



both the agreement and the payment Myers had received to preference risk. Myers had also failed to satisfy the requirements of the contemporaneous exchange for new value defense to preference liability—the only defense alleged by Myers—where Myers could not prove that its deliveries of equipment were substantially contemporaneous with the issuance of the joint check.

The Limits of Joint Check Agreements as a Risk Mitigation Tool



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Introduction

Material and service providers dealing with a financially distressed subcontractor on a construction project frequently use a joint check agreement as a risk mitigation tool. The holding of the United States District Court for the Eastern District of Virginia (the "Court"), in *Myers Controlled Power, LLC v. H. Jason Gold, in his capacity as trustee for The Truland Group, Inc., et al.* (In re The Truland Group, Inc., et al.) (the "*Truland Case*"), is a cautionary tale about the utility of a joint check arrangement that was entered into during the 90-day preference period.

Truland Walker Seal Transportation Inc. ("TWST")¹, a subcontractor on a large-scale construction project, chose Myers Controlled Power, LLC ("Myers") to supply certain electrical equipment and switches. The Court held that a joint check, issued by the general contractor on the project and payable to Myers and TWST pursuant to a joint check agreement, that Myers had received shortly before TWST had filed its bankruptcy case, was recoverable as a preference. The Court relied on TWST's entry into the joint check agreement during the 90-day preference period, which subjected

Bottom line, while Myers thought it was mitigating its risk by entering into a joint check agreement and collecting the proceeds of a joint check, Myers instead found itself embroiled in, and then losing, a very expensive and time-consuming preference litigation. And, this unfortunate result was avoidable (no pun intended)!

Joint Check Agreements

In distressed construction scenarios, goods and/or service providers frequently rely on joint check agreements to hedge against a counterparty's inability to pay. Joint check agreements involving a general contractor, a financially distressed subcontractor and a trade creditor supplying goods and/or services to the subcontractor usually require the general contractor to make payment jointly to the subcontractor and its goods/service provider to engender confidence that the goods/service provider will receive full payment of its claim. As part of the joint check arrangement, the subcontractor agrees to endorse the checks and deliver them to the goods/service provider to pay the latter's outstanding invoices. However, the subcontractor's intervening bankruptcy filing, like in the *Truland Case*, creates a risk

¹ The debtors in these cases were a group of affiliated companies performing electrical contracting work under the name "Truland." For ease of reference, all of the debtors will be referred to as TWST throughout this article, although additional related parties are mentioned by the Court.

that a general contractor's joint check payment the goods/service provider receives during the 90-day preference period could be an avoidable preference.

The Preference Statute

Pursuant to section 547(b) of the Bankruptcy Code, a trustee (or debtor in possession) can avoid and recover a transfer as a preference by proving the following *prima facie* elements of a preference claim:

1. The debtor transferred its property to or for the benefit of a creditor. The transfer of any type of property can be avoided, but the most frequent type of transfer is a cash payment (section 547(b)(1));
2. The transfer was made on account of an antecedent or existing debt that the debtor owed to the creditor (section 547(b)(2));
3. The transfer was made when the debtor was insolvent, which is a balance sheet definition of insolvency, or liabilities exceeding assets (section 547(b)(3));
4. The transfer was made within 90 days of the petition date if the transfer was to a non-insider (section 547(b)(4)); and
5. The transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation (section 547(b)(5)).

Myers argued that the Chapter 7 Trustee of TWST's bankruptcy estate (the "Trustee") did not satisfy the requirements of section 547(b)(1) because: (i) the joint check was not property of TWST's estate, and (ii) Myers was not a creditor of TWST. Myers also invoked Bankruptcy Code section 547(c)(1)'s contemporaneous exchange for new value defense to the preference claim. Myers had the burden of proving that: (a) the parties had intended the transaction to be a contemporaneous exchange for new value, and (b) the transaction was, in fact, a substantially contemporaneous exchange for new value. The Court concluded that Myers did not satisfy the "substantially contemporaneous" prong of the defense because the joint check paid to Myers during the preference period was not a substantially contemporaneous

exchange for the equipment and other goods that Myers had previously delivered to TWST.

Factual Background

Clark Construction Group, LLC ("Clark") was the general contractor for the \$273 million rehabilitation of the Orange/Blue train line—Stadium-Armory to Ronald Reagan Washington National Airport for the Washington Metropolitan Area Transit Authority (the "WMATA"). In January 2011, TWST, a project subcontractor, entered into a \$45 million subcontract with Clark (the "TWST Subcontract"). In conjunction with the TWST Subcontract, TWST caused its bonding companies to issue performance and payment bonds. The TWST Subcontract included a "flow down" provision whereby TWST had a contractual obligation to pay its own subcontractors/suppliers and avoid any bond claims against the surety that guaranteed TWST's performance.

TWST hired Myers as a second-tier subcontractor to provide electrical equipment and switches for the WMATA project. However, Myers did not subcontract directly with TWST, but instead operated through Nationwide Electrical Services, Inc. ("NES"), a disadvantaged business entity. Myers sent all but one of its invoices to NES, and NES sent invoices to TWST. Nonetheless, Myers took its directions exclusively from TWST, not from NES.

TWST ran into financial difficulties in the spring of 2014. In April 2014, TWST engaged a chief restructuring officer (the "CRO"). The CRO testified that as of spring 2014, TWST was "out of trust" by approximately \$23.7 million to its suppliers. In other words, TWST was receiving payments from its general contractors, including Clark, but not paying its suppliers and subcontractors in violation of the "flow down" provisions of the contracts.

On April 29, 2014, an employee of Clark learned Myers would not continue delivering equipment to the WMATA project until payments resumed. Also, during the first week of May 2014, Myers: (i) reiterated that they had stopped the testing and delivery of equipment, and (ii) requested that Clark issue future payment(s) via joint check payable to Myers and TWST, or alternatively,

that Clark make payment directly to Myers through "one party" checks.

On May 9, 2014, Clark advised TWST that it was in default for failure to pay its suppliers and subcontractors. As a result, on May 13, 2014, Clark insisted on a joint check arrangement whereby checks would be made out to Myers and TWST, endorsed by TWST, and then delivered to Myers. A draft joint check agreement was circulated on June 11, 2014. Clark, Myers and TWST ultimately entered into a joint check agreement (the "JCA") that became effective on June 16, 2014.

On May 27, 2014, while the JCA was still being negotiated, Myers, apparently satisfied that Clark would enter into the JCA, had delivered equipment invoiced at approximately \$1.8 million to the WMATA project. On June 18, 2014, Myers delivered additional equipment invoiced at approximately \$250,000 to the project. Thereafter, on July 11, 2014, more than a month after Myers had made the first and larger delivery of equipment, Clark delivered a check made payable jointly to Myers and TWST in the amount of \$2,107,039.86. TWST then endorsed the check, sent it back to Clark, and Clark forwarded the check to Myers.

The Bankruptcy Proceeding

On July 23, 2014 (the "Petition Date"), TWST and its affiliates filed voluntary petitions under Chapter 7 of the Bankruptcy Code in the United States Bankruptcy Court, Eastern District of Virginia (the "Bankruptcy Court"). The Trustee was appointed, and in July 2016, filed an adversary proceeding against Myers seeking recovery of the \$2,107,039.86 paid by joint check under the JCA. Following a trial, the Bankruptcy Court held that the joint check Myers had received was an avoidable preference and not subject to any defense and entered judgment in the amount of \$2,107,039.86 plus interest, in favor of the Trustee and against Myers. Myers timely appealed to the Court.

The Court's Decision

The Court affirmed the Bankruptcy Court's judgment, holding that the joint check payment that Myers had received was an avoidable preference and not subject to the contemporaneous exchange for new

value defense. Two of the requirements for avoiding a preference, a transfer of property of the debtor and a transfer by a debtor to or for the benefit of a creditor, were at issue in the *Truland* Case.

The Court initially concluded that the joint check Myers had received pursuant to the JCA was TWST's property. The court distinguished a prior decision of the United States Court of Appeals for the Fourth Circuit, in *Mid-Atlantic Supply, Inc. of Virginia v. Three Rivers Aluminum Co.* In the *Mid-Atlantic Supply* case, a general contractor had entered into a joint check agreement with a subcontractor debtor and a lower tier supplier. The general contractor had issued a joint check to the debtor subcontractor and supplier. The debtor subcontractor's secured lender claimed an interest in the joint check after the Chapter 7 trustee had abandoned the estate's interest in the check. The Fourth Circuit held that as a result of the joint check arrangement, the Debtor "had not the slightest interest in the check" and there was a constructive trust established in favor of the lower tier supplier.

On the other hand, the Court, in the *Truland* Case, held that the JCA itself was a preference because it involved the transfer of property of the debtor within 90 days of the Petition Date. The Court relied on the fact that the JCA was entered into: (i) when TWST was in material default due to being "deeply out of trust with its suppliers", and (ii) after Myers had refused to deliver equipment without catch up payments. The Court also concluded that both entry into the JCA and the joint check proceeds collected during the preference period were an "inseparable two-part process" such that the JCA—the first preference—could not be relied upon by Myers to save the joint check payment—the second preference.

The Court next concluded that there was a debtor/creditor relationship between TWST and Myers, notwithstanding that Myers had subcontracted with NES and not directly with TWST. The Court initially observed that the terms "creditor" and "claim" are broadly defined in the Bankruptcy Code. After applying these terms and the intent of the Bankruptcy Code avoidance sections, the Court concluded Myers had a quantum

meruit claim against TWST for the equipment Myers had delivered to TWST on May 27 and June 18, 2014, respectively, for which Myers was not paid until July 11, 2014.

The Court also concluded that Myers did not satisfy the contemporaneous exchange for new value defense. The Court initially concluded that the parties had intended a contemporaneous exchange for new value where Myers' delivery of equipment to the project was in anticipation of entry into the JCA and subsequent payment to Myers by a joint check issued by Clark. However, the Court held that the payment by joint check was not, in fact, substantially contemporaneous with Myers' deliveries of equipment to the project as a result of the gaps of 45 days (May 27, 2014 to July 11, 2014) and 23 days (June 18, 2014 to July 11, 2014) between Myers' two deliveries of equipment to the project on May 27 and June 18, 2014, and the issuance of the joint check on July 11, 2014.

The Bankruptcy Court had also rejected Myers' argument that its alleged release of a surety bond claim was new value that satisfied the contemporaneous exchange for new value defense. The Bankruptcy Court found that Myers had never made a claim on the bond. The court also noted that the release of inchoate rights to make a bond claim is not new value that benefits a debtor.

Conclusion

While a joint check agreement may increase a trade creditor's chances of having its claim paid by a distressed counterparty, that is only true if the parties enter into the agreement in a manner that mitigates potential preference exposure. The Court's ruling in the *Truland* Case demonstrates exactly what should not be done when entering into a joint check agreement. The decision stands for the proposition that a joint check agreement entered into during the 90-day preference period subjects the goods or service provider that is a joint check payee to increased preference risk. Best practices suggest that the supplier should hold off on delivering goods to, and/or providing services for, a construction project until after entry into an appropriately drafted joint check agreement that fully protects the creditor. Even then, the

provision of goods or services should occur as contemporaneously or close in time as possible with the execution of the joint check agreement and the issuance of a joint check to increase the likelihood that the creditor could successfully assert the contemporaneous exchange for new value preference defense.

What the decision does not discuss, or glosses over, are other risk mitigation tools about which trade creditors in the construction industry should be aware. There was no discussion about Myers' ability to recover its claim directly from a surety or performance bond after the Bankruptcy Court found that Myers had never made a bond claim. It was also unclear whether Myers could have tried to enforce its state law mechanics' lien rights, which can often-times be extremely valuable and elevate a general unsecured claim to a secured claim.

These other risk mitigation tools, coupled with the proper use of joint check agreements, can increase the chances that a trade creditor recovers its claim in the event of a distressed construction counterparty's bankruptcy.

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