Corporate Debtors Must Use Caution When Repaying Debts to Shareholders

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Scenario: A corporation is contemplating filing for bankruptcy. One of its shareholders loans it money and the corporation repays the shareholder more than ninety days and less than one year before filing for bankruptcy. This payment is known as a preference payment, under the Bankruptcy Code, if the shareholder is an "insider" of the corporation. After the debtor corporation files for bankruptcy, the shareholder is sued by the trustee of the bankruptcy estate in a preference action. Does the shareholder have a defense?

There is a general rule with respect to preference actions. According to the Bankruptcy Code, when a debtor makes a payment to a creditor during the preference period, while the debtor is insolvent, the trustee of the bankruptcy estate can bring a preference action against the creditor to avoid the debtor's payment. *See*, 11 U.S.C. § 547(b). More specifically, if the creditor is an insider, the preference period is between ninety days and one year before the bankruptcy filing; whereas, if the creditor is a non-insider, the preference period is within ninety days of the bankruptcy filing. *See*, 11 U.S.C. § 547(b)(4). The purpose of the trustee bringing such an action on behalf of the bankruptcy estate is to collect this money to pay the debtor's other creditors.

In our scenario, it is necessary to determine whether the shareholder is an insider of the debtor corporation. If the shareholder is not an insider, the shareholder will have this as a defense to the trustee's preference action. However, it is important to mention that there are other possible defenses to a preference action beyond the scope of this article, including but not limited to the earmarking doctrine as a defense, the subsequent new value exception as a defense, the ordinary course of business defense, and the ordinary business terms defense.

Section 101(31)(B)(iii) of the Bankruptcy Code states that if the debtor is a corporation, the term "insider" includes a "person in control of the debtor." In addition, section 101(31)(E) of the Bankruptcy Code states that the term "insider" includes an "affiliate." So, what is the meaning of affiliate? Generally speaking, the term "affiliate" means an entity, including a person, "that directly or indirectly owns, controls, or holds with a power to vote, 20 percent or more of the outstanding voting securities of the debtor." 11 U.S.C. § 101(2)(A); *see also*, 11 U.S.C. § 101(15). The Middle District of Florida has adhered to this reasoning, stating that the definition of an insider includes an "affiliate;" thus, once it is determined who is an affiliate of the debtor corporation that person is also considered an insider of the debtor corporation. *See*, In re Holly Hill Med. Ctr., Inc., 53 B.R. 412, 413 (Bankr. M.D. Fla. 1985).

Therefore, according to the applicable case law, discussing the meaning of affiliate, if a person holds 20 percent or more of the debtor's voting stock, that

person is deemed an insider of the debtor, even if the person does not have the power to vote the stock. *See*, In re F & S Cent. Mfg. Corp., 53 B.R. 842, 848 (Bankr. E.D.N.Y. 1985); *see also*, In re Interlink Home Health Care, Inc., 283 B.R. 429, 438-9 (Bankr. N.D. Tex. 2002).

In our scenario, if the shareholder holds 20 percent or more of the debtor corporation's voting stock, then the shareholder is an insider of the debtor corporation and the shareholder will not likely have a defense to the trustee's preference action since the debtor corporation repaid the shareholder between ninety days and one year before the bankruptcy filing. However, if the shareholder holds less than 20 percent of the debtor corporation's voting stock, then the shareholder is probably not an insider unless he or she is a director or officer of the debtor corporation, so the shareholder will likely have a defense to the trustee's preference action.

In conclusion, a corporation that is contemplating bankruptcy should utilize caution when repaying one of its shareholders prior to the bankruptcy filing, keeping in mind that the bankruptcy trustee has a right to bring preference actions, including actions against shareholders repaid by corporations during the preference period.

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