

Options for Increasing the Protection of Motor Carriers in Bankruptcy Proceedings

Prepared for the American Trucking Association, Inc.¹

By Robbin L. Itkin, Esq. & Katherine C. Piper, Esq.

I. INTRODUCTION

In the current market, carriers are increasingly at risk of being impacted by bankruptcy proceedings filed by shippers with whom they do business. Two issues appear to affect carriers the most: (i) having unpaid amounts due and owing at the time the shipper files for bankruptcy protection, thereby relegating the carrier to the role of an “unsecured creditor” in the shipper’s bankruptcy proceedings; and (ii) receiving payment from a shipper on account of antecedent debt prior to the shipper’s bankruptcy proceeding and, therefore, being subject to actions for turnover of such payments received under the “preference” provisions of the United States Bankruptcy Code (the “Bankruptcy Code”).

This paper² sets forth suggestions and strategies for addressing the two issues described above in terms of (i) proposed security interest provisions to be inserted for inclusion in contracts governing the relationship between the carrier and the shipper in an attempt to better protect the claims of carriers; (ii) possible strategies for carriers to assert and defend their rights as secured creditors in a shipper’s bankruptcy proceeding, and (iii) possible strategies for the defense of preference actions brought against carriers by shippers in bankruptcy.³

¹ This paper was prepared for the American Trucking Association, Inc. This paper does not constitute a legal opinion. No attorney–client relationship is created, nor is there any offer to provide legal services, by the publication and distribution of this paper. This paper is intended to be informative and does not constitute legal advice or counseling to any particular recipient hereof. The applicability and effectiveness of the issues and strategies outlined in this paper may depend on the particular circumstances of the given carrier. Accordingly, carriers should consult legal counsel before pursuing any of the general strategies outlined in this paper.

² This paper addresses the shipment of goods by domestic motor carriers only. It does not address the issues that may arise with respect to cross-border shipments, or domestic or international shipments that are handled jointly with other modes of transportation.

³ There are numerous ancillary issues associated with carriers and their rights under State and Bankruptcy Laws, which are not discussed in this paper. The purpose of this paper is to provide suggestions to improve carrier recoveries in shipper bankruptcy proceedings. This paper does not address possible issues that may arise under the specific facts and circumstances surrounding a particular carrier’s business dealings with a shipper or a particular shipper’s bankruptcy proceeding.

II. BRIEF SUMMARY OF THE CURRENT SITUATION AFFECTING CARRIERS' CLAIMS IN BANKRUPTCY

Carriers generally are entitled to a lien on all goods that they transport – commonly referred to as a carrier's lien. Traditionally, carriers' liens can be traced to common law. However, today most States have adopted some version of the Uniform Commercial Code that provides for carriers' liens through statute.⁴ A significant issue with statutory carriers' liens, however, is that they require *possession* of the goods for perfection of the lien. As such, in general a carrier's lien expires upon the carrier's delivery of the goods. *See, e.g.*, U.C.C. § 7-307(c) (“A carrier loses its lien on any goods that it voluntarily delivers ...”). Accordingly, when the carrier relinquishes possession of the shipper's goods and unpaid amounts remain due, the carrier loses its secured status and becomes a general unsecured creditor for such amounts due.

In addition, under most State statutes and Common Law, the carrier's lien attaches to the current goods being shipped *only* to the extent of the shipper's indebtedness to the carrier for that *particular* shipment. *See, e.g.*, U.C.C. § 7-307 (“A carrier has a lien on the goods covered by a bill of lading or in the proceeds thereof in its possession for charges *after* the date of the carrier's receipt of the goods for storage or transportation ...”) (emphasis added); 49 U.S.C. § 80109 (“A common carrier issuing a negotiable bill of lading has a lien on the goods *covered by the bill ...*”) (emphasis added). Thus, if the carrier is owed amounts from a previous shipment, the carrier generally cannot use the goods of the current shipment as security for the prior amounts due and owing.

Both of the foregoing problems are exacerbated if the shipper files for bankruptcy protection while money is owed the carrier for goods shipped as a result of credit extended to the shipper for some agreed upon period of time. If, at the time of the bankruptcy filing, the carrier is no longer in possession of the goods, the carrier may find itself treated as a general unsecured creditor in the shipper's bankruptcy proceeding – entitled to payment only after all secured, administrative and priority creditors are paid, and then perhaps, at best, only entitled to receive pennies for every dollar owed. If the carrier does have possession of the goods at the time of the shipper's bankruptcy, the carrier may be “undersecured” because the shipper may have failed to pay prior invoices when due and the carrier's lien may not secure such prior invoices, thereby rendering the carrier partially secured and partially unsecured for the amounts due. Finally, the carrier may have obtained payment from the shipper on outstanding debt immediately prior to the shipper's bankruptcy filing, leaving the carrier subject, perhaps years later, to a preference lawsuit by the shipper seeking to recover the pre-bankruptcy payments that the carrier received.

The discussion below is intended to offer some strategies to better protect carriers should they need to assert and defend their rights in a shipper's bankruptcy proceeding.

⁴ The extent, validity and perfection requirements of a carrier's lien could vary somewhat from State to State. A State by State analysis was not completed as part of this paper. Accordingly, nothing in this paper should be interpreted as providing advice or information regarding the particular requirements of any one State.

III. SECURITY INTEREST PROVISIONS TO PROVIDE CARRIERS WITH GREATER PROTECTION

In bankruptcy, a creditor who has secured claims has greater leverage, and a greater likelihood of recovering on its claims, than a creditor who has unsecured claims. This is because in the priority scheme for distribution on claims, creditors holding valid, perfected and enforceable security interests are paid first on proceeds of their collateral. In addition, to the extent a creditor is fully secured, such creditor, generally, is not subject to a preference action.

The current form of the Model Truckload Motor Carrier/Shipper Agreement (“Model Contract”) does not appear to grant any security interest to the carrier for transporting goods of a shipper. Presumably the Model Contract is silent regarding a carrier’s lien rights because carriers’ liens arise under State Law, Common Law and Federal Law (as applicable) without the need for contractual language setting forth the carrier’s lien rights. However, as set forth above, all such liens may have weaknesses in their protection for carriers in the event of a shipper’s bankruptcy.

Accordingly, to the extent feasible, it appears prudent for carriers to bolster their lien rights by including a security interest provision in their shipping contracts.⁵ Below are some proposals for security interest provisions.⁶ Please note that this paper assumes a formal written contract between the carrier and the shipper and therefore are framed as proposed contract provisions. It further assumes that carrier concern about security for payment of freight charges is likely to be greatest where high volume shipments for a single shipper of the type typically handled under such contract arrangements are involved. Nonetheless, a significant percentage of carrier shipments are handled under common carrier tariffs where the only “contract” is the one that arises by virtue of the issuance of a bill of lading incorporating carrier tariff provisions. This paper does not consider whether there are any special considerations or concerns that might apply in translating the issues addressed here to the common carriage/tariff setting.

A. Security Interest in All Assets of the Shipper to Secure Past and Future Debt

Certainly the greatest protection for carriers, other than payment in full in advance of shipment under their contracts, is to have a continuing security interest in all of the shipper’s

⁵ To ensure the maximum protection, carriers should include the security interest provisions not only in their shipping contracts, but also in all of their bills of lading or other documentation under which they operate. This consistent approach will ensure that a Bankruptcy Court does not have to interpret any conflicts between the shipping contract and the other documentation executed by the parties.

⁶ Because carriers and shippers operate in many different jurisdictions, this paper addresses Bankruptcy Law remedies in general and proposes various general contract provisions for enhanced protection in carrier contracts. Carriers should consult with counsel regarding the feasibility, enforceability and appropriate method of perfection of the additional security interests under applicable State Law.

assets, not only the goods in transport and/or their proceeds,⁷ as security for payments due. Language to this effect may include:

As security for any and all existing and future obligations of [SHIPPER/CUSTOMER] to [CARRIER], including any and all claims for charges, expenses or advances incurred by [CARRIER] in connection with any shipment or transaction of the [SHIPPER/CUSTOMER], and whether or not presently contemplated by [SHIPPER/CUSTOMER] and [CARRIER], [SHIPPER/CUSTOMER] hereby grants to [CARRIER] a continuing lien on and security interest in any and all tangible and intangible personal property of [SHIPPER/CUSTOMER] wherever located, whether now owned or hereafter acquired or in which [SHIPPER/CUSTOMER] may now have or hereafter acquire an interest, including, without limitation, fixtures, equipment, goods, inventory, money, accounts, instruments, chattel paper, general intangibles (including intellectual property), investment property, documents, deposit accounts, letter-of-credit rights (including, for avoidance of doubt, any and all goods and documents relating thereto now or hereafter in [CARRIER's] possession, custody or contract or en route), and, to the extent not listed above as original collateral, any and all proceeds and products of the foregoing (all of the foregoing, the "Collateral"). The continuing lien on and security interest in the Collateral granted by this paragraph shall be in addition to any and all liens and security interests arising under applicable statutory or common law.

It is important to note that in order to ensure that the security interest granted above is both (1) enforceable, and (2) has as high a priority as possible in comparison to the shipper's other obligations, carriers should consult with counsel and diligently follow the applicable security interest perfection requirements in their applicable State(s). Generally, perfection will require filing a financing statement in the State where the shipper is organized.⁸ Otherwise, the security interest will not be recognized in a bankruptcy proceeding or given priority over unsecured creditors.

⁷ There may be significant variance in the liens provided to carriers under various State Laws with respect to proceeds. For example, there are States where a statutory lien on proceeds is expressly granted to a carrier in possession of goods. *See, e.g.*, Ala. Code § 7-7-307(a) ("A carrier has a lien on the goods covered by a bill of lading **or on the proceeds thereof in its possession** for charges after the date of the carrier's receipt of the goods for storage or transportation ...") (emphasis added). However, there are other States where no statutory lien on proceeds is expressly granted to a carrier. *See, e.g.*, Fla. Stat. Ann. § 677.307(1) ("A carrier has a lien on the goods covered by a bill of lading for charges subsequent to the date of its receipt of the goods for storage or transportation ...").

⁸ Financing statement forms are generally available from, and must be filed with, the Office of the Secretary of State in the State where the shipper is organized. Among other things, the financing statement must set forth a description of the collateral in which the creditor has an interest. Please note that each State may have particular administrative requirements for the processing and filing of financing statements, which if not followed precisely, could jeopardize the enforceability of the financing statement. Accordingly, carriers are cautioned to consult with counsel when initially filing financing statements to ensure that all required procedures are meticulously followed.

While offering the most protection, a blanket security interest in all of the shipper's assets may prove the most difficult to procure of the proposed contract provisions contained in this paper. It is likely that a blanket security interest in favor of a carrier will be second or even third in priority as compared to the shipper's existing other secured debt, in particular the shipper's senior lender.⁹ Additionally, it is possible that the shipper's financing arrangements will prohibit the shipper from granting any security interest (even a junior security interest) in its assets.¹⁰ Accordingly, a blanket security interest, like each proposed security interest provision contained in this paper, will be subject to negotiation between the carrier and the shipper. However, if obtained and properly perfected, carriers will be able to use such security interests to bolster their rights in any bankruptcy proceeding filed by a shipper.

B. Security Interest in Goods in Transport to Secure Past and Future Debt

If unable to obtain a blanket security interest in all of the shipper's assets, a proposed security interest that may be more amenable to shippers, but which does not provide as much protection as the option above, is one that provides that the goods in a carrier's possession (as opposed to all of the shipper's assets) secure not only the obligations associated with that particular shipment, but all past obligations as well. For example, if Carrier is holding goods valued at \$10 million and Shipper owes Carrier \$500,000 for that shipment and \$3 million for prior shipments, Carrier would be oversecured if the value of its security interest in the goods covered both existing and future obligations and therefore would not be an unsecured creditor for any amounts due. Accordingly, carriers may want to negotiate the addition of some version of the following language in their contracts:

As security for any and all existing and future obligations of [SHIPPER/CUSTOMER] to [CARRIER], including any and all claims for charges, expenses or advances incurred by [CARRIER] in connection with any shipment or transaction of the [SHIPPER/CUSTOMER], and whether or not presently contemplated by [SHIPPER/CUSTOMER] and [CARRIER], [SHIPPER/CUSTOMER] hereby grants to [CARRIER] a continuing lien on and security interest in any and all property of [SHIPPER/CUSTOMER] (including

⁹ It is worthy of note that, while the security interest provisions proposed herein provide for security interests in proceeds as well as underlying assets, some shippers may be reluctant to grant security interests in proceeds due to financing arrangements that may prohibit such security interests. Also, carriers need to keep in mind that if a shipper grants security for amounts past due and then the shipper files bankruptcy within 90 days, that security interest could be avoided as a preference under the Bankruptcy Code. Thus, timing is a critical issue.

¹⁰ In particular, most secured (and even unsecured) debt financing documents contain a negative pledge that prohibits additional liens or security interests in the debtor's assets. Negative pledges nearly universally have an exception that allows statutory liens. However, the exception is generally limited to liens that arise in the ordinary course of business, securing a commercial obligation incurred in relation to the property covered by the lien. Consequently, a carrier's lien to secure the carrier's charges for carrying a particular lot of goods does not violate the typical negative pledge. However, a security interest broader than the typical carrier's lien – for example, one that secures all the outstanding obligations, or that covers all the property of a shipper and not just that which is in possession of the carrier – may violate the negative pledge.

_____ [list as specific as possible the goods being transported], any and all goods and documents relating thereto) now or hereafter in [CARRIER's] possession, custody or contract or en route, and any and all proceeds and products of the foregoing (all of the foregoing, the "Collateral"). The continuing lien on and security interest in the Collateral granted by this paragraph shall be in addition to any and all liens and security interests arising under applicable statutory or common law.

The proposed language above is substantially similar to language that was tested in the bankruptcy case, *In re Paul Harris Stores, Inc.*, 342 B.R. 290 (Bankr. S.D. Ind. 2006). In that case, the carrier was sued by the shipper/debtor to recover alleged preference payments made to the carrier during the 90 days prior to the bankruptcy filing. The carrier defended itself by arguing that there was never a preference because at all times relevant to the payments it received, the carrier was oversecured due to its possession of goods valued in excess of the indebtedness owed by the shipper/debtor. The Bankruptcy Court agreed, interpreting language similar to that contained above as granting the carrier a general lien on all assets in its possession for all indebtedness of the shipper/debtor.

Such proposed language expands a carrier's lien on particular goods to secure past unpaid invoices (up to the value of the goods in the carrier's possession) as well as the invoices associated with the subject goods.¹¹ This proposal may be met with less resistance from shippers in contract negotiations, because it applies to goods already in the carrier's possession. Of course, shippers may want to limit the security interest to only cover the current obligations and not prior obligations, so a negotiation concerning the scope of the security interest certainly may take place. Further, as already discussed above, any additional security interest may be met with resistance due to prohibitive provisions in the shipper's debt financing documents.

C. Addition of Default Provisions

Carriers also may be able to better protect their claims if their contracts with shippers contained broader default remedies. The current Model Contract does not appear to include express "Events of Default" or "Default Remedies." Therefore, in order to ensure that a carrier has the utmost ability to enforce its security interests,¹² it may be wise for its contracts to

¹¹ It is worthy of note that some States may provide for such a continuing lien by statute. See, e.g., *In re DAK Indus., Inc.*, 195 B.R. 129 (Bankr. C.D. Cal. 1995). In *DAK*, the applicable California statute allowed an ongoing carrier's lien for past due invoices to attach to future shipments in the carrier's possession, so long as the shipper was notified in writing of the continuing lien. The *DAK* Court concluded that the inclusion of such written notice in the carrier's standard freight bills was sufficient under the statute to establish a properly perfected security interest in the possessed goods for both past-due and current carrier charges. However, in the *DAK* case, the court also concluded that such carrier's lien was *junior* to the other liens on the goods – namely the liens of the shipper's secured lender. The *DAK* opinion is illustrative of how important it is for carriers to properly perfect their security interests under State Law and to understand the lien priority scheme in their applicable State(s).

¹² In particular, enforcement of a security interest in proceeds can require significant effort, including tracing the proceeds related to specific collateral. This paper does not address the specific State requirements for enforcement or foreclosure of security interests.

(a) clearly delineate what events would constitute defaults under any contract with a shipper, (b) provide the specific remedies desired, and (c) include that upon any such default, the carrier shall have any and all remedies available to a secured party under all applicable laws.

Events of default can include the failure by a shipper to adhere to certain provisions in the contract, including payment terms, but they can also be structured so that the carrier can better monitor the financial situation of the shipper. A determination regarding what default provisions may be appropriate in a given contract will heavily depend upon, among other things, the history and course of dealings among the parties, the relationship of the parties, and the financial status of the shipper. However, by way of example, some events of default could include:

- failure by the shipper to make any payment under the contract when due, or failure to make such payment after a specified notice and limited cure period;
- failure by the shipper to observe or perform any term or condition of the contract;
- failure by the shipper to generally pay its debts when due or insolvency of the shipper;¹³
- the commencement by the shipper of a voluntary proceeding, or the commencement of an involuntary proceeding with respect to the shipper, under any applicable U.S. or state bankruptcy, insolvency, reorganization or similar law or of any other case or proceeding to adjudicate the shipper insolvent or bankrupt; and¹³
- failure of the shipper to comply with specified benchmarks or triggers that would allow the carrier to monitor the shipper's financial status and address any issues and potentially enforce its remedies in advance of 90 days before any bankruptcy filing.

As discussed above, a contract that contains specific events of default should also contain a provision setting forth the specific remedies available to the carrier in the event of a default by the shipper. As set forth above, any such remedies should be *in addition to* any and all remedies available to a secured party under all applicable laws. Examples of remedies in the event of a default by a shipper may include:

- immediate acceleration of all amounts due and owing to the carrier such that all amounts shall be immediately due and payable to carrier;

¹³ Carriers should be aware that the current Bankruptcy Code prohibits the enforcement of such a default provision against a debtor after a bankruptcy filing as an *ipso facto* clause. However, an *ipso facto* clause may be enforceable outside of the bankruptcy context. Further, over time the Bankruptcy Code has been amended to allow certain parties to enforce their rights under *ipso facto* provisions. Accordingly, inclusion of such terms in a contract can offer some level of protection in the event that the Bankruptcy Code is further amended in the future.

- termination of the contract (either automatic termination or the right to terminate the contract after a specified notice and limited cure period);
- termination of all credit extended to shipper and conversion of all future shipments to cash on delivery or payment in advance.

As set forth above, the default provisions in the contract will need to be tailored to the particular facts and circumstances affecting the negotiation of the contract. In addition, because default remedies will vary State by State, carriers should again consult counsel to determine the remedies available under the applicable State Law and the appropriateness of such remedies for the carrier's applicable contract negotiation.

IV. ADDITIONAL BANKRUPTCY STRATEGIES AVAILABLE TO CARRIERS THAT ARE SECURED

Once a carrier has positioned itself as a secured creditor, either through any of the foregoing methods, or through retaining possession of the goods and asserting its carrier's lien, a carrier has several options available if a shipper files for bankruptcy.

A. Retain Possession of the Goods Despite the Automatic Stay

As most carriers are aware, the filing of a bankruptcy petition by a shipper immediately operates to stay actions against the shipper and any of its assets under Section 362 of the Bankruptcy Code – referred to as the “automatic stay.” However, Section 362(b) of the Bankruptcy Code provides that the automatic stay does not stay “any act to perfect, or to *maintain or to continue the perfection of*, an interest in property to the extent that the [debtor's] rights and powers are subject to such perfection . . .”¹⁴ 11 U.S.C. § 362(b)(3) (emphasis added). Accordingly, a carrier that maintains possession of the goods under transport in order to *maintain or continue* perfection of its State Law carrier's lien may be able to successfully defeat any charge by the shipper/debtor that it has violated the automatic stay through continued possession of the goods.¹⁵ Such a carrier may assert that it is entitled to continue to hold the goods in its possession until it receives payment of all amounts covered by its carrier's lien (up to the value of the goods the carrier is holding).

¹⁴ This section of the Bankruptcy Code has a concomitant section – Section 546(b) – which provides that the powers of the debtor to avoid certain transactions are subject to “any generally applicable law that “provides for the *maintenance or continuation* of perfection of an interest in property to be effective against an entity that acquires rights in such property before the date on which action is taken to effect such maintenance or continuation.” 11 U.S.C. § 546(b)(1)(B).

¹⁵ See, e.g., *Hayden v. Wells (In re Hayden)*, 308 B.R. 428, 432 (9th Cir. B.A.P. 2004) (“[I]f state law provides that a creditor's security interest is superior to the rights of any entity obtaining its interest in the property prior to the date the creditor takes action to maintain or continue perfection of its, the creditor's postpetition act to maintain or continue perfection of a lien does not violate the automatic stay.”); *Boggan v. Hoff Ford Inc.*, 251 B.R. 95 (B.A.P. 9th Cir. 2000) (finding in the non-carrier context, that maintenance of a possessory lien through continued possession does not violate the automatic stay because of the exception contained in 11 U.S.C. § 362(b)(3)).

This is not to say, however, that the shipper/debtor or other creditors in a shipper's bankruptcy will not (a) put pressure on the carrier to release the goods, or (b) seek to obtain relief from the Bankruptcy Court compelling the release of the goods to the shipper/debtor. Should either or both of those things occur, however, the carrier is not without remedy, as set forth below.

B. Demand for Payment in Full or Adequate Protection

If at the time of the bankruptcy filing the carrier is secured, either through possession of the goods and a carrier's lien, or through the proper grant and perfection of a security interest as suggested above, the carrier may demand either payment in full or "adequate protection" from the shipper/debtor as described below.

First, if the carrier is secured by a carrier's lien and has maintained possession of the goods, the carrier may demand payment of all amounts due (up to the value of the goods the carrier is holding) from the shipper/debtor in exchange for delivery of the goods. This demand is premised on the fact that through possession the carrier is fully secured up to the value of the goods and, therefore, the carrier has a valid, perfected, senior security interest in the goods,¹⁶ which under the Bankruptcy Code must be satisfied by (a) payment in full, or (b) allowing the carrier to foreclose on its security interest in the goods in its possession. Accordingly, the carrier may argue that turnover of the goods without payment would be akin to stripping the carrier's lien away and leaving the carrier unsecured – therefore, payment in full is appropriate.

Second, if the foregoing demand is refused by the shipper/debtor and the Bankruptcy Court compels the carrier to deliver the goods (which it is empowered to do), or if the carrier does not have possession of the goods, but has a properly perfected security interest in the assets of the shipper/debtor, then the carrier may demand "adequate protection" from the shipper/debtor. Sections 361 and 363 of the Bankruptcy Code contain the concept of adequate protection. They provide that a party with an interest in property proposed to be used by a debtor can demand "adequate protection of such interest" from the debtor. 11 U.S.C. § 363(e). Adequate protection generally comes in the form of a replacement lien on assets of the debtor, including proceeds from the sale of goods, but it may also come in the form of partial, progress or interest payments from the debtor. *See* 11 U.S.C. § 361.

A carrier facing the scenario where it is being forced to relinquish possession of the goods, may be justified in demanding a replacement lien in the assets and/or cash accounts of the shipper/debtor, or partial payments from the shipper/debtor. The carrier may argue that any replacement lien granted by the Bankruptcy Court is senior to all other liens of the shipper/debtor – a superpriority lien – so that the carrier is entitled to priority payment from the shipper/debtor's bankruptcy estate. A carrier that does not have the goods in its possession, but has another valid

¹⁶ Since a carrier's lien requires possession, it is generally accepted as superior in priority to other potential liens on the goods in transit. *See* UCC §9-333(b) ("A possessory lien on goods has priority over a security interest in the goods unless the lien is created by a statute that expressly provides otherwise."); *but see DAK Indus., Inc.*, 195 B.R. 129 (Bankr. C.D. Cal. 1995) (holding that the carrier's lien at issue was a perfected security interest, but was junior in priority to the liens held by the shipper's lenders).

perfected security interest, may demand that the shipper/debtor make some partial payments to the carrier to preserve its security interest.¹⁷

A demand for adequate protection is likely to be met with some level of resistance and will be subject to negotiation with the shipper/debtor – and possibly litigation before the Bankruptcy Court. It may require that the carrier prove that the carrier’s security interest is valid, properly perfected and that the value of the collateral is not less than the obligations to the carrier. However, if the carrier is properly secured, it should be entitled to and should demand adequate protection in some form under the Bankruptcy Code depending on the facts and circumstances of the case.

C. Request the Entry of an Order Protecting Carriers

In addition to the above, certain shipper/debtors may be in a position to request that the Bankruptcy Court enter an order allowing the shipper/debtor to pay outstanding amounts due to carriers for goods in transit. These motions (often referred to as “Shipping Motions”) generally arise in cases where there is a large debtor that relies heavily on the transport of goods for the operation of its business. Shipping Motions generally argue that carriers are secured creditors because of their various liens on the goods in transit and, therefore, the debtor should be authorized to pay outstanding amounts due to carriers at their discretion. A Shipping Motion, if granted, allows carriers to be paid prepetition amounts outstanding, which allows carriers to move forward with their operations without the concern that they will never receive payment on their claims.

However, a Shipping Motion also generally allows the debtor to reexamine the carrier’s secured status at a later date and, if appropriate, later attempt to recover any amounts paid to the carrier inadvertently when such carrier was not properly secured. Therefore, if a carrier finds that it is one of many carriers effected by a particular debtor’s bankruptcy proceeding, joining with other carriers to encourage the debtor to obtain relief from the Bankruptcy Court under the guise of a Shipping Motion may be a good option, but carriers should make sure their security interests are all properly perfected to ensure that such security interests are not attacked later on by the shipper/debtor.¹⁸

¹⁷ Depending upon the carrier’s specific circumstances there may be other avenues to pursue, however, each negotiation will be specific to the facts and circumstances of the case.

¹⁸ In addition, carriers can seek to have the shipper/debtor assume their contracts pursuant to Section 365 of the Bankruptcy Code. This section allows a debtor to choose to assume or reject executory contracts (contracts with performance due on both sides) with creditors. In order to assume a contract, the debtor must “cure” the defaults under the contract. This cure generally includes payment of all amounts due under the contract, including prepetition amounts due. Carriers should note, however, that the debtor generally has until confirmation of a plan of reorganization to make determinations about the assumption or rejection of its executory contracts, despite a creditor’s ability to move the court for an earlier determination of assumption or rejection. Assumption of the carrier’s contract also reduces, and in some circumstances eliminates, the risk that the carrier will later be subject to a preference action by the shipper/debtor.

V. CERTAIN PREFERENCE DEFENSES AVAILABLE TO CARRIERS

After a shipper/debtor has filed for bankruptcy, carriers that have been paid prior to the bankruptcy filing may find themselves the subject of lawsuits by the shipper/debtor demanding the return of certain payments made to the carriers prior to the bankruptcy filing – such lawsuits are commonly referred to as preference actions. For the shipper/debtor to be successful in a preference action against the carrier, it must demonstrate that the payment¹⁹ received by the carrier (1) was for the carrier's benefit, (2) was on account of an antecedent debt, (3) was made while the debtor was insolvent,²⁰ (4) was made on or within 90 days before the bankruptcy filing, and (5) enables the carrier to receive more than it would receive from the shipper/debtor through a chapter 7 liquidation. 11 U.S.C. § 547(b). There are various defenses to preference actions. Two common defenses are discussed for the purposes of this paper.²¹

A. Secured Creditor Defense

Where a creditor has a valid lien or security interest, a payment on such secured indebtedness does not constitute a preference. Bankruptcy Courts have found that so long as the carrier was not paid more than the value of the goods in its possession at the time of the payment, that the payment is not a preference under 11 U.S.C. § 547(b). This is because while in possession of the goods a carrier is a secured creditor, by virtue of its carrier's lien, up to the value of the goods. Accordingly, a carrier that is paid cash on delivery, for example, has a valid preference defense if the payment amount received was less than the value of the goods in the carrier's possession at the time of payment *and* if the goods in the carrier's possession were security for the payment received.²² This is because such a properly secured carrier with a carrier's lien did not receive more than it would have received in a chapter 7 liquidation of the shipper/debtor.

Similarly, if a carrier has a valid, perfected and enforceable security interest in other assets of the shipper, as suggested above, and the carrier is paid within the preference period the carrier has a valid preference defense if the payment amount received was less than the value of

¹⁹ The grant of a new security interest during the preference period as security for antecedent debt can also qualify as a preference. Accordingly, if carriers add the security interest provisions suggested above to their contracts with shippers while there is debt outstanding, they should be aware of the risk that a shipper/debtor could attack the carriers' secured status with respect to the antecedent debt outstanding at the time of the grant.

²⁰ For the purposes of preference actions, Bankruptcy Courts presume the debtor was insolvent during the 90 days preceding the bankruptcy filing.

²¹ Because each prepetition payment made to a carrier is subject to its own particular set of facts and circumstances, this paper only discusses the most common defenses, generally, that may be available to carriers. Carriers that are sued in a preference action should immediately consult bankruptcy counsel to ensure that all appropriate defenses are raised.

²² *In re Paul Harris Stores, Inc.*, 342 B.R. 290, (294 Bankr. S.D. In. 2006) (holding "[b]ecause [the carrier] was fully secured at the time the prepetition payments were made, [the shipper] cannot establish that [the carrier] received more, by virtue of such payments, than it would have received in a chapter 7 liquidation," and, therefore, the preference action failed).

the security interest securing the payment. This is because, again, as a properly secured creditor, the carrier did not receive more than it would have received in a chapter 7 liquidation of the shipper/debtor.²³

B. Ordinary Course of Business Defense

Many carriers have a statutory defense to a preference action under 11 U.S.C. § 547(c)(2) to the extent that the payment the carrier received was “in the ordinary course of business” with the shipper/debtor. Generally, this defense requires a showing that the payment received was within the terms of the contract under which the carrier and shipper were operating and that it followed the normal business practices established between the carrier and the shipper – for example, if the carrier was to be paid within 15 days after delivery, and the carrier was always paid 15 days after delivery by the shipper at issue.

However, many carriers may not enforce stringent payment terms with shippers – allowing payments within 15 days under one invoice, within 45 days under the next, and so on. Such an erratic payment history with a shipper/debtor can hurt the carrier’s defense under the “ordinary course of business theory.” Therefore, carriers should be diligent in enforcing their contract terms and payment requirements with shippers. Such diligence will lay the foundation for a viable defense by the carrier in the event that a preference action is filed.

Both of the above defenses require diligence on the part of the carrier. Carriers should maintain good records of their dealings with shippers, in particular payment terms and payment history. Further, carriers should assiduously enforce the payment terms under their contracts with shippers. Finally, carriers may be best served to ensure that at any given time the value of the goods in their possession exceeds the indebtedness owed by the shipper. By undertaking these steps, carriers will increase their chances of defeating a shipper initiated preference action.

VI. CONCLUSION

While the bankruptcy of a shipper is not an ideal circumstance, short of being paid in advance, which would be the best result and would eliminate all of the issues discussed herein, carriers can enhance their potential recoveries from a shipper’s bankruptcy estate by obtaining and perfecting security interests on property of the shipper as security for the payments due. Further, as discussed herein, other contractual protections, such as explicit default provisions and provisions that enable the carrier to better monitor the financial situation of the shipper, may be appropriate as well.

However, despite a carrier’s best efforts to protect itself, it may still be the subject of a preference action by a shipper/debtor, sometimes years after the alleged preference payment was received by the carrier. This paper offers some suggestions for carriers to better defend

²³ To ensure that this defense has the highest chance of success, carriers holding security interests in assets other than those in their possession need to make certain that their security interests have the highest priority possible – preferably first priority – as compared to the shipper’s other secured creditors. This will lessen the risk that the value of the security will not be sufficient to support the amounts paid to the carrier.

themselves if they are the subject of such actions and some proactive steps that carriers can take to protect themselves *before* a preference action is filed. The more diligent that carriers are in attempting to take proactive measures to protect themselves, the more likely they will be able to assert and defend their rights in the event that a shipper with whom they do business files for bankruptcy.

If you have any questions regarding this paper or general bankruptcy matters, please contact Robbin L. Itkin, Esq. (ritkin@steptoe.com) or Katherine C. Piper, Esq. (kpiper@steptoe.com), members of the Business Solutions Department and the Business & Financial Restructuring Group of Steptoe & Johnson LLP.