NAVIGATING MOTOR CARRIER INTERESTS IN BANKRUPTCY

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Introduction

The transportation industry has not been immune from the uneven economic climate. Transportation entities are increasingly seeking bankruptcy protection. Bankruptcy strikes fear in transportation lawyers and motor carriers alike. For the lawyer, the fear is how to properly advise the client while treading through the uncertain terrain of the Bankruptcy Code. For the client, the fear is twofold: (1) will they receive payment from the debtor, and (2) will they be making payment to the debtor.

The intent of this paper is to address methods of recovery for motor carriers after the bankruptcy filing of a transportation entity and the applicable defenses for the motor carrier when the debtor seeks the return of monies paid within 90 days of the bankruptcy filing.

A. What are the Most Immediate Avenues of Recovery of Monies?

Bankruptcy is a cruel business. Your client may have some idea of a debtor's cash flow problems prior to bankruptcy, however the likelihood of them being informed where and when of the actual filing is not likely. When bankruptcy is filed, the motor carrier's highest priority is getting paid for services being provided and those previously provided.

Often at the time of filing, a motor carrier has shipments in transit. The carrier has a lien upon the goods for its freight charges.[1] Delivery should not be made until payment of the freight charges for the load in transit. A carrier cannot refuse delivery on the basis that monies are

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[1]See *Fulton v. Allard's Moving & Storage*, 660 A.2d 1096 (1995); U.C.C. §7-307 (2002); 49 U.S.C. 13707.

owed on prior shipments.[2] The impact of non-delivery by a motor carrier is of great concern to the debtor attempting to reorganize.

At the time of filing, a motor carrier creditor may be able to receive some, if not all, of their pre-petition freight charges owed if they are determined by the debtor, as approved by the bankruptcy court, to be critical to the debtor's survival. This is commonly referred to as the doctrine of necessity. The debtor understands that as a result of the commencement of a Chapter 11 case, that the motor carrier may hold goods for delivery to debtor as of the petition date and may refuse to release such goods pending payment, thereby disrupting debtor's operations. For the debtor, it is imperative that its operations continue without disruption caused by delivery delays. Failure to pay outstanding amounts may result in motor carriers being unwilling to ship future goods. To the debtor, establishing a new distribution network is time consuming and costly. Disruption to a debtor's current shipment and distribution network could have substantial adverse effects on debtor's operations and chances for a successful reorganization.

To prevent delays and disruptions from occurring, the debtor will often contact critical motor carriers to discuss continued service during reorganization. This is the time in which your carrier client holds the most leverage in getting its pre-petition freight charges paid. Generally, a debtor submits to the court that the total amount to be paid under the critical relationship is de minimus compared with the importance and necessity of the service provided and the losses debtor may suffer if not approved.

In a long line of well established cases beginning with railroad reorganizations dating back to the 1800s, courts have consistently permitted post-petition payment of pre-petition obligations where necessary to preserve or enhance the value of a debtor's estate for the benefit

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[2]See U.C.C. §7-307(1).

of all creditors.[3] The decisions to permit the payment of pre-petition obligations post-petition have been supported by the "doctrine of necessity" also referred to as the "necessity of payment" principle.[4]

The "necessity of payment" doctrine, as it has developed since its original enunciation, teaches no more than, if payment of a claim which arose prior to reorganization is essential to continued operation, payment may be authorized, even if it is made out of the corpus.[5]

To the extent a motor carrier has the prior business rapport with the debtor, this is the easiest and most efficient way to obtain some if not all of the pre-petition monies owed. The caveat, of course, is that in turn for payment, the motor carrier will have to continue to provide services to the debtor during their reorganization. The debtor will have to make payment of post-petition services within the ordinary terms. There is some risk. It is imperative that the motor carrier keep careful tabs on the debtor's payments making sure they are current in post-petition in the event of a later conversion to Chapter 7. One way to protect your client and avoid further risk is to negotiate with the debtor for prepayment for freight services rendered.

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[3]See *Miltenberger v. Logansport Railway Co.*, 106 U.S. 286, 311-312 (1882). (Payment of pre-receivership claim prior to reorganization permitted to prevent "stoppage of ... [crucial] business relations.") *Gregg v. Metropolitan Trust Co.*, 197 U.S. 183, 187 (1905). (The payment of the employees of the railroad is more certain to be necessary in order to keep in running than the payment of any other class of previously incurred debt.) *In Re: Gulf Air, Inc.*, 112 B.R. 152 (Bankr. W.D.La. 1989).

[4]See *In Re: Columbia Gas System, Inc.*, 171 Br. 189, 192 (Bankr. D.Del. 1994) (Necessity of payment doctrine applies where payment is essential to continued operation of business.)

[5]See *In Re: Lehigh and New England R. Co.*, 657 F.2d 570 (3rd Cir. 1981).

B. Avenues of Recourse

Provided that dealing with the debtor directly for payment of services in route at the time of bankruptcy and negotiating with the debtor does not result in a satisfactory result, the next logical step is to explore other avenues of recourse.

If the debtor was operating as a property broker, the easiest initial step is to file on their surety bond or trust fund. A property broker must be registered with the Federal Highway Administration and post $10,000.[6] The surety bond or the trust fund is required to insure the financial responsibility of the broker by providing for payments to shippers or motor carriers if the broker fails to carry out its contracts, agreements or arrangements for the supply of the transportation by authorized motor carriers.[7] The bond or the trust fund, since it is not controlled by the property broker, is generally not part of the debtor's estate. Admittedly, the posted bond or trust fund does not often cover the outstanding freight charges, however failure to make a claim could deprive your client of some payment.

The carrier may also have recourse to the shipper on prepaid or collect shipments provided Section 7, the nonrecourse provision of the bill of lading contract, has not been executed.[8] It is well established that a bill of lading is the contract of carriage between the

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[6]See 49 U.S.C. 13904(d); 49 C.F.R. 387.307.

[7]See 49 C.F.R. 387.307(b); *Milan Express Co., Inc. v. Western Surety Co.,* 792 F. Supp. 571 (M.D.Tenn. 1992).

[8]See *Ranger Transportation v. Walmart Stores*, 903 F.2d 1185 (8th Cir. 1990); *Southern Pacific Transportation Co. v. Commercial Metals*, 456 U.S. 336 (1982); *Bestway Systems, Inc. v. Gulf Forge Co., et al.*, 100 F.3d 31, 34 (5th Cir. 1996); *Missouri Pacific Railroad Co. v. Center Plains Industries, Inc.*, 720 F.2d 818, 819 (5th Cir. 1983).

shipper and a carrier and that its terms and conditions bind all parties.[9] The bill of lading contract which is issued at the time the shipment is picked up, establishes a written bilateral contract. A carrier is defined on the uniform bill as the person in possession and control. The carrier is obliged to deliver the shipment to the intended destination with reasonable dispatch and assumes a direct statutory obligation for the safe delivery of the goods.[10] In return for this statutory duty, the consignor, and the consignee, upon delivery, oblige to pay carrier's freight charges.[11] The statutory duties and obligations of shippers and carriers cannot be modified except by express written waiver.[12] It follows that a carrier has a direct cause of action against the consignor or consignee for payment.[13] The bill of lading contract establishes unique contractual duties and requirements upon the consignor or beneficial owner of the goods to insure that the carrier has been paid for its services.[14]

Those who represent shippers often contend that to the extent that they have already paid the freight charges to the bankrupt entity, that the carrier is estopped from pursuing recourse to it. It must be a motor carrier's position that while it may have extended credit to the forwarder

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[9]See *Southern Pacific Transportation Co. v. Commercial Metals*, 456 U.S. 336 (1982); *Illinois Steel v. B&O Railroad.* 320 U.S. 508 (1944); *Bestway Systems. Inc. v. Gulf Forge Co.. et al.*, 100 F.3d 31, 34 (5th Cir. 1996).

[10]See 49 U.S.C. 14706.

[11]See 49 U.S.C. 13706(a), 49 U.S.C. 13707.

[12]See 49 U.S.C. 14101(b).

[13]See *Missouri Pacific Railroad Co. v. Center Plains Industries, Inc.*, 720 F.2d 818, 819 (5th Cir. 1993); *Southern Pacific Transportation Co. v. Commercial Metals,* 456 U.S. 336 (1982).

[14]See *Pittsburgh C&L Railroad v. Fink*, 250 U.S. 577, 581 (1919); *Strachan Shipping Co. v. Dresser Industries, Inc.*, 701 F.2d 483 (5th Cir. 1983).

(broker or other intermediary), there is no economically rational motive for the carrier to release the shipper from its freight charge liability.[15]

In situations where it can be determined that the shipper or consignee has not paid the debtor for the freight services, an aggressive approach is a must.

Many shippers or consignees will pay the underlying carrier for freight services rendered, however many will seek an indemnification and hold harmless if the debtor's estate seeks recovery of the same monies at a later date. For the carrier, the immediate payment is probably worth the risk of future litigation, especially in instances where the debtor was acting as a property broker or other form of conduit. Understanding the avenues of collection is only half of the battle. Equally important is grasping the concepts in defending actions instituted by the debtor.

C. Defending the "Popular" Preference Action

One of the most frustrating concepts for a motor carrier client to comprehend is the preference lawsuit, which usually raises its ugly head close to two years after the initial bankruptcy order for relief.[16] Trustees for the bankrupt entity seek to recover certain monies paid to underlying motor carriers within 90 days of the bankruptcy filing (the preference period) for proper distribution among all the debtor's creditors.[17]

When the bankrupt entity is/was licensed as a motor carrier, freight forwarder, or property broker, the first step is to determine which hat the entity was wearing in relationship to your

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[15]See *National Shipping Co. of Saudi Arabia v. Omni Lines*, 106 F.3d 1544 (11th Cir. 1997); *Strachan Shipping Co. v. Dresser Industries, Inc.*, 701 F.2d 483 (5th Cir. 1983); *Sea-Land Services, Inc. v. Amstar Corp.*, 690 F. Supp. 246 (S.D.NY 1988).

[16]See 11 U.S.C. §108(a).

[17]See 11 U.S.C. 547(b).

motor carrier client. The second step is to analyze whether (1) the payments received during the 90 day preference period were made in the ordinary course of business; and (2) whether in turn for payment of your client's freight charges, did your motor carrier client extend new value in terms of services to the debtor as a result of the payment. It is important to know the statutory distinction between a property broker and motor carrier/freight forwarder.

By statute, the term "broker" means a person other than a motor carrier, or an employee or agent of a motor carrier, that as a principal or agent sells, offers for sale, negotiates for, or holds itself out by solicitation, advertisement or otherwise as selling, providing, or arranging for, transportation by a motor carrier for compensation.[18]

Motor carriers, or persons who are employees or bona fide agents of carriers, are not brokers when they arrange or offer to arrange the transportation of shipments which they are authorized to transport and which they have accepted and legally bound themselves to transport.[19] "Brokerage" or "brokerage service" is defined as the arranging of transportation or the physical movement of a motor vehicle or of property. It can be performed on behalf of a motor carrier, consignor, or consignee.[20]

Property brokers are required to keep a record of each transaction for a period of three years and these records must show the name and address of the consignor, the motor carrier, the bill of lading or freight bill number, the amount of the broker's compensation, a description of any non-brokerage services performed in connection with each shipment or other activity, the amount of any freight charges collected by the broker and the date the payment was made to the

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[18]See 49 U.S.C. 13102(2).

[19]See 49 C.F.R. 371.2(a).

[20]See 49 C.F.R. 371.2(c).

carrier.[21] A property broker is required to maintain accounts so that the revenues and expenses relating to its brokerage portion of its business are segregated from its other activities.[22]

A freight forwarder, on the other hand, means a person holding itself out to the general public (other than as a pipeline, rail motor, or water carrier) to provide transportation of property for compensation in the ordinary course of its business:

(a) assembles and consolidates, or provides for assembling and consolidating shipments and performs or provides for break bulk and distribution of the shipments;

(b) assumes responsibility for the transportation from the place of receipt to the place of destination; and

(c) uses for any part of the transportation a carrier subject to jurisdiction under this subtitle.

The term does not include a person using transportation of an air carrier subject to part A of subtitle VII.[23]

Under the ordinary course of its business, a freight forwarder must proffer assembly, consolidation, break bulk and distribution services for any and all traffic tendered or transportation services provided. The four service elements are basic to the definition of a freight forwarder. They are neither optional nor alternative. The service elements are required by the use of the conjunctive "and" in the statutory definition. Thus, in order to be a freight forwarder, a party must hold itself out to the public that it is prepared to provide the definitional services in

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[21]See 49 C.F.R. 371.3.

[22]See 49 C.F.R. 371.13.

[23]See 49 U.S.C. 13102(8).

all transactions. Moreover, if a party acting as an intermediary does not actually perform, but merely proffers such services, its activity is more akin to, and may be deemed to be, brokerage, for which a brokerage license is required. If the conduct evidences that the intermediary is merely arranging transportation rather than undertaking the transportation, such activity will likely not be considered freight forwarding.[24]

The determination as to whether the debtor was operating as a motor carrier/freight forwarder or a property broker is fact intensive and will largely determine how you defend a preference cause of action.

Under the bankruptcy code, a debtor may not "prefer" one creditor over another by selecting to pay one but not the other during the debtor's slide into bankruptcy. In theory, the preference rule aims to insure that creditors are treated equitably based on the theory that "unless the favoring of particular creditors is outlawed, the mass of creditors of a shaky firm will be nervous, fearing that one or a few of their number are going to walk away with all the firm's assets; and this fear may precipitate debtors into bankruptcy earlier than is socially desirable."[25] Normally, your motor carrier client will receive a demand letter from a trustee or administrator appointed by the bankruptcy court for and on behalf of the debtor seeking monies returned as a result of payments made within 90 days of the bankruptcy filing. This is the precursor to the preference lawsuit. At this time, it is important to advise your clients to provide an analysis of the business relationship between the parties as far back as possible prior to the 90 day preference

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[24]See *Chemsource, Inc. v Hub Group, Inc.*, 106 F.3d 1358, 1361 (7th Cir. 1997); *Fireman's Fund Insurance v. USA Truck. Inc.*, 1992 Fed. Carr. Cases ¶83,698; See also *Travelers Indemnity Company v. Alliance Shippers, Inc.*, 654 F. Supp. 840 (N.D.Cal. 1986).

[25]See *Luper v. Columbia Gas of Ohio, Inc. (In Re: Carled)*, 91 F.3d 811, 815 (6th Cir. 1996); quoting *In Re: Tolona Pizza Prods. Corp.*, 3 F.3d 1029, 1032 (7th Cir. 1993).

period. This is done to establish the ordinary payment terms between the parties. Likewise, your client is more than likely to have monies owed to it for transportation services provided that were not paid. It is important to have your client provide any proof of claim they have filed along with an invoice summary which evidences the shipment dates for services provided to the debtor during the preference period, which would constitute new value to the debtor.

To recover funds, a trustee must prove by a preponderance that the transfer was (1) made to or for the benefit of a creditor; (2) on account of an antecedent debt; (3) made while the debtor was insolvent; (4) made within 90 days of the petition; and (5) enabled the creditor to receive more than it would have had the transfer not been made and the case liquidated pursuant to the provisions of chapter 7 of the bankruptcy code.[26]

Once the trustee proves its prima facie case under 11 U.S.C. 547(b), a motor carrier may raise certain defenses under 11 U.S.C. 547(c). The standard defenses are (1) the payments were received in the ordinary course of business between the parties, and (2) the payments received were intended to be a contemporaneous exchange for new value in the form of services provided to the debtor by the motor carrier.[27] There is a third defense not outlined under Section 547 which is the payments received were trust monies held by the debtor for and on behalf of the motor carrier.

Under the first defense, the ordinary course of business defense, a trustee may not avoid a transfer to the extent the transfer was (a) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; (b) made in the

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[26] See *Arrow Electronics, Inc. v. Justice (In Re: Kaypro)*, 218 F.3d 1070, 1073 (9th Cir. 2000).

[27] See 11 U.S.C. 547(c)(1), (4).

ordinary course of business or financial affairs of the debtor and the transferee; and (c) made in accordance with ordinary business terms.[28]

The Ninth Circuit has interpreted the "ordinary business terms" prong (Subsection C) to mean that the payment must be "ordinary in relation to prevailing business standards."[29] The courts will look to those terms employed by similarly situated debtors and creditors facing the same or similar problems. If the terms in question are ordinary for industry participants under financial distress, then that is ordinary for the industry.[30] Although a motor carrier must show that the payment it received was made in accordance with the ordinary business terms in the industry, this does not mean that the carrier must establish the existence of some single, uniform set of business terms. Rather, the ordinary business terms refers to the range of terms that encompasses the practices in which firms similar in some general way to the creditor in question engages, and that only dealings so "idiosyncratic" as to fall outside that broad range should be deemed extraordinary and therefore outside the scope of subsection C.[31] Most of the other circuit courts have adopted some variation of this standard.[32]

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[28]See 11 U.S.C. 547(c)(2).

[29]See *In Re: Food Catering & Hous., Inc.*, 971 F.2d 396, 398 (9th Cir. 1992).

[30]See *In Re: Kaypro*, 218 F.3d at 1074, quoting *Lawson v. Ford Motor Co. (In Re: Robin Industries, Inc.)*, 78 F.3d 30, 42 (2nd Cir. 1996).

[31]See *In Re: Tolona Pizza*, 3 F.3d at 1033.

[32]See *In Re: Roblin Indus., Inc.*, 78 F.3d 30, 42 (2nd Cir. 1996) at 42; *Advo-System, Inc. v. Maxway, Corp.*, 37 F.3d 1044, 1050 (4th Cir. 1994); *In Re: Carled*, 91 F.3d at 818 (Sixth Circuit holding that "ordinary business terms means that the transaction was not so unusual as to render it an aberration in the relevant industry"); *Fiber-Lite Corp. v. Molded Acoustical Prods., Inc. (In Re: Molded Acoustical Prods., Inc.)*, 18 F.3d 217, 224-225 (3rd Cir. 1994) (Substituting the word "unusual for "idiosyncratic" and allowing a sliding scale approach between subsections B and C based on the length of the relationship between debtor and creditor.) *Jones v. United Sav. and Loan Ass'n (In Re: U.S.A. Inns Of Eureka Springs, Inc.)*, 9 F.3d 680, 685 (8th Cir. 1993)

Some courts consider lateness of payment to be particularly significant to the determination of whether a payment is "ordinary."[33] Lateness of payment, however, does not preclude a finding that the payment was made in the ordinary course of business.[34] The characterization of a late payment as ordinary is based not only upon the parties' dealings, but also upon the contractual terms governing their relationship.[35] A variation from contractual terms is not fatal, but can also establish the "ordinary course of business between the parties."[36]

It is helpful to have your client analyze its payment records and to make a determination of the percentage of invoices that were paid between 0 and 30 days; 31 to 60 days; and over 61 days. This will enable you to gauge the business relationship between the parties and help you establish that payments received in the preference period were not so unusual both in the ordinary business relationship between the parties and in the industry as a whole. Hand in hand with the ordinary course of business defense you must determine whether your client provided new value to the debtor in terms of services which have not been compensated.

A trustee may not avoid monies paid to a carrier during the preference period to the extent that the transfer was intended by the debtor and creditor to or for whose benefit such transfer was to be a contemporaneous exchange for new value given to the debtor; and was in fact a

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(Substituting the term "unusual" for "idiosyncratic.")

[33]See *In Re: Fred Hawes Org., Inc.*, 957 F.2d 239, 244 (6th Cir. 1992).

[34]See *Yurika Foods v. UPS Corp.*, 888 F.2d 42, 45 (6th Cir. 1989). (A motor carrier's receipt of payments within 60 days deemed ordinary.)

[35]See *In Re: Fred Hawes Org.*, 957 F.2d at 245.

[36]See *Fiber-Lite Corp. v. Molded Acoustical Prods., Inc.*, 160 Bankr. 608 (E.D.Pa. 1993); aff'd 18 F.3d 217, 223 (3rd Cir. 1994) (Payments ranging 71 to 113 days late, despite a term of 40 to 45 days net were ordinary course of business); *Hawes Org.*, 957 F.2d at 244 (Long history of dealing between the parties could counteract the literal terms of a contract).

substantially contemporaneous exchange."[37] A trustee may not avoid monies paid to a carrier to the extent that after the alleged transfer of monies the motor carrier gave new value to or for the debtor which new value was (a) not secured by an otherwise unavoidable security interest and (b) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.[38]

"New value means money or monies worth and goods, services, or new credit ... but does not include an obligation substituted for an existing obligation."[39] What normally happens when a motor carrier/freight forwarder or property broker files bankruptcy, it usually owes the motor carrier monies for services performed during the preference period. Although it is never good to have a hole in the pocket, the fact that services were rendered and not paid for can aid your client in defending a preference cause of action. The bankruptcy code does not provide an objective standard for determining what is "substantially contemporaneous." It is not a defined phrase. The word "substantially" allows some flexibility in the analysis. It may be defined as "to a considerable or large extent."[40] Use of the word "contemporaneous" also permits some discretion. One definition provides:

> "Contemporaneous does not precisely mean 'simultaneous'; rather, it means 'belonging to the same time or period; occurring at about the same time."[41]

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[37]See 11 U.S.C. 547(c)(1).

[38]See 11 U.S.C. 547(c)(4).

[39]See 11 U.S.C. 547(a)(2).

[40]See *Websters II New Riverside University Dictionary,* 301, 1155 (1984).

[41]See *Bryan A. Garner, A Dictionary of Modern Legal Usage*, 148 (1987).

The contemporaneous exchange exception applies to several types of transactions. The legislative history shows that Congress intended Section 547(c)(1) to apply to payment for new goods and services by check.[42]

The easiest way to make a determination as to whether new value was extended is to determine when monies were received by your client and whether in close proximity thereafter new services were extended. This is the so-called "ring the bell" analysis. The third defense to a preference action involving transportation entities is the "conduit theory" or "interline trust theory."

Whether the debtor was operating as a motor carrier, freight forwarder or property broker it is proper and prudent to assert as an affirmative defense that the debtor was legally obligated at all times to receive payment from its shipper and consignee customers and to transmit monies to the actual motor carriers who rendered transportation services. It should be asserted that freight revenue paid to the debtor by a shipper or consignee for transportation services rendered was held in trust for the carrier. Where the debtor is a property broker, federal regulations support the theory that the monies paid to the broker are held in trust for the underlying carrier.[43]

A broker is required to keep records of all its brokerage transactions, including the amount of its brokeraged commission and the amount of any freight charges paid to the underlying motor carrier.[44] Furthermore, a broker who engages in any other business shall

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[42]See *H.R. Rep. No. 595,* 95th Cong., 1st Session 373 (1977); U.S. Code Cong. & Admin. News (1978) at pp. 5963, 6329.

[43]See *Transportation Revenue Management, Inc. v. Freight Peddlers, Inc. et al.,* 2000 W.L. 33399885.

[44]See 49 C.F.R. 371.3(a)(4), (6).

maintain accounts so that the revenue and expenses are segregated from its other activities.[45] The duties and obligations of a broker expressly provide that brokers are required to abide by federal regulations with respect to the transmittal of bills or payment when acting on behalf of a shipper or consignee.[46] In instances where the debtor is a freight forwarder or motor carrier, a so-called "interline trust" theory can be asserted.

In furtherance of a carrier's perfected right to receive freight charges, the so-called "interline trust" theory was an early development in transportation law which recognized that there where two or more carriers combined to provide joint service, the originating carrier received payment of freight charges in trust to the extent it was owed to the delivering carrier. [47] This doctrine has been recognized by the Sixth Circuit as being equally applicable to the motor carrier industry where a licensed entity received freight charges intended for transmission to a participating carrier which provided service.[48]

The constructive trust defense gives your motor carrier client some additional leverage in defending a preference action.

Conclusion

When a transportation entity files bankruptcy, understanding the avenues of recourse for payment of freight charges and the practical steps to take in defending against preference actions can make a big difference to the motor carrier client.

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[45]See 49 C.F.R. 371.13.

[46]See 49 C.F.R. 371.10.

[47]See *In Re: Ann Arbor Railroad Co.*, 623 F.2d 480 (6th Cir. 1980). (Adopting a rule articulated in *In Re: Penn Central Transportation Co.*, 486 F.2d 19, 523-527 (3rd Cir. 1973); *en banc*, cert. denied, 415 U.S. 990, 94 S.Ct. 1588, 39 L.Ed.2d 886 (1974)).

[48]See *Parker Motor Freight, Inc. v. Fifth Third Bank*, 116 F.3d 1137 (6th Cir. 1997)