operated, and controlled by the parent corporation. From that master bank account, the parent corporation pays all of the obligations of the subsidiaries and affiliates, even though the parent corporation is not directly liable for, or guaranteed the payment of, such obligations. Furthermore, as part of this consolidated cash management system, the parent corporation usually maintains various inter-company accounts to track receivables collected from each subsidiary and affiliate and payments made on their behalf and inter-company obligations are created in favor of the parent corporation, which obligations are subsequently repaid, often with interest.

Due to the use of consolidated cash management systems, it is not uncommon for a creditor who has a relationship with a subsidiary – possibly in Canada or Mexico – to receive

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payment for goods sold to the foreign subsidiary from the parent corporation based in the United States. The use of these cash management systems in the ordinary course of these large multiple-entity businesses may, however, give rise to avoidance litigation when the parent corporation files a bankruptcy petition. Typically, a trustee² will seek to recover all payments made from the master bank account maintained by the parent corporation, using a form complaint asserting preference and fraudulent transfer causes of action under sections 547 and 548 of the Bankruptcy Code.³ When faced with such a complaint, a creditor has several defenses.

I. PREFERENCE COUNT

Section 547(b) of the Bankruptcy Code generally enables a trustee to avoid transfers made to a creditor on account of an antecedent debt owed by the debtor before such transfer was made within ninety days before the filing of the petition that enables the creditor to receive more than it would have received in a Chapter 7 liquidation. 11 U.S.C. §547(b). A “debtor” is defined in section 101(13) of the Bankruptcy Code as an entity that filed for protection under the Bankruptcy Code.

If an avoidance action seeks the recovery of payments made by the debtor parent from the master bank account, the creditor must determine what invoices were paid by each such payment. If the payment was made on account of a debt owed by one of the subsidiaries or affiliates, the creditor must then determine if the subsidiary or affiliate is a debtor and/or if the parent has guaranteed the debt. The end result of such an investigation may be that the transfer cannot be avoided under section 547(b) because the transfer was made on account of an

² References to a trustee should be read to include a debtor, a debtor-in-possession, and any other party (such as a plan administrator) who may be authorized to bring avoidance actions on behalf of the debtor’s estate.

³ References to the Bankruptcy Code mean title 11 of the United States Code, §101, *et seq.*

antecedent debt owed by a debtor. The raising of this defense, however, opens the door for a fraudulent transfer claim, the recovery period for which is substantially longer than the ninety-day preference period and the defense of which may be time-consuming and expensive. Accordingly, a creditor should evaluate the extent and validity of its defenses to the alleged claim to determine if this “non-debtor” defense should even be raised.

II. FRAUDULENT TRANSFER COUNT

Section 548(a) generally enables a trustee to avoid any transfer of property of a debtor that was made within two years⁴ before the filing of the petition, if the debtor “received less than a reasonably equivalent value in exchange for such transfer” and the debtor was, among other things, insolvent on the date that such transfer was made.⁵ 11 U.S.C. §548(a). “Value” includes the “satisfaction or securing of a present or antecedent debt of the debtor.” 11 U.S.C. §548(d)(2)(A).

If an avoidance action seeks the recovery of payments made by the debtor parent from the master bank account on account of a non-debtor subsidiary or affiliate, and the debtor parent did not guarantee the debt, an argument can be made that the parent debtor did not receive “reasonably equivalent value” for the transfer of funds from its master bank account. The trustee bears the burden of establishing each of the elements of a fraudulent transfer claim including that a transfer was not made for reasonably equivalent value. See Collier on Bankruptcy § 548.10 (1985). However, in the context of a third-party transaction (when a parent debtor pays the obligations of an affiliate), several courts have held that, once the trustee establishes that

⁴ The expansion of the avoidance period in section 548 from one year to two years applies to cases filed after October 17, 2006, one year after the effective date of the Bankruptcy Abuse Prevention, Consumer Protection Act.

⁵ The date on which the reasonably equivalent value requirement must be met is the transfer date, not a subsequent date (such as the date on which the transfer is being challenged). See, e.g., In re Comakos, 69 F. 3d 769, 770-71 (6th Cir. 1995).

“consideration for the transfer passed to the third party, the burden of demonstrating and quantifying reasonably equivalent value for transfer shifts to the defendant.” Id.

There are three potential defenses to this type of fraudulent transfer claim. The first is based on estoppel; the second is that the debtor did not transfer an interest in its property; and the third is that the debtor received reasonably equivalent value for the transfer.

A. Estoppel

In the Chapter 11 cases of the large multiple-entity businesses that employ consolidated cash management systems, the debtors routinely seek approval to continue to use their cash management system during the course of their Chapter 11 cases as part of their first-day motions. Typically, the parent debtor explains how its consolidated cash management system operates and touts its system as not only the most efficient way for it to operate its businesses but affirmatively avers – usually in the first-day affidavit – that any disruption to its system would impair the debtors’ ability to operate and affect its going concern value. Some examples of the benefits of these consolidated cash management systems that have been touted by debtors include:

ENRON CORPORATION, ET AL.

Jointly Administered Case No. 01-16034(AJG), Southern District of New York

The [Enron] Debtors’ cash management system is one in which [the Enron affiliates’] cash was taken into the cash management system and the applicable [affiliates’] obligations were paid out of the cash management system. [This system] provides an efficient and secure means of managing and disbursing cash for the Enron companies’ operations on a daily basis. Closing these accounts and opening new ones could unnecessarily impair the Debtors’ business operations and disrupt the Debtors’ cash management system, and, therefore, hinder the operation of the Debtors’ businesses during the critical initial stages of their Chapter 11 cases.

The Debtors’ centralized cash management system is beneficial to the Debtors, their estates and creditors because it enables the Debtors to reduce the administrative expenses involved in moving funds, to maintain more accurate

information regarding receipts, account balances and disbursements, to maintain a more efficient process for the investment of disbursement control procedures.

COLLINS & AIKMAN CORPORATION, ET AL.
Jointly Administered Case No. 05-55927(SWR), Eastern District of Michigan

The crux of the cash management system is the existence of several concentration accounts maintained in the United States, Canada and Europe and a master concentration account maintained by Collins & Aikman (“C&A”) in the United States. Funds are first swept into the local concentration accounts and then swept into the master concentration account. C&A then pays all of its subsidiaries’ accounts payable from the master concentration account. C&A also maintains a master accounts payable disbursement account and various inter-company accounts to reflect the receipts from and disbursements on behalf of its subsidiaries. For example, any funds received by C&A Canada are ultimately swept into the master concentration account, C&A pays its Canadian subsidiary’s accounts payable, and C&A keeps records of the monies received and disbursed. As a result of its cash management system, C&A and its affiliates maintain business relationships with each other and other non-Debtors and, consequently, there are numerous inter-company claims reflecting receivables and payments made in the ordinary course of the Debtors’ businesses. Moreover, Debtors and non-Debtors make loans to each other to fund operations and make acquisitions.

It is critical that [the Debtors] continue to be able to consolidate their cash management and centrally coordinate fund transfers to efficiently and effectively operate their large, complex business operations. Substantially disrupting these cash management procedures would (a) severely impair the Debtors’ ability to preserve and enhance their respective going concern values and successfully reorganize during the Chapter 11 cases and (b) cripple the Debtors’ non-debtor foreign affiliates, perhaps forcing them to shut down, a result that would be disastrous for the Debtors’ customers and, as a result, severely impact the Debtors’ reorganization efforts.

PLASSEIN INTERNATIONAL CORP., ET AL.
Jointly Administered Case No. 03-11489, District of Delaware

The Plassein Debtors’ cash management system involved multiple accounts with multiple financial institutions throughout the United States. Plassein and its affiliates ultimately had all of the funds in these various accounts transferred to one “master account.” From that account all of the parent and affiliate obligations were paid and inter-company “transactions” were recorded to track the obligations that were paid.

The delays, disruption and confusion that might result from requiring Debtors to substitute new bank accounts ... could strain the Debtors’ relationships with various critical parties in interest, including vendors and employees.

When faced with a fraudulent transfer claim that arises out of a court-approved consolidated cash management system, an estoppel defense – judicial or equitable estoppel – should be asserted. In essence, the creditor should argue that the debtor cannot have it both ways, its cash management system cannot be the most efficient and appropriate way for it to do business if it also results in fraudulent transfers.

We are not aware of any reported decision on this point. However, in Enron v. Anderson Water Systems, Inc., Adv. Pro. No. 03-93117 (AJG), in the Southern District of New York, Enron sought recovery of \$477,344 in payments made by Enron on behalf of National Energy Production Company (“NEPCO”), a non-debtor subsidiary, asserting that such payments could be avoided as fraudulent transfers under section 548 of the Bankruptcy Code. Anderson Water Systems filed a motion for summary judgment arguing that the complaint should be dismissed on judicial estoppel grounds.⁶ The court denied the motion without issuing an opinion and the matter settled for \$40,000 within a few months.

B. Not property of the debtor

An argument can be made that the debtor parent’s interest in the funds that were swept from the non-debtor’s account and then were subsequently used by the debtor to pay the non-debtor’s creditors is not property of the debtor. This argument has some appeal, especially when the non-debtor was solvent at the time of the payment. However, it would be extremely difficult and expensive to trace the non-debtor’s funds because, generally, the funds swept into the master bank account from the non-debtor are commingled with funds of the debtors. Also, the broad

⁶ The purpose of judicial estoppel is to protect the integrity of the judicial process. New Hampshire v. Maine, 532 U.S. 742 (2001). Judicial estoppel “generally prevents a party from prevailing in one phase of a case on an argument and then relying on a contradictory argument to prevail in another phase.” Id. at 749. In the Second Circuit, the party seeking to use the doctrine of judicial estoppel must show that the party against whom estoppel is sought took an inconsistent position in a prior proceeding and that the court adopted that position in some manner. Bridgeway Corp. v. Citibank, 201 F.3d 134 (2nd Cir. 2000).

definition of property of the debtor's estate contained in section 541 of the Bankruptcy Code may defeat this type of argument.

C. Reasonably Equivalent Value

“Value” for purposes of section 548 can be either a direct economic benefit or an indirect economic benefit.⁷ An example of a direct economic benefit is the inter-company obligations created in favor of the parent corporation, which obligations may have been subsequently repaid. Examples of indirect economic benefits are: (a) the ability of the debtors to consolidate and centrally coordinate their funds to efficiently and effectively operate their large complete business operations; (b) the preservation of the net worth of the debtors' global business operations; or (c) the preservation of the debtors' going concern value.⁸

Unfortunately, the burden of demonstrating and quantifying reasonably equivalent value for transfer – which burden will be shifted to the creditor – will probably require the use of an expert and, thus, may be extremely time-consuming and expensive.

III. SUMMARY

When faced with an avoidance action filed by or on behalf of large multiple-entity debtors, it is important to investigate exactly what debts were paid by each transfer in order to be able to fully evaluate whether, in fact, the transfer was made on account of an antecedent debt

⁷ See, e.g., In re Wilkinson, Jr., 2006 WL 2380887 (C.A. 6 (Ky.)) (an indirect economic benefit is sufficient to satisfy the reasonably equivalent requirement); In re Northern Merchandise, Inc., 371 F.3d 1056, 1058 (9th Cir. 2004) (It is well settled that “reasonably equivalent value can come from one other than the recipient of the payments, a rule which has become known as the indirect benefit rule.”); Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 991-92 (2nd Cir. 1981) (“transactions benefit to the debtor need not be direct; it may come indirectly through benefit to a third person ... if the giving of consideration to the third person otherwise confers an economic benefit upon the debtor, the debtor's net worth has been preserved”).

⁸ See, e.g., Mellon Bank, N.S. v. Metro Communications, Inc. 945 F.2d 635, 647 (3rd Cir. 1991) (“The touchstone is whether the transaction conferred realizable commercial value on the debtor reasonably equivalent to the realizable commercial value of the assets transferred. Thus, when the debtor is a going concern and its realizable going concern value after the transaction is equal to or exceeds its going concern value before the transaction, reasonably equivalent value has been received.”); In re Jeffrey Bigelow Design Group, Inc., 956 F.2d 479, 484 (4th Cir. 1992) (“As long as the unsecured creditors are not worse off because the debtor, and consequently the estate, has received an amount reasonably equivalent to what it paid, no fraudulent transfer has occurred.”)

owed by a debtor. Assuming that the debt was not owed by a debtor, the decision to raise this issue must be carefully analyzed because raising this defense probably will open the door for a fraudulent transfer claim, which not only increases the potential recovery period but, more importantly, the defense of such a claim may be time-consuming and expensive.