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The Cash Management System Preference Defense

By Daniel F. X. Geoghan

Business owners loathe client bankruptcies. They are forced to write off or take haircuts on unpaid invoices. They lose future income if the bankrupt client liquidates or rejects the contract. Finally, adding insult to injury, the business may get sued for a preference.

What is the business owner to do? The only viable option is to hire a lawyer and start the time consuming and costly process of defending the preference. This means the business owner has to divert resources from regular operations to collect old invoices, review legacy bank records and try to calculate which payments made by the bankrupt client were paid in the ordinary course of business and how much is shielded by subsequent new value—the most prevalent of the preference defenses. [1]

[1] 11 U.S.C. §547(c)(2) and (c)(4).

However, a knowledgeable bankruptcy lawyer can steer the business owner / preference action defendant toward a little-known defense—one that is not listed in Section 547(c) of the Bankruptcy Code because it is factual rather than codified. If used, it will often allow a defendant to negotiate a far more favorable resolution to the preference. Sometimes, it provides an absolute defense to the preference and enables the defendant to simply walk away from the action without paying any money back to the estate. I'm talking about the cash management defense.

What Is a Cash Management System?

Almost every multi-entity company employs a centralized cash management system. A cash management system is a series of linked bank accounts that facilitate a company's management of cash flow. In a typical cash management system, client payments are made into the business owner's lock box or deposit collection accounts. The business owner's lock box / deposit collection accounts are linked to accounts belonging to other divisions or subsidiaries of the business. This system allows the parent company to efficiently track income at the operating subsidiary level. The payments received are swept daily from the lock box / deposit collection accounts into a single concentration account from which obligations of the business can be funded. Excess funds in the concentration account can be invested in the overnight markets.

When the business pays a vendor invoice, the funds flow through a zero balance disbursement account. That account is usually linked to a designated subsidiary or division. This structure allows the parent corporation to effectively track its cost centers.

In most cash management systems, all of the linked bank accounts are owned and controlled by a single entity for administrative convenience. That single entity can, by reviewing the cash management system statements, quickly and accurately ascertain its overall cash position at any given time. The cash management system also allows the controlling entity to track in fine detail the revenue and expenses for each business, division or entity.

What Is a Preference?

In drafting the Bankruptcy Code, the United States Congress recognized that during a debtor's slide into bankruptcy, the debtor would show certain creditors preferential treatment over other creditors and would pay those preferred creditors to the detriment of the other creditors. Such preferential payments defeat one of the core tenats of the Bankruptcy Code—equality of distribution among similarly situated creditors. Therefore, the Bankruptcy Code protects the non-preferred creditors by

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enabling the bankruptcy estate to reclaim funds paid to the preferred creditors. This ensures that the funds transferred by the debtor during the days, weeks and months preceding a bankruptcy filing are returned to the estate and evenly distributed among the debtor's creditors.

Congress codified this protection in Section 547 of the Bankruptcy Code, "Preferences." A preference is: (i) a transfer of an interest of the debtor in property; (ii) to pay a debt owed by the debtor to a creditor (i.e., an antecedent debt); (iii) made during the 90 days before the debtor filed for bankruptcy; (iv) made while the debtor was insolvent; and (v) which allowed the creditor to receive more than it would have received had the debtor not paid the creditor and the creditor instead filed a claim against the debtor in the bankruptcy case. [2] The debtor has the burden of proving that the transfer was a preference.

[2] 11 U.S.C. §547.

At the outset of any preference litigation, the advantage is almost always with the debtor. The debtor can generally prove its case by simply producing an invoice or bill of lading from the defendant for goods or services provided and a corresponding payment made during the 90-day period. This payment is easily proved with a bank statement or a copy of a check.

If the debtor successfully proves the preferential transfer, the defendant must defend itself. Defendants most often do this using statutory defenses found under Section 547(c)(1)-(9). [3] In contrast to the simple showing made by a debtor to prove that the preferential transfer occurred, the defendant must show the history of transactions between the parties, usually with the supporting documentation which can number in the thousands of pages. Defendants must generate charts and analyses of how their financial relationship with the debtor fits into the codified defenses. The cost of defending the preference through the pre-discovery phase, without full-scale litigation, will often run into the tens of thousands of dollars making a defendant eager to settle at a loss just to get out from under the costly and time consuming litigation.

[3] See 11 U.S.C. §547(c)(1)-(9).

The Cash Management Defense

The cash management defense is an assertion by the defendant that the debtor has failed to prove the transfer was a preference because (i) the transfer was not a transfer of the debtor's interest in property; or (ii) the transfer was not the payment of an antecedent debt owed by the debtor that made the transfer. In colloquial terms, it puts the debtor to its proofs before the defendant has to expend money, time and resources to prove its defenses.

By way of example, ABC Holding Corporation ("ABC Holding") and its subsidiaries and affiliates file petitions in bankruptcy. After a year in bankruptcy ABC Subsidiary Corporation ("ABC Subsidiary") files a preference complaint against a vendor that provided services to ABC Subsidiary and received transfers during the ninety days preceding the bankruptcy filing. After brief research, the defendant discovers that prepetition the debtors utilized a centralized cash management system and that the bank accounts were owned and operated by ABC Money Corporation ("ABC Money").

The defendant contacts ABC Subsidiary and asserts that the alleged preferential transfers were made by ABC Money.

Now the burden is on ABC Subsidiary to prove that the transfer was a transfer of property in which ABC Subsidiary held an interest or that the antecedent debt was the obligation of ABC Money. This is a huge obstacle because assuming ABC Money doesn't engage in the same operations as ABC Subsidiary (which is likely because otherwise there would be no reason for the separate corporate entities to exist), there is almost no possible way the goods and services for which payment was rendered could have been received by ABC Money.

What Is an Interest in Property?

In *In re Enron Corp., et al.*, Enron Corp., and many of its subsidiaries and affiliates, filed petitions in bankruptcy on December 2, 2001 ("Enron's Petition Date"). [4] Prior to Enron's Petition Date, the defendant, Rexel Southern Electrical Supply, had performed services for an Enron Corp. ("Enron") subsidiary named NEPCO Power Procurement Company ("NEPCO"). In exchange for the services, during the ninety days preceding Enron's Petition Date, the defendant received a check that had the NEPCO name on it and the Enron crooked "E" logo. NEPCO didn't file for bankruptcy until May 2002, six months after Enron Corp. [5]

[4] Minutes of Proceeding, *Enron Corp, et al., v. Rexel Southern Electrical Supply (In re Enron Corp., et al.,)*, Adv. Proc. No. 03-93246-AJG (Bankr. S.D.N.Y. June 6, 2006), ECF No. 21, at pg. 1.

[5] Id. at 2-3.

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Enron and NEPCO commenced litigation against the defendant seeking to avoid and recover the transfers as either preferences or constructive fraudulent conveyances. [6] The defendant filed a motion to dismiss the preference cause of action and to dismiss Enron, entirely from the case. The defendant argued that it had never done business with Enron, and the payment at issue was made almost eight months prior to NEPCO's bankruptcy filing, outside NEPCO's ninety day preference period.

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[6] Id.

Enron responded that it owned and controlled the bank account on which the check had been drawn. [7] The Court dismissed the NEPCO's preference and constructive fraudulent transfer claims because NEPCO had never made a transfer to the defendant; it had no ownership or control over the bank account. In addition, the court dismissed Enron's preference claims because the transfers were not made on account of antecedent debts owed by Enron; the debt was owed by NEPCO. [8]

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[7] Id. at 3.

[8] Id. at 11-12.

In ruling on the motion to dismiss, the Court first had to determine what the phrase “an interest of the Debtor in property” meant. The Bankruptcy Code does not define property of the debtor. However, because preference actions are designed to recover property that otherwise would have been property of the estate, property of the debtor “is best understood as that property that would have been part of the estate had it not been transferred before the commencement of the bankruptcy proceedings.” [9] Therefore, courts turn to Bankruptcy Code Section 541, which defines property of the estate, to determine what would have been property of the debtor prior to the petition date. [10]

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[9] *Beiger v. I.R.S.,* 496 U.S. 53 (1990).

[10] Id. at 58-59.

“Courts have generally held that for certain funds held in a bank or checking account to be considered property of the estate the debtor must have control over those funds.” [11] While control is not defined in the Bankruptcy Code, a controlling interest in a bank account has been found where one party holds “all indicia of ownership, and unfettered discretion to pay creditors of its own choosing, including its own creditors.” [12]

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[11] *Enron Corp, et al., v. Rexel Southern Electrical Supply*, Adv. Proc. No. 03-93246-AJG (Bankr. S.D.N.Y. June 6, 2006) at pg. 7 (citing *In re Southmark Corp.*, 49 F.3d 1111,1116-17 (5th Cir. 1995)(holding that an affiliate entity had an equitable interest in the funds transferred even though Southmark Corp. held legal title to the bank account)).

[12] *In re Southmark Corp.*, 49 F.3d at 1116.

When the account is part of a centralized cash management system, the party that holds the indicia (signs) of control is the holder of the interest in the account. [13] Ownership of the subsidiary by a parent or control of the subsidiary through corporate governance does not constitute control of the subsidiary's bank accounts. [14]

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[13] *In re Regency Holdings (Cayman), Inc.*, 216 B.R. 371, 377 (Bankr. S.D.N.Y. 1998).

[14] Id. at 376.

Did any of the ABC entities make a preferential transfer to the Defendant?

The answer in our example is we don't know. Superficially, ABC Money owns the account and absent evidence to the contrary, it is presumed to have unfettered discretion to pay any creditor it desires to pay. Those facts are strong inidicia that ABC Subsidiary did not make the transfer and therefore, the payment cannot be a preferential transfer by ABC Subsidiary. In addition, because the defendant was doing business with ABC Subsidiary, not ABC Money, it can't be a preference by ABC Money because ABC Money is not the entity that owed the debt to the defendant.

However, the analysis about how to answer the question is not the point of the defense. The strength of the defense is compelling the debtor to expend the time and money to prove that it owned and controlled the account from which the transfer was made. Failing this, the debtor must walk away from the preference action or negotiate to settlement from a greatly weakened position relative to the defendant. Either result is a win for the defendant.

Conclusion

Any company that has been sued for a preference knows that the deck is stacked against it. The debtor estate easily meets

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its burden of proof with an invoice or bill of lading and a bank statement. It gets maximum results from expending the barest minimum of resources. The cash management defense puts the defendant in stronger position to negotiate a settlement than it would have using codified defenses alone. It forces the debtor to spend time, energy and money proving that it received the goods or services for which the payment was made while also owning and controlling the account from which the payment originated. Except in those rare cases where the debtor and the account holder are actually the same entity, building a convincing case for ownership and control of a bank account takes time and resources not readily or cheaply available to the debtor. Diverting precious resources away from operations and reorganization efforts and toward pursuit of a vigorously defended preference action is not an attractive option to debtors. Often, the debtor is happy to abandon its claim against the knowledgeable defendant with a cash management system defense and would rather pursue a less expensive claim against a less sophisticated adversary.

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