STEVENS & LEE

Bankruptcy Client Alert

February 13, 2012

Payments to Lead Lender Are Not Avoidable Preferences to Extent of Participation Interests

Robert Lapowsky
rl@stevenslee.com
215-751-2866

Pursuant to Section 547 of the Bankruptcy Code, payments made within 90 days of a filing are avoidable as preferences, subject to certain defenses. A defense that has been asserted and sometimes accepted is that the recipient was acting as a "conduit" for another party.

In *Northern Capital, Inc. v. The Stockton National Bank et. al.* (*In re Brooke Corporation*), 458 B.R. 579 (Bkrtcy.D.Kan.,2011) a recent case decided by the United States Bankruptcy Court for the District of Kansas, the Court addressed a conduit defense in the context of a participated loan.

In *Brooke*, the debtor borrowed $4.5 million from Stockton National Bank. On the same day the loan closed, Stockton sold participations in the loan to other financial institutions. The participations sold by Stockton totaled about 95% of the interests in the loan. Pursuant to the Participation Agreement, upon receipt of payments from Brooke, Stockton was obligated to distribute to each participant its pro rata share.

After the Brooke loan was closed, Brooke filed a bankruptcy petition. Thereafter, the trustee appointed in the Brooke case sued Stockton to recover allegedly preferential transfers totaling about $488,000.

Stockton asserted a number of defenses, including that (a) it had sold the participations to the participants, (b) it had distributed 95% of the alleged preferential payment to the participants, and (c) as to that 95%, it was a mere conduit and not an initial transferee from whom a preference could be recovered.

Initially, the *Brooke* Court noted that, in *Bonded Fin. Serv. Inv. v. European Amer. Bank.* 838 F. 2d 890, 893 (7th Cir. 1988), it was held that "the minimum requirement of status as a 'transferee' is dominion over the money or other asset, the right to put the money to one's own purposes." The *Brooke* Court then went on to state, "[T]he *Bonded* definition of initial transferee has been held to mean that if the entity receiving the funds is not permitted – by law, contract, or otherwise – from using the funds as it desires, it is a mere conduit and not an "initial transferee." The *Brooke* Court then observed that there did not appear to be any case-law addressing the conduit defense in the context of participated loans.

The *Brooke* Court held that Stockton was a mere conduit from whom only the portion of the allegedly preferential payments which it retained (about 5%) could be recovered. As to the remainder, the *Brooke* Court held that the participants were the initial transferees.

The *Brooke* decision is driven by the fact that Stockton was contractually obligated to distribute 95% of the allegedly preferential payments to the participants and did, in fact, make those distributions. As a result, in the view of the *Brooke* Court, Stockton was a mere conduit from whom the funds distributed by Stockton to the participants could not be recovered notwithstanding that (a) the note evidencing the loan identified only Stockton as the creditor, (b) when received, the payments were commingled by Stockton with its other funds, and (c) Stockton filed a proof of claim for the entire amount of the loan.

While *Brooke* would appear to be good news for lead lenders in participated loans, two cautionary notes are appropriate.

First, arguably, the *Brooke* holding conflicts with the holding of the Seventh Circuit in *Paloian v. LaSalle Bank, N.A.*, 619 F. 3d 688 (7th Cir. 2010). In *Paloian*, the trustee of a securitized asset trust received payments which it was contractually obligated to, and did, distribute to the trust beneficiaries. When sued for return of those payments in a subsequent bankruptcy filed by the obligor, the trustee asserted the mere conduit defense. However, that defense was rejected. The *Brooke* Court distinguished *Paloian* on the basis that the *Paloian* trustee had legal title to all of the

trust's assets (including the loan in question) while, pursuant to the Brooke participation agreement, the participants (not Stockton) had legal and equitable title to the portions of the loans equal to the participation interests. Whether that distinction is appropriate is an open question.

Second, the *Brooke* Court mentions that the debtor, Brooke, brought the participants to Stockton and therefore could not be said to have intended that only Stockton would benefit from the allegedly preferential payments. It is not clear the extent to which that fact influenced the *Brooke* decision. However, in most participations the borrower does not bring the participants to the lead lender. Therefore, it may be possible to distinguish the *Brooke* decision in cases where the lead lender cannot show that the borrower intended that the participants would benefit from a payment.

For more information on how these issues may affect your rights, contact Robert Lapowsky at rl@stevenslee.com or 215-751-2866. Mr. Lapowsky is a Shareholder of Stevens & Lee and Co-Chair of the Bankruptcy and Financial Restructuring Group practicing in the Philadelphia office.

Stevens & Lee is a professional services firm with 180 lawyers and 60 business and consulting professionals located in 14 offices throughout the Mid-Atlantic region. You can find more information about Stevens & Lee at www.stevenslee.com.

© 2012 Stevens & Lee, a Pennsylvania Professional Corporation

Richard J. Pinto and Harry A. Horwitz, shareholders responsible for the Princeton and Cherry Hill, New Jersey offices, respectively.

This material is provided as a general informational service to clients and friends of Stevens & Lee. It should not be construed as, and does not constitute, legal advice on any specific matter. The delivery of this material does not create an attorney-client relationship. This material may be considered ATTORNEY ADVERTISING in some states. Please note that prior results discussed in this material do not guarantee similar outcomes. Readers must not rely on this general information in making decisions about such things as structuring transactions or arbitrating, settling or resolving any dispute, contested or uncontested; professional advice should be sought as to any such specific situation.