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## News at 11

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### Stopped Payments as Avoidable Unauthorized Post-Petition Transfers

Practitioners are often asked to sift through seemingly endless transfers and transactions to determine whether any of them might support causes of action under the Bankruptcy Code. For actions under § 549 in particular, it is crucial to pinpoint the relevant transfer or transfers for which liability might lie. The U.S. Bankruptcy Court for the District of Maryland analyzed three such transfers in the context of § 549 in *In re Essex Constr. LLC*.<sup>2</sup> While the court determined that certain “transfers” did not satisfy § 549, it held that for purposes of § 549, an avoidable transfer occurs when an issuing bank stops payment on a cashier’s check after the check has already been delivered to the payee.<sup>3</sup>

#### Background

In *Essex*, chapter 11 debtor Essex Construction LLC faced a motion to appoint a chapter 11 trustee after it had been in bankruptcy for one month.<sup>4</sup> Amid growing arguments presented to the court over the next several months that Essex was dissipating funds in violation of the court’s cash-collateral order, the court revoked Essex’s authority to make any disbursements without the express approval of Essex’s secured lender banks.<sup>5</sup> Despite this, two days after the court’s ruling, Essex attempted to make a disbursement without approval from either the banks or the court.<sup>6</sup>

Specifically, Essex obtained a cashier’s check for \$545,000 from M&T Bank payable to its creditor, the Laborers Trust Fund of Washington, D.C., related to unpaid employee benefits. Essex delivered the check to the Laborers Trust Fund,<sup>7</sup> which deposited the cashier’s check into its account at Capital One Bank.<sup>8</sup> Before the check was honored, however, Essex convinced M&T Bank to stop payment on the check, which left the Laborers Trust Fund in physical possession of the check while M&T Bank retained the funds.<sup>9</sup> Contemporaneously, Essex consented to the appointment of a chapter 11 trustee, whose appointment the court confirmed.<sup>10</sup>

Shortly after his appointment, the chapter 11 trustee began a course of action to recover the funds from M&T Bank pursuant to § 549.<sup>11</sup> In taking a broader approach in an attempt to resolve global claims in the case, the chapter 11 trustee began negotiations that led to a settlement, subject to court approval.<sup>12</sup>

Once the parties reached an agreement, the chapter 11 trustee filed a motion to approve the settlement, which included a provision stating that M&T Bank would transfer the \$545,000 that it had retained to the chapter 11 trustee for the benefit of Essex’s estate as proceeds of a chapter 5 avoidance claim.<sup>13</sup> The banks filed limited responses objecting to the inclusion of a settlement provision that required the court to find that the transfer to the Laborers Trust Fund was avoided under § 549 as an unauthorized post-petition transfer.<sup>14</sup> The banks contended that such a provision might prejudice



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<sup>2</sup> See *In re Essex Constr. LLC*, 575 B.R. 648 (Bankr. D. Md. 2017).

<sup>3</sup> *Id.* at 653-59.

<sup>4</sup> *Id.* at 650-51.

<sup>5</sup> *Id.* at 651.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 651-52.

<sup>12</sup> See *id.* at 652.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 650.

their claims of lien rights against the funds and urged the court to find that no transfer occurred in light of the stop-payment order.<sup>15</sup>

## Transfers Under 11 U.S.C. § 549

Under § 549 of the Bankruptcy Code, a chapter 11 trustee may seek to avoid unauthorized post-petition transfers of estate property.<sup>16</sup> In order to avoid a transfer, the chapter 11 trustee must satisfy four elements: “(1) a transfer, (2) of property of the estate, (3) made after commencement of the case, and (4) that is not authorized under the Bankruptcy Code or by the bankruptcy court.”<sup>17</sup> In *Essex*, none of the parties disputed that elements (2)-(4) had been met.<sup>18</sup> The dispute concerned only whether a “transfer” sufficient to satisfy the statute had occurred.<sup>19</sup>

In *Essex*, the chapter 11 trustee argued that it was within his discretion to structure the settlement in the case as an avoidance of transfer and specifically noted three potential transfers that occurred: (1) when M&T Bank stopped payment on the cashier’s check and retained the funds; (2) when M&T Bank issued the cashier’s check from Essex’s funds; and (3) when Essex delivered the cashier’s check to the Laborers Trust Fund.<sup>20</sup> The court reviewed each of these in turn.<sup>21</sup>

## Stopped Payment as § 549 Transfer

The court determined that M&T Bank’s voluntary stop-payment order on the cashier’s check and retention of the funds constituted a transfer for purposes of § 549.<sup>22</sup> In arriving at this conclusion, the court considered that M&T Bank made an “independent determination to stop payment of its obligation,”<sup>23</sup> which became an unconditional and primary obligation of M&T Bank when purchased.<sup>24</sup> At such point, M&T Bank ceased being a mere conduit in the transaction.<sup>25</sup>

Specifically, the court noted, “The issuing bank has placed itself in the center of a dispute between its customer and the payee over its liability.”<sup>26</sup> This left M&T Bank with “legal dominion and control of the funds” because its own liability needed to be resolved in order to properly dispose of the funds.<sup>27</sup> Accordingly, the court determined that when M&T Bank stopped payment and retained the funds, an avoidable transfer occurred sufficient to satisfy a claim under § 549.<sup>28</sup>

## Debtor Obtaining Cashier’s Check from Bank Did Not Constitute a “Transfer”

Equally as critical as which act the court determined constituted a transfer are those acts that the court determined did not constitute transfers. The court found that a “transfer”

had not occurred for bankruptcy purposes when M&T Bank issued the cashier’s check from Essex’s funds and Essex acquired the check.<sup>29</sup> In reaching this conclusion, the court relied on the Fourth Circuit’s reasoning in *Bowers v. Atlanta Motor Speedway (Bowers I)*.<sup>30</sup>

In *Bowers I*, the Fourth Circuit analyzed whether an entity was an initial transferee or an immediate or mediate transferee for purposes of determining liability for an avoidable transfer under § 550 of the Bankruptcy Code.<sup>31</sup> It determined that initial transferees are those that “exercise legal dominion and control over the property” requiring more than “physical dominion and control.”<sup>32</sup> Initial transferees are not protected from liability for avoidable transfers.<sup>33</sup> In *Essex*, the court applied this law and reasoned that no “transfer” occurred to M&T Bank when Essex acquired the cashier’s check, because M&T Bank served only as a mere conduit in the transaction.<sup>34</sup>

## Delivery of the Cashier’s Check Did Not Constitute a “Transfer”

Finally, the court considered whether a transfer occurred when Essex delivered the cashier’s check to the Laborers Trust Fund.<sup>35</sup> It concluded that because the check was not ultimately honored, delivery alone did not constitute an avoidable transfer for the purposes of evaluating the application of § 549.<sup>36</sup> To reach this conclusion, the court reviewed the timing on Essex’s stop-payment request<sup>37</sup> and determined that because M&T Bank stopped payment on the check after Essex delivered it to the Laborers Trust Fund but before the check was honored, Essex only effectuated a conditional transfer by the delivery.<sup>38</sup> The court held that this conditional transfer was not a “transfer” sufficient to satisfy § 549.<sup>39</sup>

## Essex: Conclusion

In the end, the court overruled the banks’ objections and approved the chapter 11 trustee’s settlement, noting that it only needed to find that one avoidable transfer occurred.<sup>40</sup> M&T Bank’s stopped payment and retention of Essex’s funds was avoided under § 549 as an unauthorized post-petition transfer.<sup>41</sup> The court left open the question of whether — and to what extent — its ruling would affect the banks’ lien rights regarding the funds turned over by M&T Bank.<sup>42</sup>

29 *Id.* at 654-55.

30 99 F.3d 151 (4th Cir. 1996). *See id.* at 654.

31 *See Bowers v. Atlanta Motor Speedway (Bowers I)*, 99 F.3d 151, 154 (4th Cir. 1996); *see also Bowers v. Kuse Enters. (Bowers II)*, 172 F.3d 43 (4th Cir. 1998).

32 *In re Essex Constr.*, 575 B.R. at 654 (citing *Bowers I*, 99 F.3d at 156).

33 *Id.*

34 *Id.* at 655. In addition, the court discussed how a transfer occurs under state law when a customer obtains a cashier’s check via a debit from the customer’s account or payment by check. *Id.* at 656. The court determined that “controlling federal law overrides the state law transfer for bankruptcy purposes under *Bowers I* and *II*.” *Id.* Therefore, despite the state law, the purchase of a cashier’s check is not a “transfer” under bankruptcy law. *Id.*

35 *Id.* at 657-59.

36 *Id.* at 659.

37 *Id.*

38 *Id.* According to § 101(54) of the Bankruptcy Code, “The term ‘transfer’ means — (A) the creation of a lien; (B) the retention of title as a security interest; (C) the foreclosure of a debtor’s equity of redemption; or (D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—(i) property; or (ii) an interest in property.” 11 U.S.C. § 101(54).

39 *See In re Essex Constr.*, 575 B.R. at 659. The court also noted that “[n]o one could suggest that the [Laborers Trust Fund] is liable for \$545,000 under § 549 and § 550 for receipt of a check that was never honored.” *Id.*

40 *Id.*

41 *Id.*

42 *Id.* at 650.

15 *Id.*

16 *See* 11 U.S.C. § 549.

17 *In re Merry-Go-Round Enters. Inc.*, 400 F.3d 219, 224 (4th Cir. 2005); *see In re LWMcK Corp.*, 196 B.R. 421, 423 (Bankr. S.D. Ill. 1996).

18 *See In re Essex Constr.*, 575 B.R. at 653.

19 *Id.*

20 *Id.* at 654.

21 *Id.* at 653-59.

22 *Id.* at 655-57.

23 *Id.* at 656-57.

24 *Id.* at 655; *see Rezapolvi v. First Nat’l Bank of Maryland*, 296 Md. 1, 8, 459 A.2d 183, 187 (1983).

25 *In re Essex Constr.*, 575 B.R. at 655.

26 *Id.* at 657.

27 *Id.*

28 *Id.*

## Practice Pointers

While it remains to be seen whether other courts will follow suit, *Essex* cautions practitioners to carefully advise bank clients not only on transfers the bank plans to make, but also on those the bank seeks to thwart by stopping payment or otherwise. To avoid running afoul of § 549 of the Bankruptcy Code, the bank that seeks to stop payment on a check issued from a debtor's funds should ensure that such transfer is authorized in the particular bankruptcy case. In contrast, a practitioner who represents a debtor that has initiated an unauthorized transfer (intentionally or unwittingly) may find support in *Essex* for mitigating adverse consequences (if any) by swiftly causing the transfer to be stopped before it is completed.

*Essex* also contains a useful reminder of the myriad tools in the chapter 11 trustee's (or debtor in possession's) toolbox. In *Essex*, the chapter 11 trustee creatively argued that a stopped payment was actually a "transfer" sufficient to support an avoidance action under § 549.<sup>43</sup> Beyond this, estate fiduciaries viewing the teachings of *Essex* more broadly can seek to employ the court's determinations regarding what acts constitute (or did not constitute) "transfers" in other chapter 5 contexts in order to increase recoveries for the estate. However, fiduciaries be warned: If astute lender's counsel has negotiated for its collateral to include proceeds from recoveries for litigation under chapter 5 of the Bankruptcy Code, the fiduciary's work might prove less than beneficial to the estate. Practitioners on both sides would do well to heed the lessons of *Essex* as a whole and on § 549 in particular. **abi**

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<sup>43</sup> *Id.* at 657.