ALERTS

First Circuit Rejects Fraudulent Transfer Attack on Lender's Transfer of Asset Sales Proceeds

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A bankruptcy trustee could not "*avoid* [a] debtor's transfer" of encumbered asset sale proceeds when the debtor holds the funds "as a mere disbursing agent [under] a contract that" restricted its use, held the U.S. Court of Appeals for the First Circuit on April 18, 2018. *Keach v. Wheeling & Lake Erie Railway Co. (In re Montreal, Me. & Atl. Ry.)*, 2018 U.S. App. LEXIS 9772 *14 (1st Cir. Apr. 18, 2018). Affirming the dismissal of the trustee's fraudulent transfer complaint under Maine's version of the Uniform Fraudulent Transfer Act ("UFTA"), made applicable by Bankruptcy Code § 544(b), the First Circuit stressed that the debtor "lacked a cognizable property interest in the [funds] paid to the [defendant]." *Id.* at *15.

Facts

The debtor railroad had two secured lenders (one senior to the other) with liens on all of its U.S. assets. *Id.* at*2-3. To obtain needed cash for continued operations, "the debtor asked the senior lender [the Federal Railroad Administration] to amend its existing loan agreement so as to provide 'a limited waiver of its existing senior lien over the debtor's assets.'" *Id.* at *3. That waiver "would take effect 'upon the closing of the proposed sale'" of assets to a third party, for which the senior lender would receive a "replacement lien on certain of the debtor's [Canadian property . . .]" *Id.*

The senior lender conditioned its limited waiver on the debtor's compliance with certain conditions. On the closing of the asset sale, the debtor was required "to convey the proceeds to an escrow agent." *Id.* at *4. Once the senior lender perfected its lien on the debtor's Canadian property and received $2.4 million of the sale proceeds, among other things, the debtor had to "distribute the remainder of the proceeds to [the defendant junior secured lender]." *Id.*

"The debtor distributed the proceeds in accordance with the waterfall provision of" its amended loan agreement with the senior lender. The junior lender received full payment of its secured claim. More than two years later, the debtor filed a Chapter 11 petition and a court-approved trustee took charge of the debtor's estate.

The Lower Courts

The trustee sued the junior lender, "seeking to avoid the waterfall disbursement made to it as constructively fraudulent under . . . Maine's [UFTA], ..." *Id.* at *5. The junior lender moved to dismiss the complaint, arguing that "the waterfall disbursements did not consist of 'assets' belonging to the debtor." *Id.* The bankruptcy court dismissed the complaint with prejudice for failure to state a claim, reasoning that the waterfall disbursements were part of a single transaction, with the sale proceeds remaining encumbered by the senior lender's lien up until the time of the disbursement. The district court affirmed.

The Court of Appeals

Bailment/Trust Analysis. The First Circuit adopted a different legal analysis to reach the same result. It stressed that "the debtor did not hold an interest in [the sale proceeds] that is voidable . . . ," regardless of whether the assets being sold were encumbered by the senior lender's lien when "the waterfall disbursement to [the junior lender] was made . . . ." *Id.* at *11. According to the "plain language" of the senior lender's amended loan agreement, "the relationship between the contracting parties (the debtor and the [senior lender]) was akin to a bailment, . . . an arrangement involving 'the delivery of personal property by one person to another in trust for a specific purpose, with a contract . . . that the trust shall be faithfully executed and the property returned or duly accounted for when the special purpose is accomplished . . . .'" *Id.*

The senior lender "initially held title to the [encumbered assets] as mortgagee." *Id.* By amending its loan agreement, it "approved the [asset] sale . . . and waived its lien. With respect to [the sale proceeds], the [senior lender] required, among other things, that the proceeds . . . be paid to an 'escrow agent' for the special purpose of distributing those funds to the parties enumerated" in the amended agreement. *Id.* at *12. In short, "the debtor could not have put the proceeds to any use that was not authorized by the [senior lender] under the terms of the [amended agreement]." *Id.* That amendment "had the effect of forbidding the debtor from using the proceeds to pay general creditors save for the approximately $1 million that was earmarked for accounts payable." *Id.* Because the debtor was a mere disbursing agent, "the trustee cannot avoid the debtor's transfer of the funds . . . ." *Id.* at *14.

Good Commercial Sense. The First Circuit stressed the "good commercial sense" underlying its analysis. It would "prevent unsecured creditors from sharing in funds that the debtor could not have retained for its own use . . . . [S]uch limitations are consistent with the Supreme Court's admonition that the law 'does not authorize a trustee to distribute other people's property among a [debtor's] creditors.'" *Id.*, citing *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 135-36 (1962). In sum, "the debtor was a mere 'transfer station along the road to payment' of the parties specified under the waterfall provision" in the amended loan agreement. *Id.* It thus "lacked a cognizable property interest in the waterfall distribution paid to [the junior lender]." *Id.* at *15.

The asset sale proceeds here never "belonged outright to the debtor prior to consummation of the relevant transactions, but, rather, were subject to the [senior lender's] mortgage and lien." *Id.* at *16. As the trustee conceded, the senior lender "would have been entitled to the proceeds" from any asset sale. *Id.* Although the senior lender "granted a limited waiver of its lien, it conditioned that waiver on the debtor's distribution of the proceeds in compliance with the [amended loan agreement's] waterfall provision." *Id.*

The senior lender thus chose "to allocate the proceeds to which it was entitled among certain of the debtor's creditors, an allocation that it apparently concluded" was in its interest. Because it had "imposed conditions that preclude[d] the debtor from exercising effective control over the sale proceeds," the "waterfall disbursement to [the junior lender] did not consist of property of the debtor's estate." *Id.* That the "debtor

briefly possessed the sale proceeds (apparently as an escrow agent) does not mean that it had any discretion to use those proceeds as it saw fit." *Id.* at *17. Quoting the leading bankruptcy treatise, the court explained that "if property is in a debtor's hands as bailee or agent," the bankruptcy trustee may not recover it. *Id.* Quoting 5 Collier, *Bankruptcy* ¶ 541.05 (16th rev. ed. 2017). The court thus rejected the trustee's attempt to equate "possession" with "control." *Id.* at *17.

A Senior Lender's Discretion. Calling it "magical thinking," the court rejected the trustee's argument that the senior lender's agreement to take less than the full amount of its claim was evidence of the debtor's control. 2019 U.S. App. LEXIS 9772, at *18. According to the court, "the debtor could never have sold the [assets], let alone decided how to distribute the sale proceeds, without the [senior lender's] approval." The [senior lender's] decision to divert the proceeds of the sale to less senior creditors may seem unusual, but the [senior lender] is not a typical transacting party," but "an executive agency of the United States, which employs the lending program to maintain and improve the nation's railroads." *Id.*

Comment

The First Circuit first relied on basic property rights under state law before applying federal law. As the U.S. Supreme Court held, state law determines the existence and extent of a debtor's property interest. *Butner v. United States*, 440 U.S. 48, 54-55 (1979). After applying state law, the court then applied federal law to determine whether the debtor's interest belonged to the debtor's estate. *In re WEB2B*, 815 F. 3d 400, 405 (8th Cir. 2016).

Authored by Michael L. Cook.

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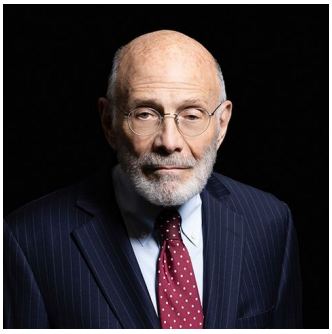

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