THE PERILS OF CENTRALIZED CASH MANAGEMENT SYSTEMS IN INSOLVENT MULTI-CORPORATE ENTERPRISES

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THE PERILS OF CENTRALIZED CASH MANAGEMENT SYSTEMS IN INSOLVENT MULTI-CORPORATE ENTERPRISES

I. INTRODUCTION

Multi-corporate enterprises use Centralized Cash Management Systems (“CCMS”) to facilitate the efficient flow of capital throughout the enterprise. But when one or more of the corporations in the enterprise becomes insolvent, the conflict between protecting the entire enterprise and the rights of creditors of a single corporation within the enterprise can create a host of unintended legal problems. Three of those problems are:

- Creditors of a solvent subsidiary risk non-payment when the parent siphons the subsidiary’s cash to use for its own needs or the needs of other subsidiaries.
- Creditors or a bankruptcy trustee of an insolvent corporate parent may have superior rights to the cash management account and can shut off the flow of capital to the subsidiaries.
- Creditors of a subsidiary who are paid out of the parent’s cash management account may be sued under fraudulent transfer statutes.

II. CENTRALIZED CASH MANAGEMENT SYSTEMS WORK

A. Centralized Cash Management Systems Operations

A CCMS, is a system that pools all capital from a multi-corporate enterprise and its subsidiaries into a single account held in the parent corporation’s name, often referred to as a concentration account, Derek Feagans, Concentration Accounts and Bankruptcy: “Where O’ Where Did. the Bankruptcy Estate Go?”, 67 UMKC L. Rev. 145, 145 (1998). In a CCMS, all of the proceeds and debts flow from the subsidiaries to the parent. Id. The funds in the CCMS are used for the day-to-day operations of the parent corporation and all its subsidiaries. In re Hillsborough, 166 B.R. 461, 465 (Bankr. M.D. Fla. 1994). The parent will supply the subsidiary with the cash necessary for their daily expenditures. Id. In a typical CCMS, the funds and revenues of the subsidiaries are withdrawn from the subsidiary’s “lock box” into the CCMS each night, maintaining a net balance of zero for the subsidiary account. Id. The parent will also pay all debts to creditors of the subsidiary through this single account. Feagans, supra at 145. All transfers in-and-out of the CCMS are identified and recorded by the parent. Id. Often these transfers of cash between the subsidiaries and the parent are treated on the company books as intercompany loans. Brad B. Erens et. al., Bankrupt Subsidiaries: The Challenges to the Parent of Legal Separation, 25 Emory Bankr. Dev. J. 65, 84 (2008). A properly maintained CCMS allows a parent corporation to monitor all of the finances of each subsidiary. Feagans supra at 145. Typically, these accounts are overseen by “cash management committees” and the CFO is responsible for appropriating the cash flow among the subsidiaries. Rhett Campbell, Lessons From Enron: Issues Raised When a Giant Falls, South Texas College of Law Bankruptcy Conference (April 2002) N-7; In re Enron Corp., 2006 Bankr. LEXIS 5165 (Bankr. S.D.N.Y. June 1, 2006).

B. Benefits of a CCMS

A CCMS provides multi-corporate enterprises with many benefits. The system promotes the efficient use of capital by facilitating the free flow of capital throughout the corporate enterprise so that capital can be shifted from one subsidiary with excess capital to another subsidiary in need of capital. Also, the corporation will often receive discounts by the bank or lending institution when seeking loans. Feagans, supra at 145. Having a single CCMS also provides for efficient maintenance and reduces the administrative cost of overseeing multiple accounts. Id. at 146. Further, a CCMS allow for maximum returns on investments. Id. By having a single large account, a multi-corporate enterprise will circulate larger amounts of money, providing them with a potential for larger returns due to investment opportunities and interest income. Id. Finally, because all creditors are paid from a single account, the corporation can easily organize payments and monitor cash flow. Id.

C. Problems with a CCMS

While a CCMS has many benefits, problems arise when either the parent or a subsidiary becomes insolvent. This is because the CCMS promotes the efficient use of capital across the entire corporate enterprise, often without regard to its impact on a particular subsidiary. However, under fundamental principles of corporate law, creditors of one entity in the multi-corporate enterprise only have legal recourse against that particular entity. United States v. Bestfoods, 524 U.S. 51, 61 (1998). So where the use
of a CCMS leaves a subsidiary or the parent with insufficient capital to pay its debts, those creditors can be harmed, and a host of issues arise. Also, if the entity which maintains the bank accounts, typically the parent, becomes insolvent, creditors of that entity may exercise their rights against the bank account, harming the subsidiaries (and their creditors). Creditors of the parent may also seek to recover funds paid by that entity for the debts of other entities, harming the creditors of all of those entities.

These problems arise out of the conflict between operating a multi-corporate enterprise for the collective benefit of that enterprise and of state and federal fraudulent transfer laws which look to the impact of any transfer of cash or property on each entity and their creditors. The result is that the parent, the subsidiaries, and their respective creditors can suffer substantial harm in unexpected ways.

III. PROBLEMS ARISING UNDER CCMS WHEN ENTITY BECOMES INSOLVENT

A. InterCompany Cash Transfers as Fraudulent Transfers

In some cases, the transfer of funds from an insolvent subsidiary to the parent may violate state and federal fraudulent transfer statutes; yet many bankruptcy courts routinely authorize the continuation of cash management systems as a routine first day motion. The raises the question of whether the courts are authorizing fraudulent transfers by allowing the transfer of funds for inadequate or no consideration without providing adequate protection to the creditors of the subsidiary.

This also raises the issue of whether there are effective ways to protect the subsidiary’s creditors while allowing the continuation of the cash management system.

Both state and federal law allow the avoidance of transfers of property when the debtor is insolvent or becomes insolvent due to the transfer, and the debtor received less than “reasonably equivalent value” in exchange for the transfer. Such a claim is a “constructive fraudulent transfer.” As a result, creditors may face adversary proceedings based on the constructive fraudulent transfer by debtors-in-possession, trustees in bankruptcy, or by judgment creditors in state actions.

The Uniform Fraudulent Transfer Act (“UFTA”) prevents debtors from harming creditors by placing assets beyond their reach. Corpus v. Arriaga, 294 S.W.3d 629, 634 (Tex. App. – Houston [1st Dist.] 2009, no pet.). The Texas Uniform Fraudulent Transfer Act (“TUFTA”) Tex. Bus. & Com. Code Ann. § 24.001 et. seq., allows creditors to avoid the prior transfer of property of the debtor to another party when the transfer was for less than reasonably equivalent value in exchange for the transfer, when the debtor was insolvent or became insolvent as a result of the transfer.

11 U.S.C. § 548 allows the debtor-in-possession or trustee to avoid any transfer of an interest of the debtor in property to a party, that was made within two years before the date of filing for bankruptcy, if the debtor received less than reasonably equivalent value in exchange for such transfer, and if the debtor was insolvent or became insolvent as a result of the transfer. For a trustee to make a valid claim of constructive fraudulent transfer against a creditor, the trustee holds the burden to establish that: (1) the debtor had an interest in the property; (2) the transfer of the interest occurred within two years of the petition; (3) the debtor was insolvent or became insolvent as a result of the transfer; and (4) the debtor received less than reasonably equivalent value in exchange for such transfer. See id.

B. The Rights of Creditors of an Insolvent Subsidiary

Under fundamental principles of corporate law, creditors of one entity in the multi-corporate enterprise only have legal recourse against that entity. If that entity is insolvent and transfers its assets for less than reasonably equivalent value, then a creditor can sue the transferee under UFTA to avoid the transfer or recover the value of the property transferred up to the amount of the creditors’ claim, and obtain other equitable relief as provided in § 24.008 of TUFTA. Tex. Bus. & Com. Code Ann. § 24.008.

As previously mentioned, a prime benefit of operating a CCMS is that it allows for the facilitation of the free flow of capital from one subsidiary with excess capital to another subsidiary in need of capital. Such transfers are commonly treated as intercompany loans. Generally intercompany loans would not be considered fraudulent transfers because the parent’s promise to repay the loan could be deemed to be reasonably equivalent value in exchange for the transfer of cash from the subsidiary. However, when the parent is unable to repay the loan (either by transferring cash to the subsidiary or by paying the subsidiary’s debts), the parent’s promise to repay the loan may not be reasonably equivalent value. As a
result, the continued use of the cash management system when the parent is insolvent or when, for example, all of its assets are pledged to an undersecured lender and the parent is rendered unable to use its cash to pay the debts of the subsidiary, would theoretically run afoul of UFTA. Nonetheless, when the parent corporation files for protection under the Bankruptcy Code, the parent commonly seeks an order to authorize the continued use of the existing CCMS. If the court allows the continuation of the CCMS without measures to protect the subsidiary, the court may arguably sanctioning fraudulent transfers.

In In re Enron Corp., et. al., the court entered an order authorizing Enron (the parent corporation) to continue to use its existing CCMS. Campbell, supra N-5. As a result, Enron began using revenue generated by Enron North America (“ENA”), a subsidiary of Enron, to fund Enron’s chapter 11 proceeding. Id. Significantly, ENA was a a liquidating entity that was not generating cash from continued operations after the filing. Its value lay in the valuable “trading book” that existed on the date of filing. Arguably the continuation of the CCMS did not provide any benefit to ENA; ENA did not need cash from other Enron entities to liquidate. Yet within the first 8 weeks of the filing, a net $320 million dollars was transferred to Enron, the parent, to operate the other entities, many of which were not in Chapter 11. The transfers were recorded as (interest free) intercompany loans. Enron had obtained $1.5 billion in DIP financing and granted the lenders a first lien on all of its assets, priming any unsecured claim ENA had against Enron arising out of the transfers. But rather than drawing on the line of credit and incurring interest charges, Enron used the “free” funds of ENA to fund its Chapter 11 and the operations of its subsidiaries. Moreover, it appeared that Enron did not have any means to repay ENA.

Upon learning this, creditors of ENA filed a motion to stop the CCMS from siphoning the ENA cash on a daily basis, and to force ENA to operate under its own cash management system. Id. at N-6. The creditors based their claims on 11 U.S.C. § 549 for the unauthorized transfer of post-petition loans. Although this claim is different from a § 548 fraudulent transfer claim, a § 549 claim for the transfer of unauthorized post-petition loan provides creditors with a similar remedy when the debtor entity has already filed for bankruptcy. The ENA creditors presented evidence of “(i) unauthorized post-petition loans by ENA to a chapter 11 debtor at zero interest, with no collateral, and without court authority, in blatant violation of 11 U.S.C. § 345(b)…and (iv) the multi-billion dollar risk to ENA and its creditors of ENA’s continued participation in this alleged [CCMS].” Id. The evidence showed that, “[Enron] had made hundreds of millions of dollars of unauthorized inter-company loans, without notice, mostly with ENA cash, with inadequate controls and no assurance of repayment.” Id. The ENA creditors claimed that the “cash committee,” in charge of approving the inter-company transfers, and which did not have an ENA representative, was insufficient to protect ENA and its creditors. Id. at N-11. Relying on the case of The Charter Company v. The Prudential Ins. Co., the creditors of ENA claimed that the court should not permit the continued use of the CCMS without providing ENA and its creditor’s adequate protection. See id. at N-12 (citing The Charter Company v. The Prudential Ins. Co. (In re The Charter Company), 778 F.2d 617 (11th Cir. 1985) (finding that the debtors’ pre-petition CCMS, which allowed intercompany loans between debtor and non-debtor entities, should be curtailed to require strict record keeping.) See also Amdura National Distribution Company v. Amdura Corp., 75 F.3d 1447 (10th Cir. 1996) (allowing CCMS to continue only on the approval of the parties and adherence to strict reporting requirements, with separate and independent representation of each of the debtor entities).

Enron countered that the transfers were authorized post-petition transfers under the first day order authorizing the continued use of the cash management system.

In the end, the bankruptcy court recognized the need for adequate protection of ENA and its creditors and entered an order, “(1) severely restricting the ability of the debtors to utilize the cash of ENA, and (2) directing the appointment of an examiner with expanded powers.” Campbell, supra at N-16. But the damage had been done

Because Enron had already filed a petition for bankruptcy, the creditors of ENA could not bring a fraudulent transfer claim. However, under the basic underlying facts of the action, a fraudulent transfer claim under 11 U.S.C. § 548 or under the Uniform Fraudulent Transfer Act could have merit had the transfers occurred pre-petition. When a parent corporation receives a transfer out of the subsidiary as a loan (and records it as an inter-company payable/receivable), the transfer will not necessarily be fraudulent because the parent’s promise to repay the loan may be reasonably equivalent value. However, when the parent has no ability to repay the loan, the transfer of the subsidiary’s property as an empty promise to repay the loan would seemingly be less than reasonably equivalent value. In some cases, it could be argued that the continuation of the CCMS,
in and of itself, provides value to the subsidiary by enabling the continuation of the enterprise to operate and preventing the loss of going concern value by forcing a liquidation. However, the Enron case demonstrates that such a fact specific justification may be impossible to determine at the commencement of the case and may, in fact, be illusory.

There are a number of prophylactic remedies creditors try to persuade courts to put in place as a condition to the continuation of a CCMS, including super-priority administrative claims and priming liens on the assets of the transferee in favor of the transferor but these efforts are often met with limited success. The seemingly inadequate remedies the Enron court authorized, which are summarized above, illustrate the following concerns: What good does the appointment of an examiner do? Is the examiner looking out for the good of the multi-corporate enterprise or the good of the individual subsidiaries with conflicting interests? What justification is there to allow dissipating the cash of a liquidating entity such as ENA to the detriment of its creditors for the benefit of the other entities?

Often courts have imposed strict record keeping requirements, see, e.g. In re The Charter Co., 778 F.2d 617 (11th Cir. 1985), but one may ask what good record keeping does without remedies? Similarly how effective is tracing funds into a commingled account when one cannot tell which entities’ funds are the first funds spent?

Other possible remedies, such as requiring the creation of multiple trust accounts to avoid the inherent problems tracing funds in commingled accounts, diminishes the effectiveness and justification for the CCMS.

Arguably, courts should treat motions for the continuation of a CCMS as post-petition financing motions under §§ 364(c) or (d) since they involve intercompany lending transactions and require adequate protection as a condition to approving them. This would put the burden on the debtor to prove it is providing adequate protection. Moreover, each case is fact-specific, so this would provide a framework to fashion remedies appropriate to the case.

C. Subsidiaries’ Efforts to Recover Transferred Funds

Creditors of denuded subsidiaries have frequently attempted to claim the net balance of transferred funds under a variety of theories but have frequently run into court’s deference to the use of a CCMS and a reluctance to extend legal theories to provide a remedy.

In re Amdura, 75 F.3d 1447, 1451 (10th Cir. 1996) is a case in point. Amdura Corporation (“Amdura”) was a parent holding company which operated a CCMS under the same principles as previously described, giving Amdura complete control of the funds in the CCMS, from which it paid all obligations and debts to the creditors of its subsidiaries regardless of how much that subsidiary deposited into the CCMS. Subsequently, Amdura and its subsidiaries filed for protection under Chapter 11. The court approved the continuation of the CCMS and, ultimately a plan was confirmed. One subsidiary, Andco, had a net balance in Amdura’s concentration account of over $1 million and sued Amdura to recover those funds and prevent Amdura from using the funds to pay off Amdura’s own creditors. As discussed later in this article, the court found that the funds belonged to Amdura. The Andco creditors sought the imposition of a constructive trust under various theories, all of which were rejected.

Andco argued that a constructive trust should be imposed because Andco was a mere agent for Amdura and that, alternatively, Amdura abused its confidential relationship with Andco, resulting in unjust enrichment to Andco. The court rejected the imposition of a constructive trust even though the use of the CCMS resulted in the inequitable transfer of funds, finding that the use of a CCMS was not evidence of fraud or unjust enrichment but, rather, a legitimate business tool. Id. at 1452. That raises the question of why transfers which would constitute constructive fraud under state and federal fraudulent transfer laws were treated with such deference because they may also be characterized as legitimate business tools.

Andco also attempted to use the corporate trust fund doctrine as a justification for imposing a constructive trust. The court, quoting United States v. Van Diviner, 822 F. 2d 960, 965 (10th Cir 1987) stated the doctrine as follows:

Under the trust fund doctrine, the assets of an insolvent or dissolved corporation constitute a trust fund for the benefit of creditors, and an equitable action may be brought against a stockholder or distribute when the assets of the insolvent or dissolved corporation are distributed without affording an opportunity for creditors to present and enforce claims.
Id. (emphasis in original). Then the court paraphrased Van Diviner, stating: “The trust fund doctrine applies, if at all, only where creditors do not otherwise have an opportunity to enforce their claims against the insolvent corporation.”

Id. (emphasis in original). By adding the phrase: “against the insolvent corporation” to the test enunciated on Van Diviner, the court focused on whether Andco’s creditors had the right to enforce their claims against the denuded Andco rather than examining the impact of the transfer of funds on the creditors’ opportunity to recover on their claims against Andco.

The Court wrote:

In this case, Amdura’s bankruptcy proceeding gave Andco the chance to recover the disputed funds as an unsecured creditor, and Andco’s own bankruptcy proceeding gave Andco’s creditors a chance to present and enforce their claims against Andco. While this arrangement may result in Andco’s creditors receiving less than all of those disputed funds, it still constitutes and opportunity to ‘present and enforce’ their claims.

Id. With a nod to the inequitable result that $1 million in funds generated from the operations of Andco were to be used to pay the creditors of Amdura simply because they had been transferred out of Andco under the CCMS, the court added a rather philosophical comment in footnote 2 following the paragraph quoted above.

This result is obviously more favorable to Amdura’s creditors than to Andco’s. It is the nature of bankruptcies to result in hardship even as they seek to fairly allocate scarce assets under the law in order to reflect policies accepted by Congress. Here because Amdura wholly owned Ando and because Andco cannot avail itself of the equitable remedies it seeks, this result is compelled.

Id. In any event, many courts have rejected the imposition of constructive trusts on concentration accounts on similar grounds. See In re Southmark Corp., 49 F.3d 1111, 1118-19 (5th Cir. 1995) (applying Texas law, a constructive trust was not justified in the absence of actual fraud or breach of fiduciary duty by the parent).

Creditors of a subsidiary may also try to pierce the corporate veil as a remedy, arguing that the corporate control by the parent and the use of the CCMS warrant this result.

One case that illustrates the courts’ hostility to this remedy is In re Hillsborough Holdings Corp., 166 B.R. 461 (Bankr. M.D. Fla. 1994). There, the parent filed a declaratory action against its subsidiary, The Cellotex Corporation, and asbestos claimants with claims against Celotex, seeking a declaration that the corporate veil should not be pierced and so the parent should not be held liable to the asbestos claimants. The Defendants sought to pierce the corporate veil.

The court first stated that the Defendants had the burden of proof to establish that the parent and subsidiary operated as a single economic entity.

Given that the very purpose of a cash management system could be fairly characterized as operating the multi-corporate enterprise as a single economic unity, one may conclude that there is validity to the Defendants’ claims. But the court went on to pronounce a much tougher burden of proof:

Under both the laws of Florida and Delaware, there must be persuasive proof of shareholder misconduct before a court will pierce the corporate veil. The courts of both Florida and Delaware require proof of deliberate misuse of the corporate form — tantamount to fraud — before they will pierce the corporate veil. Thus, absent proof of fraud or ulterior motive by the shareholder, the corporate veil will not be pierced. [citations omitted].

Id. at 469.

The court examined the level and dominion of control of intercompany transactions and rejected the argument that the use of the CCMS was evidence that the corporations were being operated as a single economic unit, stating, “Based on this record there is no doubt, and this Court is satisfied, that the cash management system was totally consistent with sound business practices widely recognized in the corporate business world.” Id. at 471.

The Defendants also pointed to the repayment by Cellotex of its intercompany debt to the parent out of the proceeds of the liquidation of the assets of Cellotex as improper, and asked the court to recharacterize the loans of the parent as equity infusions and, presumably, the repayment as improper
dividends made when Cellotex had not been provided insurance or any means to address its potential liability to asbestos plaintiffs.¹

The court determined that the proper analysis to determine whether a transfer was debt or equity was to look to a variety of factors including the initial capitalization of the corporation, the amount of shareholder control, the label placed on the transaction by the parties involved, the intent of the parties to the transaction, and the documentation of the transaction. The Court rejected these arguments. In focusing on the element of inadequate capitalization, the court focused on the capitalization of the subsidiary at the time it was created years before rather than on the lack of the subsidiary’s undercapitalization at the time of the transfers and found that Cellotex had been adequately capitalized initially. Id. at 474.

This analysis could lead one to ask what relevance the initial capitalization years before was rather than the capitalization at the time of the transfers which would seem to be the more relevant analysis.

These cases serve to illustrate that existing theories of law are inadequate to permit creditors of a denuded subsidiary from recovering funds that may have been available to pay their claims in the absence of a CCMS. They further illustrate that the more effective approach is to vigorously challenge motions for the continuation of the use of a CCMS unless the debtors provide adequate protection to the subsidiary’s creditors.

D. The Rights of Creditors of the Parent to the Cash Management Accounts

As previously mentioned, creditors generally only have legal recourse against the debtor with whom it has dealings, under fundamental principles of corporate law. Because the creditor’s recourses are limited to the interest in property of the debtor, it is crucial to determine which entity owns the funds in the concentration account under the CCMS, or, put another way, to determine which bankruptcy estate the funds belong to. Property of the estate is generally defined as “comprising all legal or equitable interest of the debtor in property as of the commencement of the case, wherever located and by whomever held.” § 541(a)(1);

Courts have repeatedly found that funds in the parent’s cash concentration account belong to the parent regardless of the source of those funds. In re Southmark Corp., 49 F.3d 1111, 1116-17 (5th Cir. 1995). Evidence of ownership interest in a bank account such as a CCMS has been found where the party holds legal title thereto, “all indicia of ownership, and unfettered discretion to pay creditors of its own choosing, including its own creditors.” Id. at 1116. In a typical situation, the parent corporation holds legal title to the account (the CCMS). As a result, creditors of the parent can reach all of the multi-corporate enterprise funds that are pooled together in the CCMS. Indicia of ownership, such as power to distribute and use funds of the account, the name for which the account was set up, and that the account holder could use the proceeds of the account as it saw fit, indicates the property interest belongs to that of the parent corporation. In re Amdura, 75 F.3d 1447, 1451 (10th Cir. 1996).

In Southmark, the parent corporation, Southmark, sued Grosz, an ex-officer of its subsidiary, American Realty Advisors (“ARA”), to recover a settlement payment made to him for the benefit of ARA out of the Southmark concentration account as a voidable preference. ARA had a positive balance in the concentration account, the check named ARA as the remitter, and the W-2 form reporting Grosz’s income to the IRS identified ARA as the payor. Grosz moved for summary judgment on the grounds that the funds were property of the ARA estate, not the Southmark estate. The bankruptcy court agreed. The court noted that, throughout the case, Southmark had encouraged the court to be very mindful of the separate entity with which parties were dealing to avoid the imposition of liability of the parent corporation. The court apparently found it inequitable for Southmark to use the corporate separateness as a shield and then to ask the court to ignore the corporate separateness when it suited Southmark’s purposes to use as a sword. The bankruptcy court found that the payment was from ARA and the fact that the funds came out of Southmark’s account did not raise a genuine issue of material fact. Id. at 1115-1116.

The district court affirmed but did so on the grounds that the funds were funds of ARA held in quasi-trust, or a constructive trust, by Southmark. Id. at 1117.

The Fifth Circuit reversed and remanded. The court found that the source of the funds was determinative and that the bankruptcy court had exceeded its bounds as a court of equity by attempting to fashion a remedy that did not exist. It rejected the

¹ In an interesting twist, the creditors of the subsidiary were attempting to obtain this recharacterization to alter the balance sheet of the parent and render it insolvent so that they could attack a subsequent leveraged buyout as a fraudulent transfer.
district court’s imposition of a constructive trust finding that a constructive trust was not justified in the absence of actual fraud or breach of fiduciary duty by the parent. \textit{Id.} at 1119.

In \textit{Amdura}, the court also addressed the issue of who owned the funds deposited by the subsidiaries into the parent’s concentration account and reached the same result. \textit{Id.} at 1450. Andco claimed it owned the funds outright and therefore such funds should be used to pay the creditors of Andco. \textit{Id.} The court found that funds in the (CCMS) into which subsidiaries’ receipts were deposited and from which the subsidiaries’ expenses were paid were not property of the subsidiary’s bankruptcy estate, and the fact that the parent corporation usually paid the subsidiary’s debts did not establish that the parent’s control over money from the subsidiaries was exercised solely for the subsidiary’s benefit so that disputed funds were not part of the parent’s estate.

\textit{Id.} at 1451.

Outside the bankruptcy context, finding that funds in the parent’s concentration account belong to the parent can have serious consequences to the entire enterprise. For example, a judgment creditor of the parent would have the right to garnish the funds and effectively prevent the continued use of the CCMS to fund the operations of the subsidiary.

But the consequences of this finding have far-reaching consequences to creditors of the subsidiaries as discussed in the following section.

\textbf{E. The Rights Of Creditors Of The Parent To Recover Funds Paid To Vendors Of Subsidiaries}

The holding of \textit{In re Southmark} and its progeny that funds in a parent’s concentration account are property of the parent’s bankruptcy estate has resulted in a multitude of lawsuits by the parent against creditors of subsidiaries under 11 U.S.C. § 548 for the recovery of payments made to them out of the parent’s concentration account for debts of a subsidiary.

Had a creditor been paid from the account of the subsidiary that owed it, the creditor may be exposed to a voidable preference claim under § 547, but a non-insider creditor generally only faces that risk if it received the payment within 90 days of the bankruptcy filing. Moreover, the creditor could avail itself of the numerous defenses under § 547, such as contemporaneous exchange of value, payments made in the ordinary course of business, and setoffs to the extent of new value given to the debtor by the creditor after the creditor was paid.

But when the parent pays the creditor from the concentration account, the parent is paying a debt it does not owe; the subsidiary owes the debt. Since the payment is not a payment of an antecedent debt of the parent, § 547 does not apply. Instead the parent sues under § 548, arguing that the payment was a transfer of property of the insolvent parent for less than reasonably equivalent value, claiming that the parent did not receive any or at least inadequate value for the transfer of its property. Now the creditor is at risk for payments it received within two years of the bankruptcy filing under § 548 and as long as four years under the Uniform Fraudulent Transfer act, incorporated under 11 U.S.C. 544. Moreover, the creditor is stripped of the defenses available to it under § 547. This undermines the underlying principle justifying the recovery of voidable preferences, that is, to recover extraordinary payments to unsecured creditors made on the eve of bankruptcy in order to fairly redistribute the proceeds pro rata to all of the unsecured creditors. In fact, the recovery in this situation does not benefit the creditors of the subsidiary at all because the recovery goes to the benefit of the creditors of the parent, arguably, unjustly enriching them.

So we are faced with a non-productive diversion of economic resources from business, if not an outright miscarriage of justice, by exposing creditors who were rightly paid for their goods or services, perhaps years before the filing, who had the fortuitous misfortune to do business with a company who may have had the cash to pay them swept out of its reach in a CCMS.

As discussed previously, the bankruptcy judge in \textit{In re Southmark} saw the injustice of allowing the corporate parent to shield itself from its subsidiaries’ liabilities by hiding behind the corporate separateness throughout the case and then trying to recover payments made out of its concentration account on behalf of a subsidiary (with a positive balance in the account) for the benefit of the parent’s creditors. Perhaps the judge saw the wide-ranging ramifications of this rule of law on thousands of creditors in future cases. In any case, the court of appeals found that the bankruptcy court did not have the power to deviate from or expand existing legal theories to do equity.

Creditors have advanced a number of theories to defend against these claims. As has been discussed, efforts to claim that funds in the concentration account belong to the subsidiary or that the funds should be
imposed with a constructive trust have failed. In re Southmark, 49 F.3d at 1119. Attempts to pierce the corporate veil based upon the use of a CCMS have failed as well, with courts often requiring that actual fraud be present. Hillsborough, 166 B.R. at 469. However, since these cases are fact specific, they do not foreclose the use of those defenses when presented with a more egregious set of facts. For example, see the analysis of piercing the corporate veil under Delaware law without showing actual fraud in In re Sunbeam, 284 B.R. 355 (Bankr. S.D.N.Y. 2002). While the case does not involve a CCMS, the survey of all discussed in the case may be applicable in some cases.

Creditors have had some success arguing that the parent received “reasonably equivalent value” indirectly depending on the specific facts of the case.

Courts have held that payments made on behalf of a solvent subsidiary confer value on the parent as the shareholder. See, e.g. Branch v. Fed. Deposit Ins. Corp., 825 F. Supp. 384, 389 (D. Mass. 1993). But courts have been reluctant to presume this indirect benefit exists when the subsidiary is insolvent. See, e.g. In re Duque Rodriguez, 77 B.R. 937, (Bankr. SD. Fla. 1987).

Nonetheless, there are other arguments that have been made, albeit fact-specific, that payments by one entity for the benefit of another indirectly benefit the paying entity.

In re Fairchild Aircraft Corp., 6 F.3d 1119 (5th Cir. 1993), while not a case involving a CCMS, is instructive. There, the Fiscal Agent for Fairchild, with the power to pursue avoidance actions, sued Butler Aviation to recover fuel payments Fairchild made to Butler for Air Kentucky Airlines (“Air Kentucky”), a sister corporation of Fairchild at the time. The court found that Fairchild received value indirectly because the transfer conferred an economic benefit to Fairchild and further found that the value was sufficient to constitute reasonably equivalent value. Fairchild sold airplanes to Air Kentucky, a commuter airline, before they were affiliated. Fairchild deemed Air Kentucky to be an important customer and a possible avenue to a long term relationship with USAir, with which Air Kentucky had a code sharing agreement. Air Kentucky was in dire financial distress, and so Fairchild entered into a number of transactions to assist Air Kentucky. Then, due to an acquisition, Fairchild became a commonly owned affiliate of Air Kentucky. USAir objected to the ownership of a commuter airline by the parent of an airplane manufacturer and threatened to terminate its code sharing agreement with Air Kentucky, which would have been a fatal blow to Air Kentucky and caused Fairchild serious harm. Fairchild’s parent sought to sell Air Kentucky before USAir terminated the code sharing agreement but Air Kentucky’s suppliers refused to deliver fuel on credit, so Fairchild agreed to and did, in fact, pay for the fuel. Ultimately Air Kentucky failed. The bankruptcy court, after surveying cases finding indirect reasonably equivalent value in a variety of contexts, found that the benefits flowing to Fairchild from keeping Air Kentucky in operation were reasonably equivalent value for the fuel payments but that the payments made after Air Kentucky ceased operations did not. The Court of Appeals affirmed. The appeals court rejected the argument that the only value to be considered under § 548 is property actually received and wrote: “The recognized test is whether the investment conferred an economic benefit on the debtor; which benefit is appropriately valued as of the time the investment was made.” Id. at 1127.

Read broadly, this proposition of law may support an argument that the very justification debtors advance to obtain authority to continue the CCMS during bankruptcy — to confer an economic benefit on the entire enterprise by preventing the collapse of the enterprise — supports the proposition that payments made to creditors out of the concentration account, a key component of the CCMS, confer reasonably equivalent value to the entire enterprise, including the parent. To this author’s knowledge, however, no court has so broadly held.

In In re Collins & Aikman Corp. v. Borg Instruments AG, 401 B.R. 900 (Bankr. E.D. Mich. 2009), defendants argued that the debtor parent corporation receives reasonably equivalent value for the transfer in exchange for the goods supplied to a subsidiary by the defendant-creditor. Defendants moved for summary judgment on the fraudulent transfer claim brought by the parent corporation arguing that, “defendants supplied goods to [the subsidiary], which allowed it to operate and create products that were sold to its customers, including the debtors [parent corporation].” Id. at 903. The defendants argued that “non-debtor customer payments derived from products delivered to [the subsidiary] were swept into the debtor through the CCMS and therefore the debtor received the benefit, including cash proceeds from the products supplied by the defendants.” Id. The plaintiff-debtor argued that the fact that the CCMS is valuable as a whole does not mean that every dollar expended through it also provided value. Id.. Further, they contended, it cannot be assumed that reasonably equivalent value was
received simply by sweeping revenue into the CCMS due to the creditor providing the goods necessary for the subsidiary to maintain its business operations. Id. The court found that genuine issues of material facts existed and denied the motion for summary judgment. Id. at 906. Significantly, the court did not reject out of hand the defendant’s argument that there can be indirect value to the parent for goods sold and delivered to the subsidiary.

Another approach taken by defendants is to argue that the transferor is a mere conduit for its affiliate and so the transfer should be deemed to have been made by the affiliate. One court found that where a subsidiary used funds it received from a parent as a repayment of an intercompany loan to pay the parent’s debts, the subsidiary was a mere conduit and no fraudulent transfer occurred. In In re Trigem America Corp., 2010 WL 2787855 (Banker. C.D. Cal. 2010), a Korean company owned an American subsidiary. When the parent company was facing insolvency, the bondholders of the parent corporation sought payment. To facilitate the transaction, the parent corporation wired funds into the subsidiary’s account, and the subsidiary subsequently paid the funds to the parent’s bondholders at the direction of the parent. Id. The payments from the parent to the subsidiary were recorded on the books as a payment for an intercompany receivable, owed from the parent to the subsidiary. Id. Ultimately, both the parent and the subsidiary filed bankruptcy petitions. Id. The trustee for the subsidiary filed a fraudulent transfer action against the bondholders, claiming the payment had been a fraudulent transfer since the subsidiary was insolvent and received no value in exchange. Id. The bankruptcy court held that the money had never become property of the American subsidiary and therefore could not be recovered by its trustee. Id. Under the “earmarking” doctrine, the subsidiary was deemed a mere “conduit” for the funds. Id. The court concluded that “if the debtor was only a conduit and its creditors would not otherwise have had any reasonable expectation of recovering this money, why should those creditors receive a windfall now? From the standpoint of debtor’s creditors, in whose behalf the Trustee sues, there was no net diminution of expected recovery, which is and must be the touchstone of every avoidance action…” Id.

This case may be limited by its facts because the subsidiary was directed by its parent to pay the bondholders. While the subsidiary legally had control of the funds in its accounts and could legally use them for other purposes since they were booked as the repayment of an intercompany loan, the court found that the subsidiaries’ creditors did not have any expectations that the funds would be used for any other purpose than as directed by the parent.

An adventurous argument to defend the fraudulent transfer action may be to advance the theory of “collapsing” the series of transactions involved so they are viewed as a single transaction.

“A series of transactions may, under certain circumstances, be ‘collapsed’ and treated as a single transaction for the purpose of determining whether there has been a fraudulent conveyance.” In re Sunbeam Corp., 284 B.R. 355, 370 (Bankr. S.D.N.Y. 2002) citing HBE Leasing v. Frank, 48 F.3d 623, 635 (2nd. Cir. 1995)

“Courts have ‘collapsed’ a series of transactions into one transaction when it appears that the formal structure erected and the labels attached, the segments, in reality, comprise a single integrated scheme when evaluated focusing on the knowledge and intent of the parties to the transaction.” Id at 370.

This concept has been used primarily in the context of multi-step leveraged buyouts when analyzing whether the transaction was a fraudulent transfer, but it has been used in other contexts. Id. at 370. See In re Best Products Co., Inc., 157 B.R. 222, 229-30 (Bankr. S.D.N.Y. 1993) (collapsing intercompany lease used as a financing vehicle and treating loan to subsidiary as loan to parent): See also, Voest-Alpine Trading Corp. v. Vantage Steel Corp., 919 F.2d 206, 213 (3rd Cir. 1990) (collapsing series of transactions designed to deprive creditors of access to the debtor’s assets through foreclosure and transfer of assets to another corporation without adequate consideration.)

To this author’s knowledge, there are no reported decisions where this defense has been raised to defend a § 548 action involving a CCMS but it may have applicability under the broad standards quoted here. Perhaps what makes it most problematic, however, is identifying the seemingly non-linear series of transactions to collapse – e.g., the delivery of goods to the subsidiary, the use of those goods by the subsidiary to operate and generate revenues, the sweeping of the revenues into the parent’s account, and the payment of the subsidiary’s debts by the parent to maintain the operations of the subsidiary. But, if the argument were successful, any value given to the subsidiary in the collapsed transaction would arguably be value given to the parent and provide a meritorious defense.
IV. CONCLUSION

The development of centralized cash management systems allowing corporations to move cash across corporate boundaries for the mutual benefit of the common enterprise, often to the detriment of an individual corporation in the enterprise and its creditors, has outpaced the law’s ability to deal with the consequences, leading to unexpected and unfair results and windfalls to creditors with claims against the parent. Courts have often approved the continuation of centralized cash management systems without appreciating the negative consequences to the subsidiaries’ estates and have been reluctant to view the stripping of cash from insolvent subsidiaries as rising to the level of misconduct deserving application of constructive trusts or other remedies such as piercing the corporate veil to right the wrongs and windfalls created. Although the operations of cash management systems are often fairly characterized as constructive fraudulent transfers, the absence of actual fraud and the deference the courts often give to the legitimacy of a CCMS as a business tool have created obstacles to developing theories under existing law to allow the laws to catch up the commercial realities of business. Millions of dollars are being diverted from productive business uses to the cost and risk of uncertain litigation. Until the application of existing theories of law by the courts broaden or Congress passes remedial legislation, we will be forced to continue explaining to our clients ensnared in the traps of our making that Alice is not just in Wonderland, she roams our system of justice.