YOU WANT PREFERENTIAL TREATMENT?
Sometimes Avoidance of a Transfer in Chapter 11 is Not Enough

By: William L. Hallam

Most creditors have received a letter from a bankruptcy trustee or from a customer who has filed a Chapter 11 bankruptcy case and is now a debtor-in-possession with the powers of a trustee demanding that the creditor return a payment made within 90 days of the customer's bankruptcy filing. To promote equal treatment of creditors in bankruptcy and to discourage creditors from racing to the courthouse to force financially-troubled debtors to pay, the Bankruptcy Code allows a trustee to "avoid" as a "preference" a transfer if it: (1) was of property of the debtor; (2) was to or for the benefit of a creditor; (3) was made on account of an antecedent debt owed by the debtor before the transfer was made; (4) was made while the debtor was insolvent; (5) was made within the 90 days preceding the bankruptcy filing; and (6) enabled the creditor to be paid more than if it had not received the transfer and had received payment of its claim in a Chapter 7 bankruptcy liquidation.

A trustee who avoids a transfer as a preference may recover the property transferred or its value from: (1) the initial transferee or the entity for whose benefit the transfer was made; or (2) any immediate or subsequent transferee of the initial transferee or entity for whose benefit the transfer was made. A trustee may not recover from an immediate or subsequent transferee who "takes for value, including satisfaction…of…a… debt, in good faith, and without knowledge of the voidability of the transfer…" However, much to the frustration of creditors, for the initial transferee or the entity for whose benefit the preferential transfer was made, the fact that the transferee had no reason to believe that the debtor was in financial trouble and that the transfer was made to pay a legitimate debt is not a defense.

As favorable as the Bankruptcy Code is to trustees seeking to avoid and recover preferences, they still must be mindful of its technical requirements. In a recent decision of the United States Court of Appeals for the Fourth Circuit, one such requirement thwarted a trustee's attempt to recover more than $2 million in avoidable preferences.

In *In re Railworks Corporation*, 760 F.3d 398 (4th Cir. 2014), the debtor ("Railworks") had paid over $2 million during the 90 days preceding the filing of its Chapter 11 petition to an insurance underwriter ("CPG") for premiums due on policies issued by an insurer ("TIG"). CPG's agreement with TIG required CPG to collect the premiums due on policies that it underwrote, to remit what it collected, minus CPG's commission, to TIG, and to hold collected premiums in trust for TIG until they were remitted to TIG. CPG's agreement with TIG also obligated CPG to pay TIG the premiums due on policies that CPG underwrote even if the insured did not pay.

Railworks' trustee sued to avoid Railworks' payments and recover them from CPG. There was no dispute the Railworks' payments satisfied all of the elements of an avoidable preference. However, CPG argued that the payments could not be recovered from it because CPG was not the initial transferee or the entity for whose benefit the transfers were made.

The Fourth Circuit began by noting that, "The avoidance of a transfer and the recovery from the transferee are distinct from one another… Although the avoidance of a transfer is necessary to recover from a transferee, avoidance of a transfer does not automatically entitle the trustee to a recovery."

The Fourth Circuit noted that it had "long ago" held that "a party cannot be an initial transferee if he is a mere conduit for the party who had a direct business relationship with the debtor." CPG was such a "mere conduit" because CPG's agreement with TIG obligated CPG to remit to TIG any premiums that it collected.

The lower court, however, had held that CPG was an entity for whose benefit Railworks' payments were made because CPG was obligated to pay TIG for the policies and the payment by Railworks relieved CPG of that obligation. The Fourth Circuit rejected this reasoning, noting that "a conduit, by definition, has an obligation to pass the funds on to a third party." The Court said that if it adopted the position of the lower court, "that one can be both a 'mere conduit' and 'one for whose benefit the transfer occurred' we would eviscerate the conduit defense—something that we are unwilling to do." Instead, the Court held that "a party—in this instance CPG—cannot be an entity for whose benefit the transfer was made if it is a mere conduit for the party that had a direct business relationship with the debtor."

The *Railworks* decision demonstrates that, in bankruptcy, what appears obvious may not be so obvious after all. Without the benefit of experienced bankruptcy counsel, it is doubtful that CFG would have thought it possible that, for bankruptcy purposes, it was neither the initial transferee of payments made directly to it, nor a party for whose benefit those payments were made.

For any of your other creditors' rights needs, please contact an attorney in our creditors' rights group:

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