

UNITED STATES BANKRUPTCY COURT  
FOR THE WESTERN DISTRICT OF NORTH CAROLINA  
CHARLOTTE DIVISION



JUDGEMENT ENTERED ON NOV 12 2002

IN RE:	)	Case No. 99-31596
	)	
CAROLINA ALLOY & STAINLESS, INC.	)	Chapter 7
	)	
Debtor	)	
	)	
	)	
R. KEITH JOHNSON, Trustee for	)	Adversary No. 01-3147
the bankruptcy estate of	)	
CAROLINA ALLOY & STAINLESS, INC.,	)	
	)	
Plaintiff,	)	<b>ORDER</b>
	)	
	)	
v.	)	
	)	
PEOPLES BANK,	)	
	)	
Defendant.	)	
	)	

THIS CAUSE coming on to be heard, and being heard, before the undersigned United States Bankruptcy Judge on Motion of Defendant Peoples Bank ("Peoples Bank") for Summary Judgment pursuant to Rule 7056 of the Federal Rules of Bankruptcy Procedure, and having considered the Affidavits filed in support of Peoples Bank's Motion, the Affidavit of R. Keith Johnson, the Stipulation of the parties, as well as the arguments of counsel, the Court hereby finds as follows:

**FINDINGS OF FACT**

1. Peoples Bank is a North Carolina chartered banking organization headquartered in Newton, North Carolina.

2. The Plaintiff, R. Keith Johnson, Trustee for the bankruptcy estate of Carolina Alloy & Stainless, Inc. (the "Trustee"), is the duly appointed, qualified, and acting Trustee for the Bankruptcy Estate of the Debtor Carolina Alloy & Stainless, Inc. (the "Debtor").

3. The business relationship between Peoples Bank and the Debtor then known as Carolina Carbon & Stainless Products, Inc., d/b/a Carolina Alloy & Stainless, Inc., began in early 1997 when Mickey F. Smith, president of the Debtor approached Mr. Danny Richard, a Business Development Officer with Peoples Bank about a commercial loan for the Debtor. While he was employed at NationsBank Carolina, N.A., Mr. Richard had worked with Mr. Smith to provide commercial loans to the Debtor. When the Debtor needed a loan in the form of a line of credit in 1997, Mr. Smith came to Mr. Richard at Peoples Bank due to their prior business relationship. Ultimately, the Debtor applied for and received a \$490,000 line of credit from Peoples Bank in February 1997.

4. After the Debtor obtained its line of credit from Peoples Bank, the Debtor also opened a checking account with Peoples Bank on June 7, 1997, and it was assigned account number 53 4829487 (the "Peoples Bank Account").

5. The Debtor continuously maintained the Peoples Bank Account from June 5, 1997 until it was closed on June 6, 1999.

6. Also during this same approximate time frame, the Debtor maintained a checking account at NationsBank of Texas ("NationsBank") (the "NationsBank Account").

7. From Peoples Bank's perspective, the Debtor's account history was uneventful until May 11, 1999. Prior to that time, no agent or employee of Peoples Bank was suspicious of any wrongdoing or improper activity by the Debtor with regard to its Peoples Bank Account.

8. Before May 11, 1999, Peoples Bank may have extended provisional credit to the Debtor and did not place holds on deposits of the Debtor in the ordinary course of business of Peoples Bank.

9. On May 11, 1999, five (5) checks totaling \$296,295.00 were presented for payment on the Debtor's Peoples Bank Account. There were insufficient funds on deposit in the Peoples Bank Account to cover three (3) of these items totaling \$243,650.00. Because of the insufficient available funds balance in the Debtor's Peoples Bank Account, Peoples Bank employees reviewed items left for deposit in the night deposit its Triangle, North Carolina Branch where the Debtor typically made its deposits to check for a deposit to cover the three (3) incoming checks at issue. Peoples Bank discovered that the Debtor had left seventeen (17) checks totaling \$1,125,000.00 in the night deposit at Peoples Bank's Triangle, North Carolina Branch for deposit on May 11, 1999 (the "May 11 Deposit") into the Peoples Bank Account.

10. The May 11 Deposit, however, contained irregularities on the transit-routing and/or account numbers that appear at the bottom of each check. Some of these numbers appeared to have been erased or changed so as to make them unreadable for automated processing equipment. Because of these irregularities with the encoding on the checks that made up the May 11 Deposit, Peoples Bank refused to provide provisional credit to the Debtor on the deposited items and placed a hold on the deposits. Each of the items submitted for deposit with the May 11 Deposit were drawn on the Debtor's NationsBank Account.

11. On May 11, 1999 and over the next several days, Peoples Bank dishonored all checks presented for payment on the Debtor's Peoples Bank Account not supported by collected funds.

12. On May 13, 1999, Peoples Bank received a \$700,000.00 wire transfer from the Debtor which it credited to the Peoples Bank Account. This wire transfer was sufficient to pay some, but not all checks presented for payment on the Peoples Bank Account on May 14, 1999. As such, Peoples Bank exhausted the \$700,000.00 wire transfer by using those funds to partially pay twelve (12) checks totaling \$701,790.00 presented for payment on the Peoples Bank Account.<sup>1</sup>

13. On May 17, 1999, Mr. Richard received a letter from Mr. Dale Morrison, Mr. Smith's attorney. In the letter dated May 14, 1999, Mr. Morrison stated that Mr. Smith was out of town but had instructed the Debtor to wire \$1.1 million on May 14, 1999 to its Peoples Bank Account. Mr. Morrison also stated that Mr. Smith had talked to NationsBank employees in Texas, and that they reported that in excess of \$1.9 million in funds were available as of May 13, 1999 and that approximately \$1 million had been honored on the May 11 Deposit made at Peoples Bank that remained frozen by Peoples Bank.

14. Later in the day on May 17, 1999, Mr. Mike Hamra, Vice President in charge of risk management for Peoples Bank, contacted Gayle Taylor at NationsBank in Texas. Ms. Taylor told Mr. Hamra that "the checks at issue have cleared," but refused Mr. Hamra's request of her to fax documentation or otherwise certify in writing that the checks at issue with the May 11 Deposit had cleared. Without written assurances from NationsBank, Peoples Bank was unwilling to release the hold placed on the May 11 Deposit.

15. Despite the prior assurances from Mr. Smith's attorney and NationsBank, on May 18, 1999, NationsBank notified Peoples Bank by wire that fifteen (15) checks totaling \$960,000.00 were

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<sup>1</sup>Based on the fact that Peoples Bank paid out the full amount of the wire transfer, the Trustee withdrew his claim to recover the \$700,000.00 wire transfer as a preferential transfer.

being returned marked "refer to maker" for insufficient funds in the Debtor's NationsBank account. A later review of the checks indicated that checks being returned included checks deposited to the Peoples Bank Account as far back as May 5, 1999.

16. On May 20, 1999, Peoples Bank received the checks NationsBank returned for insufficient funds that previously had been deposited into the Peoples Bank Account. These checks had been deposited between May 5 and May 11, 1999. The amount of checks deposited and dishonored by NationsBank totaled \$960,900.00. Of these dishonored checks, \$400,000.00 had been submitted as part of the May 11 Deposit for which no provisional credit had been extended.

17. Of the checks returned by NationsBank, Peoples Bank contended seven (7) checks totaling \$446,800.00 deposited between May 5 and May 7 were not returned within the time required to support their dishonor and asserted claims for late presentment of these items on May 20 and 24, 1999.

18. NationsBank disputed Peoples Bank's claim for late presentment and negotiations ensued between Peoples Bank and NationsBank.

19. On May 25, 1999, the Debtor gave written instructions Peoples Bank to pay over any and all collected funds in the Peoples Bank Account to NationsBank.

20. On June 1, 1999, Peoples Bank and NationsBank reached an agreement concerning Peoples Bank's claim of late presentment on the seven (7) disputed returned items. Because the Debtor had instructed Peoples Bank to transfer all collected funds in the Peoples Bank Account to NationsBank, it became a moot point as to whether the seven (7) checks totaling \$446,800 should be treated as collected or uncollected funds, as either way, NationsBank ultimately would retain those funds. Therefore, Peoples Bank agreed to withdraw its claim for late presentment on those

seven (7) items, and NationsBank agreed to not pursue any protest of such claims. Further, Peoples Bank agreed to wire transfer the full collected balance after deducting the amount of the disputed items in the Peoples Bank Account totaling \$168,784.59 to NationsBank.

21. Thereafter, Peoples Bank transferred \$168,784.59 to NationsBank and the Debtor's Peoples Bank Account was closed on June 4, 1999.

22. After May 11, 1999, Peoples Bank honored only those checks that were supported by collected funds in the Debtor's Peoples Bank Account. During that period, \$701,790 in checks which were supported by collected funds were paid, while \$4,162,266.47 in checks presented for payment on the Debtor's Peoples Bank Account were returned.

23. The Debtor's Peoples Bank Account contained a positive available balance at all times relevant hereto. There was no evidence before the Court on whether there was or was not a positive collected balance in the Peoples Bank Account at all times relevant hereto.

24. On July 1, 1999, an involuntary petition under Chapter 7 of the United States Bankruptcy Code was filed against the Debtor.

25. Between May 5, 1999 and May 11, 1999, the Debtor deposited checks totaling \$4,383,100.00 into its Peoples Bank Account, and made one deposit via wire transfer in the amount of \$700,000.00 on May 13, 1999.

26. The Trustee initiated this action against Peoples Bank by filing a Complaint to avoid transfers with the United States Bankruptcy Court for the Western District of North Carolina on June 28, 2001 (the "Complaint"). In his Complaint, the Trustee initially sought the return of all funds allegedly deposited into the Debtor's Peoples Bank Account after May 5, 1999, either by check or wire deposit.

27. By Stipulation dated September 30, 2002, the Trustee withdrew his claim as to the \$700,000 wire deposit and as to \$400,000 in checks deposited on May 11, 1999 for which no provisional credit was extended. Therefore, following the Stipulation, the Trustee sought the return of \$3,983,100.00 of checks deposited to the Debtors Peoples Bank Account; that amount consisting of \$3,422,200.00 in checks honored by NationsBank and \$560,900.00 in checks dishonored by NationsBank.

28. On July 12, 2002, Peoples Bank moved for Summary Judgment as to any and all of the Trustee's claims.

### **CONCLUSIONS OF LAW**

Based on the foregoing Findings of Fact, the Court hereby makes the following Conclusions of Law:

1. Summary judgment is appropriate "when the pleadings and other evidence show that there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law." See Fed. R. Civ. P 56(c); Celotex Corp. v. Catrett, 477 U.S. 317, 322-23, 106 S.Ct. 2548, 2552 (1986). "Where the record taken as a whole could not lead a rational trier of fact to find for the non-moving party, there is no genuine issue for trial," and summary judgment should be entered in favor of the movant. Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 587, 106 S.Ct. 1348, 1356 (1986). Summary judgment should be entered "against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial." Celotex, 477 U.S. at 322, 106 S.Ct. at 2552.

2. ““Only disputes over facts that might affect the outcome of the suit”” constitute genuine issues of material fact. Bell v. E. Davis Intern., Inc., 197 F. Supp. 2d 449, 453 (W.D.N.C. 2002) (quoting Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248, 106 S.Ct. 2505 (1986)).

3. As set forth in the Affidavits filed in support of Peoples Bank’s Motion, a myriad of transactions, attempted transactions and communications occurred in and related to the Peoples Bank Account in the days and weeks leading up to the closing of the Debtor’s Peoples Bank Account. Any disputes as related to those facts, however, would have no impact on the ability of the Trustee to prove his claim. Rather, those facts constitute background helpful only as a point of reference.

4. For purposes of determining whether the Trustee can meet his burden of proof to establish preference liability on behalf of Peoples Bank, the only material facts in this case are as follows: (1) \$4,383,100.00 in checks drawn on the NationsBank Account were deposited into the Peoples Bank Account; (2) \$3,422,200.00 in checks were honored by NationsBank; (3) \$960,900.00 in checks were dishonored; (4) a \$700,000.00 wire transfer was made to the Peoples Bank Account by the Debtor; (5) Peoples Bank never extended any provisional credit on six of the dishonored checks in the amount of \$400,000.00 in the May 11 Deposit; (6) the Peoples Bank Account had a collected balance of \$168,784.59 which was transferred to NationsBank before the account was closed; and (7) the funds from the \$700,000.00 wire transfer were used to cover checks presented on the Peoples Bank Account after receipt of the wire transfer. There is no genuine issue as to these material facts.

5. In order to avoid any prepetition transfer as a preference, the burden is upon the Trustee to prove that (1) the debtor’s property was transferred to or for the benefit of a creditor; (2) that the transfer was made when the debtor was insolvent; (3) the transfer was made for the purpose



of satisfying an antecedent debt to the creditor; (4) the transfer was made within ninety (90) days before the debtor's bankruptcy filing; and (5) that the transfer enabled the creditor to receive more than it would have received in a Chapter 7 liquidation. 11 U.S.C. § 547(b)(1)-(5). Based on the undisputed material facts in the record, even if the Trustee could establish that Peoples Bank was a creditor of the Debtor, the Trustee will be unable to prove that Peoples Bank recovered more than it would have received in a hypothetical liquidation, and therefore cannot establish that these deposits constituted preferential transfers.

6. To establish that a "claim" arose in favor of Peoples Bank making Peoples Bank a "creditor" of the Debtor, the Trustee must show that the Debtor was granted provisional credit on those deposited items and that the Debtor took advantage of that provisional credit by withdrawing those provisional funds through checks or otherwise. Howell v. Bank of Newnan (In re Summit Financial Servs., Inc.), 240 B.R. 105, 114-15 (Bankr. N.D. Ga. 1999). That inquiry need not be undertaken in this case, however, because even if the Trustee could prove that Peoples Bank was a "creditor" with a claim against the Debtor, the Trustee still will be unable to prove another essential element of his claim; namely, that Peoples Bank recovered more through collecting on the deposited items than it would have received in a hypothetical Chapter 7 liquidation of the Debtor.

7. Article 4 of the Uniform Commercial Code as adopted by North Carolina and other states grants banks a security interest in checks deposited in an account and all proceeds derived therefrom. N.C. Gen. Stat. § 25-4-208.<sup>2</sup> In every reported case from a court examining the effect

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<sup>2</sup>N.C. Gen. Stat. § 25-4-208 provides as follows:

(a) A collecting bank has a security interest in an item and any accompanying documents or the proceeds of either:

of this security interest on the preference analysis in a check kiting scheme, the courts have unanimously concluded that the defendant bank was at all relevant times a secured creditor, and therefore recovered no more through deposits than it would have under a hypothetical Chapter 7 liquidation. See, e.g., First Tennessee Bank, N.A. v. Stevenson (In re Cannon), 237 F.3d 716, 721 (6th Cir. 2001); Pereira v. Summit Bank, 2001 WL 563730, \*15 (S.D.N.Y. May 23, 2001); Howell, 240 B.R. at 119; Emerson v. Federal Savings Bank (In re Brown), 209 B.R. 874, 885-88 (Bankr. W.D. Tenn. 1997). “UCC Article 4 teaches that a bank, acting primarily as a conduit in the collection process, is always fully secured for its uncollected provisional exposure.” Pereira, 2001 WL 563730 at \*15. A bank’s security interest arises by operation of law whenever a customer takes

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- (1) In case of an item deposited in an account, to the extent to which credit given for the item has been withdrawn or applied;
- (2) In case of an item for which it has given credit available for withdrawal as of right, to the extent of the credit given, whether or not the credit is drawn upon or there is a right of charge-back; or
- (3) If it makes an advance on or against the item.

(b) If credit given for several items received at one time or pursuant to a single agreement is withdrawn or applied in part, the security interest remains upon all the terms, any accompanying documents or the proceeds of either. For the purpose of this section, credits first given are first withdrawn.

(c) Receipt by a collecting bank of a final settlement for an item is a realization on its security interest in the item, accompanying documents, and proceeds. So long as the bank does not receive final settlement for the item or give up possession of the item or accompanying documents for purposes other than collection, the security interest continues to that extent and is subject to Article 9, but:

- (1) No security agreement is necessary to make the security interest enforceable (G.S. 25-9-203(1)(a));
- (2) No filing is required to perfect the security interest; and
- (3) The security interest has priority over conflicting perfected security interests in the item, accompanying documents or proceeds.

N.C. Gen. Stat. § 25-4-208.

advantage of provisional credit granted it by the bank of a deposited item. N.C. Gen. Stat. § 25-4-208(a)(1); see also, Cannon, 237 F.3d at 720 (applying identical Tennessee provision); Pereira, 2001 WL 563730 at \*15 (applying identical New Jersey provision); Summit Financial Servs., 240 B.R. at 115-16 (applying identical Georgia provision). The security interest in the deposited item continues until funds are either collected or deposited into the account from other sources. N.C. Gen. Stat. § 25-4-208(c); Cannon, 237 F.3d at 720. Even where a deposited check is dishonored and covered by substitute funds, the bank's security interest attaches to those substitute funds. Cannon, 237 F.3d at 721; Pereira, 2001 WL 563730 at \*16; Brown, 209 B.R. 874 at 887.

8. Therefore, to the extent that it had any claim against the Debtor, Peoples Bank at all times was fully secured by virtue of N.C. Gen. Stat. § 25-4-208(a). This security interest remained perfected by operation of law until all deposited items were satisfied either through NationsBank's honoring of those deposited items or other transfers to cover those deposits.

9. The possibility that some of the dishonored checks on which Peoples Bank had extended provisional credit were covered by funds collected from sources does not change this analysis. As the Sixth Circuit held in Cannon, supra, Peoples Bank's security interest continues in the deposited items until satisfied, regardless of the source of the funds. Peoples Bank had a secured claim for all dishonored deposited checks in the amount of \$960,900.00, which could be satisfied from any assets of the Debtor. See also Pereira, 2001 WL 563730 at \*16 (holding satisfaction of Article 4 security interest through wire transfer did not create preferential liability). Because Peoples Bank enjoyed secured creditor status, it did not recover more than it would have under a hypothetical Chapter 7 liquidation. Therefore, the Trustee will be unable to prove an essential element of his preference claim as to the dishonored checks.

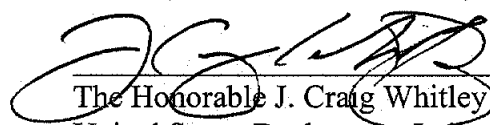
10. Although some courts first addressing the issue of preferential transfers in the context of a check kiting scheme allowed recovery of preferences, see, e.g., McLemore v. Third National Bank in Nashville (In re Montgomery), 983 F.2d 1389 (6th Cir. 1993), those courts did not address the issue of a bank's secured status in deposited items. Cannon, 237 F.3d at 720. Indeed the Sixth Circuit itself in Cannon concluded that Montgomery was useful only in situations "where the depository or collecting bank acts with knowledge of the kiting scheme," and "does not control situations . . . where the bank acts in the ordinary course of business, without knowledge of questionable banking practices by its account holder." Cannon, 237 F.3d at 720. This Court agrees with the reasoning of the Sixth Circuit in Cannon, and rejects the application of Montgomery under these facts. Although the Trustee urges the Court to find that Peoples Bank knew or should have known of the Debtor's check kiting scheme, the record is devoid of any evidence to support such a conclusion.

11. Because there are no genuine issues of material fact, and because the Trustee cannot establish an essential element of his preference claim, Peoples Bank is entitled to judgment as a matter of law.

THEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED:

1. Peoples Bank's Motion for Summary Judgment pursuant to Rule 7056 of the Federal Rules of Civil Procedure is hereby GRANTED;
2. This Adversary Proceeding is dismissed, with prejudice; and
3. Each party shall bear its own costs.

SO ORDERED this the 12<sup>th</sup> day of <sup>Nov</sup>~~October~~, 2002.

  
The Honorable J. Craig Whitley  
United States Bankruptcy Judge

**BROOKS, PIERCE, McLENDON, HUMPHREY & LEONARD, L.L.P.**

ATTORNEYS AND COUNSELLORS AT LAW

FOUNDED 1897

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November 5, 2002

**VIA FEDEX**

Clerk, United States Bankruptcy Court  
401 W. Trade Street  
Charlotte, North Carolina 28202

Re: Carolina Alloy & Stainless, Inc.  
Case No. 99-31596  
Adv. Proceeding No. 01-3147

Dear Sir/Madam:

Please find enclosed a proposed Order for Judge Whitley's consideration in the above-referenced matter. We have submitted this Order to Keith Johnson for his prior review, and Mr. Johnson has given us his comments. If you require anything further, please do not hesitate to contact me.

Sincerely,

H. Arthur Bolick II

HABII/dmb

Enclosure

cc: Keith Johnson

Local Form



Revised 2002

UNITED STATES BANKRUPTCY COURT  
WESTERN DISTRICT OF NORTH CAROLINA  
Form for Tender of Order or Judgment

I. Case Name: In Re Carolina Alloy & Stainless, Inc.  
Base Case No: 99-31596 Chapter: 7 Adv. Proc. #: 01-3147  
Adv. Proc. Name: R. Keith Johnson Trustee v. Peoples Bank  
Primary Relief: Summary Judgment

II. ☐ Consent Order ☐ Order after "No-Protest Notice" with No  
Objection or Response  
☐ Ex Parte Order Submitted With Motion  
☒ Pursuant to Court's Oral Ruling at Hearing on: October 15, 2002  
☐ Other Order \_\_\_\_\_

III. ☐ No Opposing Counsel or Party  
☒ Form of Order Approved by Opposing Counsel  
☐ Date Opposing Party/Counsel was Served with Copy of Proposed Order and this Form: \_\_\_\_\_

IV. Order will be Tendered to the Court on: \_\_\_\_\_

V. ☒ Return filed copy of order in enclosed self-addressed, stamped envelope to attorney who prepared order.

VI. Attorney Preparing Order: H. Arthur Bolick II  
Address: P.O. Box 26000  
City, State and Zip: Greensboro, NC 27420  
Telephone and Bar Number: 336-373-8850 State Bar No. 20866  
Representing: Peoples Bank

**INFORMATION MUST BE COMPLETED IN EACH SECTION (I-VI) OR THE COURT  
MAY REJECT THE ORDER AS SUBMITTED**

REPRODUCE THIS FORM ON GREEN STOCK AND SUBMIT IT WITH ORIGINAL AND ONE COPY OF ORDER.  
SUBMIT AN ORDER WITH *EX PARTE* MOTION. SUBMIT OTHER ORDERS ONLY AFTER EXPIRATION OF  
NOTICE OR OBJECTION PERIODS, AS APPLICABLE.