UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:	)	
	)	
Alamance Knit Fabrics, Inc.,	)	Case No. 96-13527C-7G
	)	
Debtor.	)	
	)	
	)	
William O. Moseley, Jr., Trustee in Bankruptcy for Alamance Knit Fabrics, Inc.,	)	
	)	
Plaintiff,	)	
	)	
v.	)	Adversary No. 99-2036
	)	
John E. McCallus,	)	
	)	
Defendant.	)	

ORDER

This adversary proceeding came before the court on January 4, 2000, for hearing upon a motion by plaintiff for approval of a proposed settlement with the defendant. William O. Moseley, Jr., appeared on behalf of the plaintiff and Robert W. Franklin appeared on behalf of the defendant. Also appearing at the hearing was Richard M. Horton.

MATTER BEFORE THE COURT

On January 13, 1997, the defendant filed a proof of claim in the underlying bankruptcy case in which the defendant asserted a secured claim in the amount of $135,860.00. The claim is based

upon a severance agreement between the defendant and the Debtor dated June 11, 1996, which provides for certain payments to the defendant and which purports to grant "a lien on all of Alamance's assets."[1] On October 30, 1998, the plaintiff, as Chapter 7 Trustee, objected to the claim filed on behalf of the defendant. Thereafter, on July 9, 1999, the plaintiff filed this adversary proceeding. In the complaint, the plaintiff alleges that any lien held by the defendant is preferential and should be avoided pursuant to § 547 of the Bankruptcy Code. The defendant filed answer denying that the lien is preferential and alleging affirmative defenses based upon § 547(c)(1)(contemporaneous exchange of value), § 547(c)(2)(ordinary course of business transaction) and statute of limitations based upon § 546(a)(1) of the Bankruptcy Code. The motion now before the court was filed on December 1, 1999, and seeks court approval of a settlement under which the defendant would be allowed a secured claim in the reduced amount of $11,000.00 without interest.

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[1]Debtor's assets were sold in June of 1997 for the sum of $400,000.00 pursuant to an order which transferred defendant's lien, if any, to the portion of the proceeds, if any, resulting from the sale of the assets upon which the defendant claimed a lien.

APPLICABLE LAW

In deciding whether a settlement proposed by a bankruptcy trustee should be approved, the bankruptcy court should be guided by what is in the best interest of the bankruptcy estate. Central to this determination is a comparison of the terms of the settlement with the probable outcome and cost if the litigation or matter in dispute is not settled. The factors which should be considered by the court are the probability of success, the complexity of the litigation or matter in dispute and the expense, inconvenience and delay likely to result if the settlement is not approved and the litigation or matter in dispute proceeds to a conclusion. See Matter of Energy Cooperative, Inc., 886 F.2d 921, 927 (7th Cir. 1989). In weighing or evaluating these factors, the court should consider the stage of the proceedings, the extent of the discovery which has been conducted and the experience and ability of counsel who represent the trustee. However, the court should not turn the settlement hearing into a trial or a rehearsal of the trial, nor is the court required to reach any dispositive conclusions regarding any unsettled legal issues in the case. Instead, the court may limit the proceedings and consideration to whatever is necessary in order for the court to determine whether the settlement is in the best interest of the estate. See Flinn v.

FMC Corp., 528 F.2d 1169, 1172-73 (4th Cir. 1975).

ANALYSIS

In light of the provisions of § 502(d) of the Bankruptcy Code, the Trustee's proposed payment of $11,000.00 to the defendant cannot be justified solely on the basis of the statute of limitations issue raised by the defendant. Section 502(d) provides that the court "shall disallow any claim of any entity . . . that is a transferee of a transfer avoidable under section . . . 547 . . . ." Even though an adversary proceeding is barred by the expiration of the limitations set forth in § 546(a), the Trustee still is entitled to object to the defendant's claim pursuant to § 502(d). "The clear weight of authority permits defensive reliance on the trustee's avoiding powers outside the two-year limit under § 546(a)." In re Badger Lines, Inc., 206 B.R. 521, 527 (E.D. Wis. 1997). Therefore, a creditor's claim may be objected to and barred as a preference under § 547, even though the trustee failed to filed an adversary proceeding or objection within the time specified in § 546(a). See In re McLean Indus., Inc., 196 B.R. 670 (S.D.N.Y. 1996); In re Romano, 175 B.R. 585 (Bankr. W.D. Pa. 1994); In re KF Dairies, Inc., 143 B.R. 734 (9th Cir. B.A.P. 1992); In re Chase & Sanborn Corp., 124 B.R. 368 (Bankr. S.D. Fla. 1991); In re Mid Atlantic Fund, Inc., 60 B.R. 604 (S.D.N.Y. 1986).

The same result has been reached where the trustee objects to a lien claimed by a creditor under § 502(d). See In re Bucholz, 224 B.R. 13 (Bankr. D.N.J. 1988)(§ 546(b) did not bar debtor's objection to creditor's mortgage lien because lien not properly perfected under state law, and § 546 does not terminate trustee's status as a bonafide purchaser); In re America W. Airlines, Inc., 208 B.R. 476, 480 (Bankr. D. Ariz. 1997)(debtor or trustee may object to a statutory lien after § 546 statute of limitations period expires by relying on § 502(d) and establishing the elements of § 545). Thus, even though the Trustee in this case may not be entitled to maintain an adversary proceeding, the Trustee arguably may accomplish the same result by objecting to the secured claim pursuant to § 502(b) based upon § 547 of the Bankruptcy Code.

The Trustee's position regarding the merits of his objection under § 547 is not as strong, however. In order to establish that the "transfer" of the security interest from the Debtor to the defendant in the present case was preferential, the Trustee would have to establish the elements specified in § 547(b)(4), which involves showing that the transfer: (1) was to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made on or within 90 days before the date of the

filing of the petition or between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and (5) that enables such creditor to receive more than such creditor would receive in a chapter 7 case if such transfer had not been made. There appears little dispute regarding elements (1) and (5). However, the remaining elements are contested and must be addressed.

The transaction in which the Debtor agreed to grant the security interest occurred on June 11, 1996, when the underlying agreement was signed by the parties. The filing of the financing statements required in order to perfect the security interest did not occur until June 20, 1996, which is within ninety days of the filing of the petition. However, § 547(e)(2)(A) provides that a transfer is made "at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 10 days after, such time . . . ." Since the transfer of the security interest in the present case was perfected within ten days of the June 11, 1996, transaction, the perfection of the security interest relates back to that date and, therefore, is deemed to have occurred on June 11, 1996. June 11, 1996, is ninety-one days before the date of the petition and, therefore, the creation of the security interest did not occur within ninety days

of the petition.

It nevertheless appears that the Trustee may be entitled to maintain a preference objection to defendant's lien. It appears that the defendant was an officer and director of the defendant. Although the agreement calls for the defendant to resign, it appears that he still was an officer and director at the when the agreement was signed and the security interest granted. If so, then the pertinent reach-back period would be one year rather than ninety days, which would enable the Trustee to satisfy the requirement contained in § 547(b)(4).

The Trustee's position regarding the remaining elements of a preferential transfer is more uncertain and problematic. As to whether the Debtor was insolvent at the time of the transfer, the Trustee does not get the presumption of insolvency contained in § 547(f). Without the presumption, the Trustee is faced with the expense and uncertainty of locating and offering witnesses and exhibits which would establish by a preponderance of the evidence that the Debtor was insolvent on June 11, 1996.

Whether the transfer was "for or on account of an antecedent debt" is even more problematic from the Trustee's standpoint. The defendant's promissory note and security interest were provided for under a severance agreement between Debtor and defendant that set

forth the terms and conditions under which defendant's relationship with Debtor as an employee, shareholder, officer and director of the Debtor would be terminated. Employment agreements generally are considered to be executory contracts. See In re Southmark Corp., 62 F.3d 104 (5th Cir. 1995); In re Jolly, 574 F.2d 349 (6th Cir. 1978); In re Continental Country Club, Inc., 114 B.R. 763, 766 (Bankr. M.D. Fla. 1990). A debt is antecedent under § 547(b) if the debtor incurs it before making the alleged preferential transfer. See In re Southmark Corp., 62 F.3d at 105. With respect to executory contracts, a debt is incurred at the time of the actual breach or termination of the contract. See In re Energy Coop., 832 F.2d 997, 1002 (7th Cir. 1987)(debt not incurred until anticipatory repudiation of executory contract occurred); In re Continental Publications, Inc., 131 B.R. 544, 549 (Bankr. D. Conn. 1991)(severance-related debt not incurred until termination of employee). To the extent that the transaction on June 11, 1999, involved the termination of an employment agreement, these cases provide support for the argument that the obligation arose when the termination occurred on June 11, 1999, and hence was not an antecedent debt.

Additional uncertainty regarding the Trustee's position arises from the affirmative defense which has been pleaded by the

defendant under § 547(c)(1)(contemporaneous exchange of value). "Although the substitution of one obligation for an existing obligation does not constitute new value, there is support for the proposition that a modification of the terms of an existing obligation may constitute consideration (i.e., new value). 'To the extent that a creditor can demonstrate that its agreement to modify the terms of the debtor's obligation gave the debtor money or monies worth in credit, goods, services or property, there is no reason to avoid the transfer.'" In re Spada, 903 F.2d 971, 976 (3d Cir. 1980), quoting from In re F&S Cent. Mfg. Corp., 53 B.R. 842, 850 (Bankr. E.D.N.Y. 1985). There is also authority for the proposition that if a transfer is made partly for an antecedent debt and partly for a present consideration, the transfer is voidable only to the extent of the antecedent debt. See Aulick v. Largent, 295 F.2d 41, 45 (4th Cir. 1961).

In the present case, the severance agreement was executed on June 11, 1996, and provided for the defendant to resign as an employee, officer and director and to surrender his stock in the Debtor. The agreement also called for the defendant to perform certain consulting services following the execution of the agreement. The promissory note, representing the payment due under the severance agreement, also was executed on June 11, 1996, as was

the security agreement. The promissory note apparently represents the consideration agreed upon by the parties for the things required of the defendant under the severance agreement. Defendant contends that the indebtedness under the promissory note first arose on June 11, 1999, as consideration for new obligations agreed to on that date by the defendant and therefore involved a contemporaneous exchange of new value for purposes of § 547(c)(1). If defendant ultimately prevailed on this defense, the Trustee's objection could be reduced or fail entirely.

If the settlement now before the court is not approved, there is substantial risk that the Trustee will not be successful in establishing that the lien granted to the defendant is invalid under § 547. In particular, the Trustee may be unable to show that the indebtedness secured by the lien constitutes an antecedent debt for purposes of § 547(b)(2) or be able to successfully resist the affirmative defense raised by the defendant based upon § 547(c)(1). Moreover, if the settlement is not approved and the Trustee has to prosecute the objection, considerable legal expenses will be incurred and the distribution to creditors will be delayed. Additionally, if the settlement is not approved and the Trustee ultimately is unsuccessful with the objection, the payment which the Trustee will have to make to the defendant will be

substantially greater than the $11,000.00 settlement figure. While the actual payment to the defendant cannot exceed the amount of the proceeds realized from the assets covered by the lien,[2] it is clear that these proceeds are at least $20,000.00. Considering the probability of success by the Trustee and the expense, inconvenience and delay likely to result if the settlement is not approved, the court has concluded that the settlement is in the best interest of the estate in this case. Accordingly, the settlement will be approved and the Trustee will be authorized to settle the claim of the defendant by recognizing and paying a secured claim in the amount of $11,000.00 as full and complete settlement of the claim of the defendant.

IT IS SO ORDERED.

This 27th day of January, 2000.

William L. Stocks

WILLIAM L. STOCKS
United States Bankruptcy Judge

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[2]It appears unlikely that there will be any funds available for distribution to unsecured creditors after administrative, priority and secured claims are paid.