



Joint Check Agreement Does Not Cut the Mustard to Avoid Preference Liability

Suppliers of goods and/or services on construction projects frequently use joint check agreements when doing business with financially troubled counterparties to increase the likelihood of payment. Under a joint check agreement, (1) when a general contractor purchases goods and/or services, the project owner usually agrees to make payment jointly to the general contractor and the supplier or subcontractor to assure payment; and (2) where the subcontractor purchases goods and/or services, the project owner and/or general contractor agrees to make payment jointly to the subcontractor and the supplier.

As part of a joint check agreement, the owner, general contractor or subcontractor agrees to endorse checks and deliver them to the subcontractor or supplier in payment of the latter's outstanding invoices. Unfortunately, problems may arise for the recipient of a joint check when the contractor or subcontractor that endorsed and delivered the joint check files bankruptcy within 90 days, leading to potential preference risk.

The U.S. District Court for the Eastern District of Pennsylvania, in the *VCW Enterprises Inc.* bankruptcy case, addressed the risk of the assertion of preference and

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other avoidance type claims arising from payments under a joint check agreement. A general contractor, a subcontractor (that failed to timely pay certain invoices owing to its supplier) and a supplier entered into a joint check agreement within 90 days of the subcontractor's bankruptcy filing to pay the supplier's past due invoices. The general contractor made a payment by joint check to the subcontractor and supplier during the preference period shortly before the subcontractor's bankruptcy filing and then made two payments by joint check after the subcontractor's bankruptcy filing.



The District Court held that the joint check paid prepetition was recoverable as a preference under Section 547(b) of the Bankruptcy Code, notwithstanding the fact that the supplier might have recovered full payment of its claim from non-debtor sources, such as from a surety on a construction bond and/or from a non-debtor owner of real property on which the supplier has a mechanic's lien. The District Court also rejected the supplier's argument that the joint check payment was not a preference because it was subject to the ordinary course of business defense arising under Section 547(c)(2) of the Bankruptcy Code. The court found that the joint check payment was instigated by the supplier's aggressive collection efforts to protect itself from the debtor's deteriorating financial condition.¹

This decision is, therefore, a cautionary tale for goods sellers, service providers and subcontractors on a construction project seeking to prevent loss while insulating them from preference liability. Bottom line, the supplier here might have been better off collecting on the construction bond or enforcing its mechanic's lien rights instead of trying to recover via a joint check agreement. Read on to see why!

The Preference Statute

A trustee can recover a preference by satisfying all of the requirements of Section 547(b) of the Bankruptcy Code. One of Section 547(b)'s requirements, contained in Section 547(b)(5), is that the payment or other transfer enabled the creditor to receive more than it would have recovered in a hypothetical Chapter 7 liquidation involving the debtor, otherwise known as the "greater than liquidation recovery requirement." A trustee

satisfies this requirement, which was at issue in the *VCW Enterprises* case, unless the creditor is fully secured by the debtor's assets or the debtor's unsecured creditors receive full payment of their claims.

After a debtor or trustee satisfies all of Section 547(b)'s requirements, the defending creditor can seek to reduce or eliminate preference exposure by satisfying one or more of the preference defenses contained in Bankruptcy Code Section 547(c). A creditor's preference defenses include the ordinary course of business defense set forth in Section 547(c)(2). Section 547(c)(2) requires a creditor to prove that the alleged preference paid indebtedness incurred in the ordinary course of business or financial affairs of the debtor and the creditor; and either the payment (1) was made in the ordinary course of business or financial affairs of the debtor and the creditor, or (2) was made according to ordinary business terms. The first requirement of the ordinary course of business defense, that the debt was incurred in the ordinary course of business of the debtor and creditor, is rather straightforward and can be proved by the creditor's extension of trade credit to the debtor. The second requirement, that the payment was made in the ordinary course of business of the debtor and creditor, is subjective in nature. It requires the creditor to show some consistency between the alleged preference payment and the debtor's and creditor's payment history and other aspects of their prior relationship.

A creditor that cannot satisfy the subjective requirement of the ordinary course of business defense can still escape preference liability by proving that the alleged preference was paid according to ordinary business terms. This part of the ordinary course of business defense is objective in nature. It requires proof that the alleged preference payment was consistent with the payment practices and range of terms in the creditor's industry, the debtor's industry, or some subset of either or both.

The issues for the District Court to decide on appeal in *VCW Enterprises* were (1) whether the general contractor's payment of the pre-petition joint check in the amount of \$6,827.58 to United enabled United to receive more than it would have recovered in a hypothetical Chapter 7 liquidation of VCW Enterprises in light of United's potential full recovery from a construction bond or United's assertion of mechanic's lien rights on real property owned by a non-debtor; and (2) whether the joint check payment was subject to the ordinary course of business defense because it was consistent with the ordinary course of business of VCW and United and/or was made according to ordinary business terms.

Background

This case arose out of a Chester County (PA) Solid Waste Authority (CCSWA) construction project to expand a local landfill. CCSWA bonded the project to provide additional assurance of payment to contractors on the project. Kinsley Construction, Inc. (Kinsley) was hired as the general contractor. Kinsley hired the debtor/plaintiff, VCW Enterprises, Inc.

(VCW), a manufacturer and supplier of precast concrete structures, pipes, and related products, as a subcontractor. VCW then purchased concrete pipe from United Concrete Products Inc. (United). VCW and United had no prior business dealings other than the project.

As of Oct. 31, 2012, VCW was past due on its obligation to pay invoices totaling \$95,409.70 owed to United. United pushed Kinsley and VCW to enter into a joint check agreement to ensure full payment of United's already past-due invoices owed by VCW. On that date, United threatened to repossess goods it had previously delivered to VCW (which VCW had not yet delivered to Kinsley) if Kinsley, VCW and United did not execute a joint check agreement. United also made a claim on the CCSWA construction bond for the unpaid balances owing by VCW.

Section 547(c)(2) requires a creditor to prove that the alleged preference paid indebtedness incurred in the ordinary course of business or financial affairs of the debtor and the creditor; or was made according to ordinary business terms.

At the beginning of November 2012, Kinsley, VCW and United entered into a joint check agreement. The joint check agreement allowed VCW to submit to Kinsley the past due invoices that VCW owed United. Kinsley paid these invoices by joint checks in the aggregate amount of \$95,409.70 payable to United and VCW. Although the joint check agreement provided that Kinsley's checks would be made payable to both VCW and United, the agreement stipulated that VCW would hold the checks "in trust" for the benefit of United. The joint check agreement also stated that, in the event of VCW's death, dissolution, liquidation, insolvency, business failure, default, or bankruptcy filing, Kinsley could, in its sole discretion, pay directly to United all unpaid invoices owing by VCW to United related to the project.

United received the first joint check in the amount of \$6,827.58 on Nov. 26, 2012, less than two weeks before VCW filed bankruptcy. Following VCW's bankruptcy filing, United received two additional joint checks, one in the amount of \$63,996.49 on Dec. 12, 2012, and another joint check in the amount of \$24,585.63 on Dec. 31, 2012.

On Dec. 6, 2012 (the "petition date"), VCW filed its Chapter 11 petition in the U.S. Bankruptcy Court for the Eastern District of Pennsylvania. VCW's general unsecured creditors were not expected to receive any meaningful recovery on their claims, and clearly not the 100% distribution United had received as a result of the joint check agreement, because VCW owed its primary secured lender, M&T Bank, substantially more than the value of M&T Bank's collateral, which consisted of substantially all of VCW's assets.

On April 24, 2013, VCW commenced a lawsuit against United. VCW sought recovery from United of the pre-petition joint check payment in the amount of \$6,827.58 as a preference pursuant to Bankruptcy Code Section 547(b). VCW also sought recovery from United of the remaining two joint check payments in the amounts of \$63,996.49 and \$24,585.63 as unauthorized post-petition transfers pursuant to Bankruptcy Code Section 549. A trial was held on May 19, 2014. On June 23, 2014, the Bankruptcy Court entered judgment in favor of VCW and against United avoiding and recovering the pre-petition joint check payment in the amount of \$6,827.58 as a preference and further avoiding and recovering the second and third joint check payments totaling \$88,582.12 as unauthorized post-petition transfers.

The court held that United recovered more from the debtor's estate as a result of the pre-petition joint check pursuant to the joint check agreement than United would have recovered as an unsecured creditor in VCW's hypothetical Chapter 7 case.

On Aug. 27, 2014, United appealed to the District Court, which subsequently affirmed the Bankruptcy Court's ruling.

This article focuses on the District Court's decision upholding the preference claim against United.

The Joint Check Payments Were Avoidable and Recoverable

On appeal, United argued that it was not subject to preference liability on account of the pre-petition joint check payment in the amount of \$6,827.58 because VCW could not satisfy the greater than liquidation recovery requirement of Section 547(b)(5) (that United had received more as a result of the payment than it would have recovered in a hypothetical Chapter 7 liquidation involving VCW where Kinsley had not made the joint check payment). To support its position, United contended that it would have fully collected its claim had it invoked its right to recover on the CCSWA bond and/or assert its mechanics' lien rights. United also argued that the pre-petition joint check payment was subject to the ordinary course of business defense because it was made either in the ordinary course of business of the parties or according to ordinary business terms.

Conversely, VCW argued that the determination of whether United had received better treatment by obtaining the pre-petition joint check payment in the amount of \$6,827.58 versus what United would have recovered in a hypothetical Chapter 7 involving VCW should have been based solely on what United would have recovered from VCW's assets and should not include recovery from third party non-debtor sources. Relying on this interpretation of the greater than

liquidation recovery requirement of Section 547(b)(5), VCW argued that United recovered more from the pre-petition joint check payment of \$6,827.58 than United would have recovered in a hypothetical Chapter 7 of VCW. It did not matter that United might have obtained full payment of its claim from non-debtor third party sources (such as by collecting the CCSWA construction bond or asserting mechanic's lien rights on non-debtor real property).

VCW also argued that the ordinary course of business defense did not protect United from preference liability because the parties took certain actions that were not consistent with the parties' prior business practices. By pursuing its bond claim and later agreeing to the joint check arrangement, United took unusual action both to collect its claim and protect itself from VCW's deteriorating financial condition. Moreover, prior to entry into the joint check agreement, United invoiced VCW regularly on 30-day terms for goods United had sold and delivered to VCW on the project and United had expected these invoices to be paid according to their terms. Then, the joint check agreement was signed and Kinsley quickly and fully paid United's claim in response to the pressure United was applying.

The District Court sided with VCW, ruling that the pre-petition joint check payment was recoverable from United as a preference. There was no question that the execution of the joint check agreement and the joint check payments United had received were transfers of an interest of VCW's property (the right to payment from Kinsley). But for the agreement, Kinsley would have issued a check solely to VCW. The joint check agreement amounted to a transfer of this property right (that was originally exclusive to VCW) because following the execution of the joint check agreement, VCW instead shared that right with United. The court concluded that VCW satisfied all of the requirements of Section 547(b), including Section 547(b)(5)'s greater than liquidation recovery requirement. The court noted that the value of the hypothetical liquidation payment under Section 547(b)(5) is determined by the creditor's recovery *from the debtor's estate*, and not from non-debtor third party sources. The point of Section 547(b)(5) is to ensure creditors receive their fair share of the debtor's estate in the event of a bankruptcy. This is supported by the language of Section 547(b)(5) that the relevant inquiry is what the creditor would have recovered from the debtor's bankruptcy estate and not from some other source. The District Court, therefore, held that the value of the hypothetical payment does not include payments from non-debtor parties, such as a surety's payment on a construction bond or a general contractor's or a property owner's payments to obtain a release of a mechanics' lien filed on non-debtor real property.

The court held that United recovered more from the debtor's estate as a result of the pre-petition joint check payment pursuant to the joint check agreement than United would have recovered as an unsecured creditor in VCW's hypothetical Chapter 7 case. General unsecured creditors' claims against

VCW totaled approximately \$9 million. In a Chapter 7 liquidation, those creditors would have received a distribution of only about \$700,000. As such, United would have recovered only a small percentage of its unsecured claim against VCW.

The District Court also rejected the applicability of the ordinary course of business defense to the pre-petition joint check payment. First, the court considered the following factors in determining whether an alleged preference satisfied the subjective part of the ordinary course of business defense as ordinary between the parties: (1) the length of time the parties have engaged in the type of dealing at issue; (2) whether the subject transfer was in an amount more than usually paid; (3) whether the payments were tendered in a manner different from previous payments; (4) whether there was any unusual action by either the debtor or creditor to collect or pay the debt; and (5) whether the creditor did anything to gain an advantage (such as obtaining additional security) in light of the debtor's deteriorating financial condition. The District Court, after applying these factors, concluded that the joint check agreement, pushed by United to collect its claim, was unusual, was not ordinary between the parties, and, therefore, did not satisfy the subjective prong of the ordinary course of business defense.

The District Court noted that there were no transactions with which to compare the alleged preference because the parties had only recently begun doing business together on the project prior to the pre-petition joint check payment. Thus, the District Court had to focus on the last two factors of the subjective test involving unusual activity and strategic creditor behavior to gain an advantage. United took unusual action

The District Court, concluded that the joint check agreement, was not ordinary between the parties, and, did not satisfy the subjective prong of the ordinary course of business defense.

both to collect its claim and protect itself from VCW's deteriorating financial condition by pursuing a claim on the construction bond and pushing for and later agreeing to the joint check arrangement. Indeed, the court regarded United's push for execution of the joint check agreement as unusual activity to collect United's claim, and gain an advantage over VCW in light of VCW's poor financial condition. The court also noted that prior to entry into the joint check agreement, United had invoiced VCW from August through September 2012, and each invoice was a separate payment obligation with full payment expected within 30 days. After the parties entered into the joint check agreement in November 2012, Kinsley had paid United's entire claim in a little more than a month by tendering the three joint checks.

The District Court also rejected the applicability of the objective prong of the ordinary course of business defense. The court noted that United had presented no evidence on what was ordinary in the industry and, thus, failed to prove that the pre-petition joint check payment was made according to ordinary business terms.²

Conclusion

The VCW decision should not be all that surprising. United clearly received a preference when it, Kinsley and VCW entered the joint check agreement during the preference period to pay United's outstanding past-due invoices owing by VCW. One has to wonder why United did not either collect its claim on the construction bond and/or assert its mechanic's lien rights! Also, query whether United could have avoided preference and other avoidance liability if Kinsley had full setoff rights with respect to the amounts it owed VCW in the event United had exercised its mechanic's lien rights or collected on the bond. None of this was addressed in the litigation. ■

1. The court also ruled that the two post-petition joint check payments were recoverable under Section 549 of the Bankruptcy Code as improper unauthorized post-petition transfers. Section 549(a) states that a trustee may avoid a transfer of property of the estate that occurs after a debtor's bankruptcy filing and was not authorized by either the Bankruptcy Code or a bankruptcy court order.

2. The District Court also affirmed the Bankruptcy Court's ruling that the second and third joint check payments were not authorized under the customer programs order approved by the Bankruptcy Court and, therefore, were avoidable and recoverable as unauthorized post-petition transfers under Section 549(a).

Bruce S. Nathan, Esq. is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy, Financial Reorganization and Creditors' Rights Group and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM and is a former member of the Board of Directors of the American Bankruptcy Institute and is a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached via email at bnathan@lowenstein.com.

David M. Banker, Esq. is a partner in the law firm of Lowenstein Sandler LLP. He practices in the firm's Bankruptcy, Financial Reorganization and Creditors' Rights Group and focuses his practice on trade creditors' rights. David can be reached at dbanker@lowenstein.com.

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