FREE ABA Business Bankruptcy Committee Webinar:

**Tropical Storm TOUSA: Has the 11th Circuit Burst Lending to Distressed Borrowers on the Bubble?**

**Thursday, July 12, 2012**

1:00 PM - 2:30 PM ET | 12:00 PM - 1:30 PM CT
11:00 AM - 12:30 PM PT | 10:00 AM - 11:30 AM PT

A distinguished panel of leading bankruptcy experts, with very divergent views and sparks among them, will analyze the 11th Circuit's rulings in the controversial TOUSA decision. These experts will discuss whether TOUSA expanded the reach of fraudulent transfer law by imposing liability on a creditor whose repayment was financed by a fraudulent transfer of collateral to a lender. The panelists will also offer practical advice: (1) to lenders who are contemplating loans to financially distressed borrowers, and (2) to creditors who are tendered repayment by financially distressed obligors.

Please join us in this free webinar sponsored by the Business Bankruptcy Committee of the ABA Business Law Section.

**Panelists:**

- G. Eric Brunstad, Partner, Dechert LLP, Hartford, CT
- Jessica D. Gabel, Of Counsel, Vernia Law Firm and Professor, Georgia State University College of Law, Atlanta, GA
- William J. Rochelle (Ret.), Partner, Fulbright & Jaworski L.L.P, New York, NY
- Steven O. Weise, Partner, Proskauer Rose LLP, Los Angeles, CA

**Moderator:** Bruce J. Borrus, Principal, Riddell Williams P.S., Seattle, WA

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**HOT TOPICS AND RECENT DEVELOPMENTS**

**Featured Articles:**

- **In re TOUSA: The Eleventh Circuit Spins a Cautionary Tale for Lenders**
  Terrance J. Keenan, Foster Pepper PLLC, Seattle, Washington

   It is well known that creditors receiving payments or other transfers of property interests from a debtor may be forced to return the transfer under Bankruptcy Code § 550 if the debtor enters bankruptcy and the transfer is found to have been preferential, fraudulent or otherwise avoidable. The U.S. Court of Appeals for the Eleventh Circuit's recent ruling in Senior Transeastern Lenders v. Official Committee of Unsecured Creditors (In re TOUSA, Inc.), however, is a stark reminder of the possibility that a creditor will be compelled to return property to the debtor's bankruptcy estate extends *not only* to transfers received...
from the debtor, but also to transfers made by someone other than the
debtor, such as a refinancing lender. It also serves as a reminder that
participants in the credit markets have a duty to exercise due diligence
regarding the debtor's financial condition when they elect to receive
such transfers, while leaving open the question as to the level of
diligence required before a transfer is found to have been made in bad
faith.

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Who is a "Transferee" Under Section 550(A) of the Bankruptcy Code?: The Divide
Over Domination, Control and Good Faith in Applying the Mere Conduit Defense

Jessica D. Gabel, Assistant Professor, Georgia State University College of Law,
Atlanta, Georgia; Paul R. Hage, Jaffe Raitt Heuer & Weiss, P.C., Southfield, Michigan

Determining whether the recipient of an avoidable transfer is a
transferee of such transfer or, alternatively, a mere conduit, is a
question that poses a challenging scenario for lawyers. Two distinct
tests have emerged for determining whether the recipient of a transfer
is a transferee, namely: (i) the "dominion test" which focuses on
whether the recipient had dominion over the money or other asset
transferred; and (ii) the "control test" which requires courts to examine
the entire circumstances of the transaction, including whether the
recipient acted in good faith, in order to determine whether the
recipient actually controlled the transferred funds. The test utilized by
the court in determining whether the broker was a transferee or,
alternatively, a mere conduit, will largely determine the outcome of the
lawsuit.

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Judith Greenstone Miller, Jaffe Raitt Heuer & Weiss, P.C., Southfield, Michigan; My
Chi To, Debevoise & Plimpton LLP, New York, New York

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Legislation Subcommittee on the ABA Business Bankruptcy
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In conjunction with the ABA Business Law Section Annual Meeting

Business Bankruptcy Program - Chair, Mark E. Leipold

Friday, August 3, 2012, 8:00 AM - 10:00 AM

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Avoiding the Pitfalls of Representing the Innocent Investor, Creditor, or
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Corporate Counsel Program - Chair, Robert L. Haig
Co-Sponsored by the Audit Responses, Business Bankruptcy, Business and

Friday, August 3, 2012, 2:30 PM - 4:30 PM
Program: Corporate Litigation Problems That Keep General Counsel Awake at Night and How to Solve Them

Business Bankruptcy Program - Chair, Margaret M. Anderson

Saturday, August 4, 2012, 8:00 AM - 10:00 AM
Program: Magistrates and Federal Courts after the Supreme Court Speaks in Stern v. Marshall

Commercial Finance Program - Chair, John E. Murdock, Ill
Co-Sponsored by the Uniform Commercial Code, Business Bankruptcy, LLC’s Partnerships and Unincorporated Entities, and Taxation Committees

Saturday, August 4, 2012, 10:30 AM - 12:30 PM
Program: Lending to LLC’s Dealing with Key Collateral, Workout, and Bankruptcy Issues

Trust Indenture and Indenture Trustees Program - Co-Chairs, Harold L. Kaplan and Ellen L. Marks
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Saturday, August 4, 2012, 10:30 AM - 12:30 PM
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Uniform Commercial Code Program - Co-Chairs, Sandra M. Rocks and Edward K. Gross
Co-Sponsored by the Business Bankruptcy, Commercial Finance, and Securitization and Structured Finance Committees

Sunday, August 5, 2012, 8:00 AM - 10:00 AM
Program: Princes into Toads: How Recharacterization and Other Readjustments to Your Transactions Could Wreak Havoc with Your Rights

Business Bankruptcy Program - Chair, Kyle Mathews
Co-Sponsored by the Commercial Finance Committee

Sunday, August 5, 2012, 8:00 AM - 10:00 AM
Program: Federal Receiverships - The Solution to the Current Patchwork of State Receivership Laws?

Business Bankruptcy Program - Co-Chairs, Leianne S. Crittenden and Patricia A. Redmond
Co-Sponsored by the International Coordinating Committee

Sunday, August 5, 2012, 10:30 AM - 12:30 PM
Program: Thunderclouds on the Horizon? What Happens if Your Cloud Provider is Insolvent?

Uniform Commercial Code Program - Co-Chairs, Kristen David Adams and Pamela J. Martinson
Sunday, August 5, 2012, 10:30 AM - 12:30 PM

Program: Two's Company, Three's a Crowd: Triangular Arrangements in Commercial Law

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Below is a link to the full webinars and to the slide show presentations.

Business Bankruptcy Committee Webinars

Materials from the Business Bankruptcy Section 2012 Spring Meeting

At the Spring Meeting of the ABA Section of Business Law Business Bankruptcy Committee in Las Vegas, Nevada, members of the Committee presented a number of informative and interesting programs. Below is a link to all of the materials provided at these programs. (Access to some of the articles requires your ABA password.)

2012 Spring Meeting Materials

Submit Articles for the Business Bankruptcy Newsletter

The Business Bankruptcy Committee invites you to submit articles for possible publication in future issues. The articles do not need to be long or in-depth, and it is a great way to get involved in the Business Bankruptcy Committee. Articles can survey the law nationally or locally, discuss particular business bankruptcy issues, or examine a specific case. If you are interested in submitting an article, please contact Newsletter Editor-in-Chief Christopher Alston at ALSTC@foster.com or Editor Marvin Ruth at MRUTH@lrlaw.com.
In re TOUSA: The Eleventh Circuit Spins a Cautionary Tale for Lenders

By Terrance J. Keenan, Esq.1

It is well known that creditors receiving payments or other transfers of property interests from a debtor may be forced to return the transfer under Bankruptcy Code § 550 if the debtor enters bankruptcy and the transfer is found to have been preferential, fraudulent or otherwise avoidable. The U.S. Court of Appeals for the Eleventh Circuit’s recent ruling in Senior Transeastern Lenders v. Official Committee of Unsecured Creditors (In re TOUSA, Inc.),2 however, is a stark reminder of the possibility that a creditor will be compelled to return not only transfers received from the debtor, but also transfers made by someone other than the debtor, such as a refinancing lender. It also serves as a reminder that participants in the credit markets have a duty to exercise some degree of due diligence regarding the debtor’s financial condition when they elect to receive such transfers, while leaving open the question as to the level of diligence required before a transfer is found to have been made in bad faith.

I. Overview of the TOUSA Transfers

TOUSA, Inc. was one of the nation’s largest homebuilders. It grew rapidly by buying other homebuilders, which became subsidiaries of TOUSA. The subsidiaries earned substantially all of the revenue and owned most of the assets of the TOUSA enterprise.

To finance its acquisitions, TOUSA issued unsecured bonds and took out a secured revolving line of credit administered by Citicorp North America, Inc. The bonds

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1 Mr. Keenan is an Associate in the Creditors’ Rights and Bankruptcy Practice Group of Foster Pepper PLLC, Seattle, Washington.
were often guaranteed by TOUSA’s subsidiaries, and TOUSA and its subsidiaries were jointly and severally liable for repayment of the line of credit. Under both the bond and line of credit agreements, any judgment against TOUSA or its subsidiaries in excess of $10.0 million would constitute an event of default. Upon such a default, the bondholders and Citicorp would be entitled to accelerate the debt under their respective agreements. Thus, TOUSA and its subsidiaries were exposed to substantial risk in the event of a default.

In June 2005, TOUSA—through its subsidiary TOUSA Homes LP—entered into a joint venture with a third party to acquire assets of homebuilder Transeastern Properties, Inc. In connection with that purchase, TOUSA and TOUSA Homes incurred new unsecured debt from the “Transeastern Lenders.” TOUSA’s other subsidiaries were neither obligors nor guarantors of that debt. Within months, the joint venture defaulted on its obligations, and the Transeastern Lenders brought suit against TOUSA and TOUSA Homes for over $2.0 billion. Entry of any judgment in that suit in excess of $10.0 million would have constituted an event of default under TOUSA’s other bond and line of credit agreements.

In July 2007, TOUSA, TOUSA Homes and its joint venture partner settled with the Transeastern Lenders. Under the settlement, the Transeastern Lenders received more than $421.0 million from TOUSA. To fund the settlement payments, TOUSA and certain of its subsidiaries—including various subsidiaries that were not obligated to the Transeastern Lenders (the “Conveying Subsidiaries”—incurred new debt syndicated by Citicorp to new lender groups (the “New Lenders”). The New Lenders included some of the Transeastern Lenders. The debt was secured by first- and second-position liens on
substantially all of the assets of TOUSA and the Conveying Subsidiaries. The loan agreements required that the proceeds be used to fund the settlement.

Upon the closing of the settlement transaction, Citicorp transferred the loan proceeds to a TOUSA subsidiary that was otherwise unrelated to the settlement. That subsidiary then transferred proceeds to the Transeastern Lenders’ administrative agent. Finally, the administrative agent made disbursements totaling more than $421.0 million to the Transeastern Lenders.

II. The Transfers Work Their Way Through the Courts

A. The Bankruptcy Court Unwinds the Settlement Transaction

In January 2008, TOUSA and the Subsidiaries filed Chapter 11 petitions in the U.S. Bankruptcy Court for the Southern District of Florida. The unsecured creditors’ committee (the “Committee”), on behalf of the debtors’ estates, filed an adversary proceeding under (a) Bankruptcy Code § 548(a)(1)(B) to avoid the transfers to the New Lenders of the first- and second-position liens on assets of TOUSA and the Conveying Subsidiaries, and (b) Bankruptcy Code § 550(a)(1), to recover from the Transeastern Lenders the value of those liens. As of the petition date, TOUSA owed approximately $1.0 billion of principal on its bonds and $224.0 million on its line of credit.

Following a thirteen day bench trial, the Bankruptcy Court unwound the settlement transaction in its entirety and permitted the Conveying Subsidiaries to recover from the Transeastern Lenders the value of the liens as of the petition date. The court concluded that the liens were fraudulently granted under § 548(a)(1)(B), because the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the

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3 In re TOUSA, Inc., Bankr. S.D. Fla. No. 08-10928-JKO (jointly administered).
4 The Committee also alleged a claim under § 547 that was not at issue before the Eleventh Circuit.
liens, were insolvent before and after the settlement transaction was consummated, and were left with unreasonably small capital with which to operate after the transaction. The Court relied upon contemporaneous evidence and expert testimony in determining that those elements of § 548 were satisfied. The court’s opinion cites to extensive corporate records and correspondence of TOUSA’s subsidiaries, opinions of industry experts, events relating to the collapse of the subprime market, and circumstances surrounding Citicorp’s troubled syndication process for the New Lenders’ loan to fund the settlement transaction. The court specifically found that the satisfaction of the joint venture’s indebtedness, the elimination of TOUSA’s and TOUSA Homes’ guaranties of that debt, and the settlement of the litigation involving TOUSA and TOUSA Home provided no value to the Conveying Subsidiaries.

The court also found that the Transeastern Lenders were the entities for whose benefit the Conveying Subsidiaries transferred their liens, and the value of the liens could therefore be recovered from the Transeastern Lenders under § 550(a)(1). The court noted that TOUSA undertook the new loan, and the Conveying Subsidiaries granted the liens securing that loan, for the express purpose of settling the Transeastern Lenders’ claims against TOUSA and TOUSA Homes. The new loan agreements required that more than $421.0 million of the loan proceeds be used to pay the Transeastern Lenders, and that the settlement agreement be executed by the parties. In effect, the Court found that the liens were granted to the New Lenders to satisfy TOUSA’s debt to the Transeastern Lenders.

Finally, the court concluded that the Transeastern Lenders and the New Lenders could not raise any defense to liability under § 550(b)(1) because they did not act in good faith and were grossly negligent when they consummated the transaction. The court
pointed to “overwhelming” evidence of TOUSA’s financial distress when it determined that the Transeastern Lenders and the New Lenders knew or should have known that the debtors were insolvent or becoming so at the time of the settlement, and that the debtors would be left with inadequate capital after the settlement. The court observed that the lenders nevertheless proceeded with the settlement without careful inquiry into the debtors’ solvency or the potential avoidability of the settlement transaction.

Consequently, and pursuant to § 548, the court avoided all obligations of the Conveying Subsidiaries to the New Lenders arising out of the settlement transaction, disallowed all claims asserted or assertable by the New Lenders against the Conveying Subsidiaries arising out of that transaction, and avoided all liens granted by the Conveying Subsidiaries to the New Lenders to secure those obligations and claims.

The court also directed the Transeastern Lenders to disgorge to the Conveying Subsidiaries’ estates $403.0 million of the $421.0 million the Transeastern Lenders received through the settlement transaction, plus prejudgment interest. That amount was recoverable because § 550(a)(1) permits recovery of property transferred fraudulently under § 548 from the entity for whose benefit the transfer was made. The court reasoned that the liens on the Conveying Subsidiaries’ property were transferred for the benefit of the Transeastern Lenders through the settlement transaction, and the value of the liens was therefore recoverable from the lenders.

Finally, under § 550, the court ordered the New Lenders to disgorge to the Conveying Subsidiaries’ estates all amounts paid to, for the benefit of, or on behalf of, the New Lenders with respect to the avoided claims and obligations, including attorneys’ fees and costs and other payments made by the Conveying Subsidiaries in connection
with the settlement transaction, or by their Chapter 11 estates post-petition in accordance with cash collateral and other court orders.

B. The District Court Vacates the Bankruptcy Court’s Order

The Transeastern Lenders appealed the Bankruptcy Court’s ruling to the District Court for the Southern District of Florida. The District Court quashed the Bankruptcy Court’s ruling as it relates to liability of the Transeastern Lenders and declared the Bankruptcy Court’s imposition of remedies as to the Transeastern Lenders null and void. The District Court concluded that remand to the Bankruptcy Court for further proceedings was unnecessary because the record could not support a ruling against the Transeastern Lenders with respect to liability—that is, (a) the District Court could only find that the Conveying Subsidiaries received reasonably equivalent value in exchange for the liens and the liens were therefore not granted fraudulently under § 548(a)(1)(B), and (b) the Transeastern Lenders were not entities for whose benefit the Conveying Subsidiaries transferred their liens and the value of the liens could therefore not be recovered from the Transeastern Lenders under § 550(a)(1) even if the liens had been conveyed fraudulently under § 548(a)(1)(B).

The District Court also determined that the Conveying Subsidiaries received reasonably equivalent value in exchange for granting the liens to the New Lenders. The District Court faulted the Bankruptcy Court for adopting too narrow a definition of “value” for the purpose of § 548(a)(1)(B). The District Court found that the record undisputedly established that the Conveying Subsidiaries received indirect economic benefits in exchange for the lien transfers that constituted reasonably equivalent value.

Those benefits included the debtors’ opportunities through the settlement agreement to avoid default, facilitate the TOUSA enterprise’s rehabilitation, and avoid bankruptcy. The District Court observed that those benefits were “not susceptible to exact quantification but are nonetheless legally cognizable under Section 548.”6 It found that the Conveying Subsidiaries’ mere expectation that the settlement would enable them to avoid default and produce a benefit to the enterprise as a whole was legitimate and reasonable, and therefore sufficient to confer the requisite value under § 548. Based upon those findings, the court concluded that the lien transfers were not fraudulent and could not be avoided under § 548.

Because there was no avoidable transfer under § 548, as a matter of law there could be no liability under § 550 as to the Transeastern Lenders. Nevertheless, the District Court went on to determine that the Transeastern Lenders could not be compelled to disgorge the funds they received from TOUSA under § 550 because they were not the parties for whose benefit the Conveying Subsidiaries transferred their liens to the New Lenders. According to the District Court, the Bankruptcy Court characterized the benefit received by the Transeastern Lenders from the settlement transaction as follows:

[T]he Transeastern Lenders received a benefit flowing from the use to which the initial lien transfer was put; namely, the further transfer of proceeds to TOUSA which, in turn, transferred the proceeds to the Transeastern Lenders in settlement and payment of a valid, antecedent debt.7

Based on that characterization, the District Court found that the Transeastern Lenders were “subsequent transferees” of the proceeds backed by the liens.8 Because the benefit received by the Transeastern Lenders merely flowed from the manner in which the New

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6 Id. at 666.
7 Id. at 672-73.
8 Id. at 674.
Lenders used the liens, but was not the immediate and necessary consequence of the lien transfer, the District Court concluded that the Transeastern Lenders did not qualify as entities for whose benefit the lien transfers were made within the meaning of § 550(a)(1).

C. The Eleventh Circuit Reverses and Remands to the District Court

On appeal from the District Court, the Eleventh Circuit reversed the District Court, affirmed the Bankruptcy Court’s findings that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the lien transfers and that the Transeastern Lenders were entities for whose benefit the liens were transferred, and remanded to the District Court to consider the Transeastern Lenders’ challenges to the remedies imposed by the Bankruptcy Court.

First, the Eleventh Circuit affirmed the Bankruptcy Court’s finding that the benefits received by the Conveying Subsidiaries in exchange for their liens was not reasonably equivalent to the value of those liens because the record demonstrates that the “the almost certain costs of [the settlement transaction] far outweighed any perceived benefits” of the transaction.9 The Eleventh Circuit stated that the Bankruptcy Court correctly asked whether, based on the circumstances at the time the settlement transaction was contemplated, there was any possibility that the transaction would generate a positive return, and the Eleventh Circuit agreed with the Bankruptcy Court’s conclusion that there was no such possibility based on the record.

The Eleventh Circuit agreed that public knowledge and expert analysis of data available before the date of the settlement transaction, along with statements made by TOUSA insiders before that date, supported the Bankruptcy Court’s conclusion that “even assuming that all of the TOUSA entities would have spiraled immediately into

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9 11th Cir. Op. at *12.
bankruptcy without the [settlement transaction], the [t]ransaction was still the more harmful option."10 The Eleventh Circuit observed that “not every transfer that decreases the odds of bankruptcy for a corporation can be justified,” and “[t]he opportunity to avoid bankruptcy does not free a company to pay any price or bear any burden.”11

Next, the Eleventh Circuit affirmed the Bankruptcy Court’s finding that the Transeastern Lenders were entities for whose benefit the liens were transferred because the settlement loan agreements required that the proceeds of the loans secured by the Conveying Subsidiaries’ liens be transferred to the lenders. The Eleventh Circuit cited as controlling authority its decision in American Bank of Martin County v. Leasing Service Corp. (In re Air Conditioning, Inc. of Stuart)12, in which the court avoided a preferential lien transferred to a lender who, as part of the same transaction, transferred funds to a creditor. In that case, the creditor receiving the funds was deemed to be an entity for whose benefit the lien transfer was made under § 550(a)(1). Furthermore, the Eleventh Circuit rejected the Transeastern Lenders’ argument that they were “subsequent transferees” of the lien transfers and therefore not subject to liability under § 550. Although the settlement funds passed through a TOUSA subsidiary before it reached the Transeastern Lenders’ administrative agent, that subsidiary never had control of the funds because the loan documents required the subsidiary to immediately wire the funds to the administrative agent. The temporary handling of funds by the subsidiary without any actual control over the funds did not render the Transeastern Lenders subsequent transferees.

10 Id. at *13.
11 Id. at *12, 14.
12 845 F.2d 293 (11th Cir. 1988).
III.  The Vastly Different Results May Have Arisen Due To Differing Standards of Review

The appropriate standard of review has been, and continues to be, a significant issue in *TOUSA*. The District Court determined that it could review the Bankruptcy Court’s findings of fact under a “relaxed” application of the applicable “clearly erroneous” standard. That standard requires reversal when the record lacks substantial evidence to support the findings such that appellate review “results in a firm conviction that a mistake has been made.”13 The District Court concluded that relaxation of the “clearly erroneous” standard in this case was appropriate because the Bankruptcy Court’s order was a nearly verbatim adoption of the findings of fact and conclusions of law submitted by the Committee, with none of the lenders’ findings and conclusions. As a general rule, such wholesale adoption of a party’s proposed findings and conclusions is discouraged as “confidence in the integrity of the judicial process inevitably suffers when judges succumb wholesale to [the] practice.”14

The extent to which the District Court’s “relaxed” standard of review may have influenced its decision to quash the Bankruptcy Court’s order and forego remand is unclear. However, the Eleventh Circuit’s strict application of the clearly erroneous standard without reference to the nearly universal adoption of the Committee’s proposed findings and conclusions, and thus greater deference to the Bankruptcy Court as fact finder, suggest that the District Court may have relaxed the standard of review beyond the Eleventh Circuit’s comfort level and impermissibly engaged in independent fact finding.

13 *Id.* at 643-44.
14 *Id.* at 644-45 (citing *S. Pac. Commc’n Co. v. AT & T Co.*, 740 F.2d 980, 995 (D.C. Cir. 1984)).
The Transeastern Lenders now argue that the Bankruptcy Court’s opinion was entitled to no deference at all, and that the District Court could permissibly engage in independent fact finding. On June 5, 2012, in their petition for en banc review of the Eleventh Circuit’s ruling, the Transeastern Lenders argue that under the U.S. Supreme Court’s decision in Stern v. Marshall, the Bankruptcy Court lacked constitutional authority to enter a final order on the Committee’s fraudulent transfer claims against the Transeastern Lenders and the New Lenders. As such, the Transeastern Lenders argue that the District Court’s opinion quashing the Bankruptcy Court’s order—and not the Bankruptcy Court’s opinion unwinding the settlement transaction and directing disgorgement of the settlement proceeds—is entitled to deference by the Eleventh Circuit, as the Bankruptcy Court’s order should have been regarded merely as proposed findings of fact. The manner in which yet another standard of review would affect the outcome of this case remains to be seen. The petition for rehearing is pending before the Eleventh Circuit.

IV. Creditors’ Due Diligence Duties and Risks of Disgorgement

The effect that the Bankruptcy Court’s ruling is having and will continue to have on credit markets is unclear, in part because the ruling is still under review. The District Court expressed grave concern that the Bankruptcy Court’s ruling “would pose an unfair burden on creditors to investigate all aspects of their debtors and the affiliates of those debtors before agreeing to accept payments for valid debts owed.” It labeled as “patently unreasonable and unworkable” the Bankruptcy Court’s holding, which it paraphrased as follows:

It is “bad faith” for a creditor of someone other than the debtor to accept payment of a valid, tendered debt repayment outside of any preference period, through settlement or otherwise, if the creditor does not first investigate the debtor’s internal re-financing structure and ensure that the debtor’s subsidiaries had received fair value as part of the repayment, or that the debtor and its subsidiaries, in an enterprise, were not solvent or precariously close to being insolvent.\(^{17}\)

Under the District Court’s analysis, the “good faith” defense to liability under § 550(b)(1) would be unavailable to any creditor found to have accepted a transfer in bad faith under the above standard. That is, liability would extend to any creditor that did not exercise that “extraordinary duty of due diligence” imposed above, which duty “equal[s] or exceed[s] those imposed upon lenders extending credit in the first place.”\(^{18}\)

The Eleventh Circuit, on the other hand, is unfazed by the specter of creditors holding debts of all sizes and types finding themselves liable under § 550(a)(1) on account of their failure to perform “extraordinary” duties of due diligence prior to accepting repayment of antecedent debts.\(^{19}\) Its observation that every creditor is obligated to exercise some due diligence when receiving a transfer of property from a struggling debtor suggests that it does not believe its TOUSA ruling breaks any new ground. Its further observation that it was “far from a drastic obligation to expect some diligence from” the Transeastern Lenders in connection with their receipt of $421.0 million from a party other than their obligor reflects the Eleventh Circuit’s view that the circumstances of the TOUSA case are unique.

The Eleventh Circuit’s decision also suggests that the extent of the diligence due in a particular case must be determined by the particular circumstances of that case. The diligence reasonably expected from the Transeastern Lenders—who received hundreds of

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\(^{17}\) Id. at 675 (emphasis in original).
\(^{18}\) Id. at 675-76.
\(^{19}\) 11th Cir. Op. at *16.
millions of dollars from a non-debtor and who were found to have access, before receiving the settlement payment, to extensive public and non-public data and information suggesting that TOUSA’s bankruptcy was inevitable whether or not they settled their litigation against TOUSA—was deemed to be substantially greater than the diligence reasonably expected from a creditor receiving a nominal payment and having access to limited data and information. The Eleventh Circuit indicates—and common sense dictates—that the thresholds for value given for, and good faith acceptance of, a transfer in the latter instance would as a practical matter be relatively low.

Any due diligence requirement may impose too heavy of a burden according to the Transeastern Lenders, however. In their petition for en banc rehearing pending before the Eleventh Circuit, the Transeastern Lenders argue that the Eleventh Circuit panel plainly erred when it concluded that every creditor must perform some due diligence when it receives a struggling debtor’s payment, and that by extension, any creditor may refuse to accept a debtor’s payment if the creditor’s diligence reveals some cause for caution. Because billions of dollars are transferred to creditors daily via checks and wire transfers with no opportunity for creditors to conduct diligence regarding the debtors’ financial circumstances or the source of the funds used for the payment, the Transeastern Lenders contend the imposition of a due diligence requirement will be debilitating to the credit markets. They further urge that they cannot be liable to the Conveying Subsidiaries under § 550(a)(1) because the transfer from which they received a benefit—i.e., the transfer of the settlement payment from TOUSA to the lenders’ administrative agent in payment of an antecedent debt—was distinct from the avoided lien transfer from the Conveying Subsidiaries to the New Lenders. Whether the Eleventh
Circuit finds those arguments compelling and agrees to rehear the matter remains to be seen.

V. **Conclusion**

Participants in the credit markets must give due consideration to the Eleventh Circuit’s ruling, take commercially reasonable steps to protect themselves from exposure to preference and fraudulent transfer liability, and be prepared to disgorge amounts received in some cases. The extent to which lenders can and should conduct diligence in their relationships with troubled debtors will vary under the circumstances. A creditor that has the right to review and reject payments may find that certain payments justify greater attention based upon the amount of money involved, the severity of the debtor’s financial issues, the availability of public and non-public information, and the nature of the payment or other transaction. Those same factors may be considered in determining the creditor’s risk of disgorgement. It was true before the Eleventh Circuit’s ruling, and it will continue to be true, that in many instances only minimal diligence with respect to a given transaction will be warranted. *TOUSA* is an important reminder that while high-dollar, highly-complex credit transactions involving a deeply troubled debtor require a commensurate level of diligence to avoid liability in the event of a bankruptcy filing, transactions of all sizes and complexity involving a risky debtor may also require some attention.
I. Introduction.

In practice, attorneys often think that the twists and turns of their cases would make for the perfect law school exam. While perhaps not ripped from the headlines, practice often inspires and informs the lengthy questions that await students toiling away the hours to answer complicated fact patterns. It seems only fitting then that lawyers would get tripped up by equally challenging scenarios. One such scenario involves the determination as to whether the recipient of an avoidable transfer is a transferee of such transfer or, alternatively, a mere conduit. Two distinct tests have emerged for determining whether the recipient of a transfer is a transferee, namely: (i) the “dominion test” which focuses on whether the recipient had dominion over the money or other asset transferred; and (ii) the “control test” which requires courts to examine the entire circumstances of the transaction, including whether the recipient acted in good faith, in order to determine whether the recipient actually controlled the transferred funds.

To demonstrate the issue, consider the following hypothetical:

Prior to the commencement of its bankruptcy case, the debtor operated an automotive supply company. For years, the debtor utilized an insurance broker to: (i) provide risk management consulting; and (ii) select and purchase various insurance policies on the debtor’s behalf. These policies included casualty insurance, directors and officers insurance, workers compensation insurance and umbrella and excess insurance. Historically, the debtor consulted with the broker regarding which policies it should purchase and, thereafter, transferred substantial funds to the broker who, in turn, advanced such funds to the selected insurers as

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premiums. In exchange for these consulting and other services, the broker retained a portion of the funds advanced by the debtor as its commission/consulting fee.

Shortly before the bankruptcy filing, the insurance broker advised the debtor to renew its various policies and, in fact, enhance its coverage. Assume there is evidence to suggest that the insurance broker encouraged the debtor to obtain such coverage even though it knew that bankruptcy and the liquidation of the debtor was imminent and, thus, much of the purchased coverage was unnecessary. Moreover, assume that the evidence suggests that the insurance broker was motivated to make such a recommendation because it knew that the additional coverage would result in a higher commission/consulting fee for itself.

Upon receipt of substantial funds from the debtor pre-petition, the broker retained its percentage based commission/consulting fee and advanced the remaining funds on to at least ten different insurers as premiums. Post-petition, the debtor’s chapter 7 trustee avoids the transfer of the funds as a fraudulent transfer and, thereafter, seeks to recover such funds under section 550(a) of the Bankruptcy Code from the broker as the initial transferee. In response, the broker asserts that it was not an initial transferee who is strictly liable to repay the transfer but, rather, was a “mere conduit” with respect to such funds.

As discussed in more detail below, the test utilized by the court in determining whether the broker was a transferee or, alternatively, a mere conduit, will largely determine the outcome of the lawsuit.

The mere conduit defense is a frequently discussed and litigated defense to a trustee’s ability to recover an avoidance action. It is not a defense that is expressly identified in the statute (such as those to preference actions under section 547(c) of the Bankruptcy Code). Rather, the mere conduit defense is a judicially created defense resulting from various courts’ interpretation of the term “transferee” in section 550(a) of the Bankruptcy Code that has developed over the years in the case law. Perhaps the two most notable examples of the application of this defense are the opinion by the Seventh Circuit Court of Appeals in Bonded Financial Services, Inc. v. European American Bank,3 which established a “dominion test” to determine whether an entity

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3 Bonded Financial Services, Inc. v. European American Bank, 838 F.2d 890 (7th Cir. 1988).
is a transferee of an avoidable transfer or, alternatively, a mere conduit who is not liable under section 550 of the Bankruptcy Code and the opinion by the Eleventh Circuit Court of Appeals in In re Chase & Sanborn Corp.,⁴ which adopted a more holistic approach and required courts to examine the entire circumstances of the transaction.

Since Bonded and In re Chase & Sanborn Corp., all but one of the federal appellate circuits has opined on the mere conduit defense, although application and articulation of the defense has been neither consistent nor predictable. Recent appellate decisions regarding the mere conduit defense in Paloian v. LaSalle Bank⁵ and In re Harwell⁶ appear to consider additional factors beyond the traditional tests utilized and, arguably, represent a departure from the established law.

In the first part of this article, we explain how the mere conduit defense works and why the determination of whether a recipient of an avoidable transferee is a transferee is so important. Second, we discuss the two most important appellate decisions addressing the mere conduit defense, Bonded and In re Chase & Sanborn Corp. Thereafter, we survey the application of the mere conduit test across the circuit courts of appeal and examine how the frequently cited “dominion and control” test is, in fact, a combination of two very different tests, namely the “dominion test” and the “control test.” Next, we discuss the most recent deviations from traditional notions of the mere conduit test which incorporate considerations of convenience for the bankruptcy trustee and the transferee’s good faith. Finally, we highlight how these various tests can lead to very different results, by applying such tests to the facts set forth in our hypothetical above, and conclude that the increased complexity of financial transactions today

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⁴ Nordberg v. Societe Generale (In re Chase & Sanborn Corporation), 848 F.2d 1196 (11th Cir. 1988).
⁵ Paloian v. LaSalle Bank, 619 F.3d 688 (7th Cir. 2010).
⁶ Martinez v. Hutton (In re Harwell), 628 F.3d 1312 (11th Cir. 2010).
should likewise change the shape of the mere conduit defense. In that vein, we conclude, it is appropriate for courts to abandon a strict “dominion test” and consider whether a recipient of an avoidable transfer acted in good faith when determining whether such recipient is an initial transferee or, alternatively, a mere conduit.

II. Cultivating Conduits: Section 550 and the Impact of Initial Transferee Status.

Various provisions of chapter 5 of the Bankruptcy Code give a bankruptcy trustee the power to avoid and recover a number of transfers of property of the estate. These “avoidance powers” represent important tools that a trustee may use to collect estate property and maximize the value of an estate for the benefit of creditors. Although chapter 5 contemplates a variety of avoidance powers, the most common are: (i) preferential transfers under section 547(b) of the Bankruptcy Code; (ii) fraudulent transfers under section 548(a) of the Bankruptcy Code; and (iii) unauthorized post-petition transfers under section 549(a) of the Bankruptcy Code.

Once avoided, section 550 of the Bankruptcy Code provides the mechanism for allowing the trustee to recover the avoided transfers. In pertinent part, that section provides:

(a) Except as other provided in this section, to the extent that a transfer is avoided under … this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from –

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

(2) any immediate or mediate transferee of such initial transferee.

(b) The trustee may not recover under section (a)(2) of this section from –

(1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or

(2) any immediate or mediate good faith transferee of such transferee. 7

Simply put, section 550 of the Bankruptcy Code allows a trustee to recover an avoidable transfer from its initial transferee or, subject to certain defenses, subsequent (i.e. immediate or mediate) transferees of the transfer. The trustee is, of course, limited to a single satisfaction of the amount of the avoided transfer.8

The term “transferee” is not defined in the Bankruptcy Code, and “there is no legislative history to elucidate its meaning.”9 Nevertheless, whether the recipient of a transfer is deemed a transferee in the first place and, thereafter, whether such recipient is deemed the initial transferee or a subsequent transferee, has significant implications. For example, if the initial recipient of an avoidable transfer is not deemed a transferee, then such recipient has no liability to the trustee for the avoided transfer under section 550 of the Bankruptcy Code.

If a recipient of an avoidable transfer is deemed a transferee, the inquiry becomes whether the transferee was: (i) an initial transferee; or (ii) a subsequent transferee. The statute makes clear that an initial transferee is strictly liable to the trustee for recovery of an avoidable transfer, regardless of whether the transferee received the avoidable transfer in good faith or without knowledge of the voidability of the transfer.10 Conversely, subsequent transferees get the benefit of a good faith defense pursuant to section 550(b) of the Bankruptcy Code, which provides that a subsequent transferee will not be liable for having received an avoidable transfer

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9 Bonded Financial Services, Inc. v. European American Bank, 838 F.2d 890, 893 (7th Cir. 1988).
10 Richardson v. United States of America, Internal Revenue Service (In re Anton Noll, Inc.), 277 B.R. 875 1st Cir. BAP 2002) (citing Schafer v. Las Vegas Hilton Corp. (In re Video Depot, Ltd.), 127 F.3d 1195, 1197-98 (9th Cir. 1997).
if “the subsequent transferee accepted the transfer for value, in good faith, and without
knowledge of the transfer’s voidability.”11

Given the “harsh result of an overly literal approach” to section 550 of the Bankruptcy
Code, courts have adopted various tests to determine whether a recipient of a transfer should be
deemed an initial transferee.12 Regardless of the test employed, courts seem to agree that the
term “transferee” must mean something different from anyone who simply touches the avoided
transfer, such as an agent or a courier.13 As the Seventh Circuit Court of Appeals recently noted,
such an approach “tracks the function of the bankruptcy trustee’s avoiding powers: to recoup
money from the real recipient…”14

III. Bonded Financial Services – The Genesis of the “Dominion Test.”

The preeminent case on the mere conduit defense is the Seventh Circuit Court of
Appeals’ decision in Bonded Financial Services, Inc. v. European American Bank,15 which held
that a recipient of a transfer is not a transferee for purposes of section 550 of the Bankruptcy
Code unless it has dominion over the transferred funds. In that case, the corporate principal of
the debtor, a currency exchange, caused the debtor corporation to issue a check in the amount of
$200,000 made payable to the company’s depository bank.16 The instructions written on the
check directed the bank to deposit the funds into the principal’s personal account, and the bank
complied with those instructions.17 Ten days later, the principal instructed the bank to debit the

11 Id.
13 Id.
14 Id. (citing Paloian v. LaSalle Bank, N.A., 619 F.3d 688, 691 (7th Cir. 2010)).
15 Bonded Financial Services, Inc. v. European American Bank, 838 F.2d 890 (7th Cir. 1988).
16 Id. at 891.
17 Id.
$200,000 from his account and to apply the funds to reduce his personal indebtedness to the bank.\textsuperscript{18}

Upon the commencement of bankruptcy cases for both the corporate debtor and the principal, the trustee in the corporation’s bankruptcy case successfully sought to avoid the $200,000 transfer as a fraudulent transfer under section 548(a) of the Bankruptcy Code.\textsuperscript{19} Because the principal himself was insolvent and imprisoned for mail fraud, the trustee sought to recover the fraudulent transfer from the bank, alleging that although the funds were ultimately transferred to or for the benefit of the principal, the bank was the initial transferee of such funds.\textsuperscript{20} The bankruptcy court found that the bank was not the initial transferee and the district court affirmed.\textsuperscript{21}

On appeal, the Seventh Circuit Court of Appeals affirmed, holding that the bank was not the “initial transferee” of the debtor’s misappropriated funds even though it was the payee because, among other reasons, it acted as a financial intermediary and received no benefit.\textsuperscript{22} Under the law of contracts, the court found, “the Bank had to follow the instructions that came with the check.”\textsuperscript{23} Therefore, it “was no different than a courier or an intermediary on a wire transfer; it held the check only for the purpose of fulfilling an instruction to make the funds available to someone else.”\textsuperscript{24}

The court reasoned that merely having the ability to control funds does not automatically render the possessor a transferee, stating:

\textsuperscript{18} Id.
\textsuperscript{19} Id.
\textsuperscript{20} Id.
\textsuperscript{21} Id.
\textsuperscript{22} Id. at 893.
\textsuperscript{23} Id.
\textsuperscript{24} Id.
We think 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. When A gives a check to B as agent for C, then C is the ‘initial transferee’; the agent may be disregarded.\footnote{\textit{Id.}}

The court found that the bank’s possession of the funds in the principal’s account did not render the bank a transferee of those monies until the corporate principal directed them to apply the funds to his personal indebtedness.\footnote{\textit{Id.} at 893-894.} Until then, the bank had no dominion over the funds and the principal was free to direct the funds to any transferee or, as the court colorfully noted, “invest [them] in lottery tickets or uranium stocks.”\footnote{\textit{Id.} at 894.} In the meantime, the principal’s personal indebtedness to the bank remained unchanged.\footnote{\textit{Id.}}

The court rejected the approach adopted by some other courts which held that an agent can be an “initial transferee” but that such transferee’s liability can be excused using “equitable powers.” The court noted that it had serious doubts about the propriety of courts declining to enforce statutes merely because they produce inequitable results.\footnote{\textit{Id.}} Rather, a more limited interpretation of the term “transferee” was appropriate.\footnote{\textit{Id.}} The court explained:

“Transferee” is not a self-defining term; it must mean something different from “possessor” or “holder” or “agent.” To treat “transferee” as “anyone who touches the money” and then to [use equity to] escape the absurd results that follow is to introduce useless steps; we slice these off with Occam’s Razor and leave a more functional rule.\footnote{\textit{Id.}}

In conclusion, the court 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 purpose.”\footnote{\textit{Id.}}

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\begin{itemize}
\item \footnote{\textit{Id.}}
\item \footnote{\textit{Id.} at 893-894.}
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\item \footnote{\textit{Id.}}
\item \footnote{\textit{Id.}}
\item \footnote{\textit{Id.}}
\end{itemize}

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other words, in order to be a transferee of the debtor’s funds, one must (i) actually receive the funds; and (ii) have full dominion over them for one’s own account, as opposed to receiving them in trust or as agent for someone else.

IV. *In re Chase & Sanborn Corp.* - The Genesis of the “Control Test.”

In *In re Chase & Sanborn Corp.*, the Eleventh Circuit Court of Appeals, while recognizing *Bonded*, established its own test for the mere conduit defense which required an evaluation of the transaction in its entirety and focused on equitable considerations. In that case, the debtor, a struggling coffee company, opened a bank account solely for purposes of laundering money for an individual who controlled the debtor. That same individual owned Columbian Coffee Corporation (“Columbian”), also a struggling coffee company.

Prior to the debtor’s bankruptcy filing, the debtor wired $500,000 into Columbian’s bank account at Societe Generale bank. Before receiving the debtor’s check, the bank received a large check drawn on Columbian’s bank account that, if honored, would create a large overdraft. The bank checked with Columbian, which assured the bank that the large wire transfer from the debtor was coming in to cover the overdraft. The bank received confirmation from the debtor’s bank that such wire was forthcoming. The bank then honored Columbian’s large check and awaited receipt of the debtor’s wire, which arrived the next day.

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33 Nordberg v. Societe Generale (*In re Chase & Sanborn Corporation*), 848 F.2d 1196 (11th Cir. 1988).
34 *Id.* at 1198.
35 *Id.*
36 *Id.*
37 *Id.*
38 *Id.*
39 *Id.*
40 *Id.*
Upon the commencement of the bankruptcy case, the debtor’s trustee sought to recover the $500,000 from the bank as a fraudulent transfer because, he alleged, no value came back to the debtor (as opposed to Columbian) in exchange for the wire.\textsuperscript{41} The bankruptcy court assumed without deciding that the transfer was fraudulent.\textsuperscript{42} Nevertheless, the bankruptcy court held that the bank was not liable as the initial transferee because it was merely a commercial conduit of the funds.\textsuperscript{43} The district court affirmed.\textsuperscript{44}

Although it discussed the Bonded “dominion test,” the Eleventh Circuit articulated a “control test,” which “simply requires courts to step back and evaluate a transaction in its entirety to make sure that their conclusions are logical and equitable.”\textsuperscript{45} The court stressed that this approach “was consistent with the equitable concepts underlying bankruptcy law.”\textsuperscript{46} The court explained:

Bankruptcy courts considering the question of whether a defendant is an initial transferee have traditionally evaluated that defendant’s status in light of the entire transaction. And, in the past, courts have refused to allow trustees to recover property from defendants who simply held the property as agents or conduits for one of the real parties to the transaction. Had these courts employed an overly literal interpretation of section 548, they could have allowed the trustees to recover the funds from the defendants. Instead, they determined that, although technically the defendants had received the funds from the debtors and could be termed “initial transferees,” the defendants had never actually \textit{controlled} the funds and therefore it would be inequitable to allow recovery against them.\textsuperscript{47}

The court distinguished the situation where a bank receives money from a debtor to pay off a loan, in which case the bank has \textit{control} over the funds and is an initial transferee, from where a bank receives money being deposited into a customer’s account, in which case the bank

\begin{footnotes}
\item[41] Id.
\item[42] Id. at 1198-1199
\item[43] Id. at 1197.
\item[44] Id.
\item[45] Id. at 1199.
\item[46] Id.
\item[47] Id. at 1199-1200.
\end{footnotes}
is a mere conduit, never has actual *control* of the funds and, thus, is not an initial transferee.\textsuperscript{48} The court noted that equitable considerations played a major role in the “control test,” stating that “it is especially inequitable to hold conduits liable in situations in which the conduits cannot always ascertain the identity of the transferor.”\textsuperscript{49} Such a requirement would force banks to examine the source of a wire transfer and try to determine its solvency, thereby severely impairing the wire transfer system generally.\textsuperscript{50}

Turning to the transaction at issue, the Eleventh Circuit concluded that the bank was a conduit and not the initial transferee. The payment of the Columbian check to the bank, the court noted, created an overdraft on paper and overdrafts have traditionally been considered debts.\textsuperscript{51} If, the court found, the paper overdraft constituted a debt owed to the bank by Columbian, then the money wired from the debtor – for the express purpose of paying that debt – would actually have been sent to the bank.\textsuperscript{52} If that’s the case, the court continued, the bank had actual control of the funds when it received the money from the debtor and, thus, would be the initial transferee.\textsuperscript{53} Conversely, the court found, if there was no real debtor-creditor relationship, then the bank merely deposited the funds into Columbian’s account, and Columbian used that money to satisfy the large check that led to the overdraft in the first place.\textsuperscript{54} “When viewed in that manner, [the bank] functioned as a conduit, receiving the funds and depositing them into the [Columbian] account.”\textsuperscript{55} Thus, it would never have control over the funds.

\textsuperscript{48} *Id.* at 1200.
\textsuperscript{49} *Id.* at 1201.
\textsuperscript{50} *Id.* at 1201-1202.
\textsuperscript{51} *Id.* at 1200.
\textsuperscript{52} *Id.* at 1200-1201.
\textsuperscript{53} *Id.* at 1201.
\textsuperscript{54} *Id.*
\textsuperscript{55} *Id.*)
The court adopted the second interpretation of the facts, emphasizing that: (i) the overdraft and wired funds were “virtually simultaneous;” and (ii) the bank honored Colombian’s check that created the overdraft only after it knew that the debtor’s wire was forthcoming.\(^{56}\) Thus, the court concluded, the bank’s decision to honor the Columbian check did not establish a debtor-creditor relationship between Columbian and the bank.\(^{57}\) Based on these particular facts, the court concluded that the bankruptcy court properly determined that the bank was a mere conduit and not a transferee.

V. Embracing the Conduit: Noteworthy Appellate Decisions Interpreting the Mere Conduit Defense.

In the wake of Bonded and In re Chase & Sanborn Corp, two separate standards emerged with respect to the issue of whether a party was a transferee, the “dominion test” and the “control test.” With the notable exception of the Third Circuit, appellate courts within all of the federal circuits have opined on the mere conduit defense. Nearly all of these courts have adopted Bonded’s “dominion test” in one form or another, although many of the courts appear to have combined the “dominion test” with the “control test,” at least by name, applying what they refer to as a “dominion and control” test. Regardless of what the test is called, the cases suggest that courts often employ a results-driven approach to the mere conduit defense, leading to inconsistent outcomes and a lack of clear guidance for practitioners and courts.

A. In re Coutee.

In In re Coutee,\(^{58}\) the Fifth Circuit Court of Appeals adopted a “dominion or control” test, which focused on the recipient’s legal rights with respect to the transferred funds. In that

\(^{56}\) Id.

\(^{57}\) Id.

case, the debtors were clients of the defendant, a personal injury law firm.\textsuperscript{59} The law firm negotiated an arrangement whereby clients would request a loan from a particular bank with the law firm as unconditional guarantor of the loan.\textsuperscript{60} Clients, including the debtors, obtained such loans from the bank in order to finance their litigation.\textsuperscript{61} In this particular case, the firm won a settlement for the debtors, placed the funds in its client trust account and, thereafter, paid their legal fees and repaid the loan out of the settlement proceeds, with the remaining funds going to the debtors.\textsuperscript{62}

Within ninety days, the debtors filed for bankruptcy protection and the trustee sought to avoid the payment to the bank as a preferential transfer.\textsuperscript{63} The trustee sought to recover the transfer from the bank as the initial transferee.\textsuperscript{64} In its defense, the bank argued that the firm, not it, was the initial transferee of the funds.\textsuperscript{65} The bankruptcy court held that the payment of the note was avoidable, that the bank was the initial transferee and that the firm was a mere conduit.\textsuperscript{66} The district court affirmed, finding that the bank was the initial transferee.\textsuperscript{67}

On appeal, the Fifth Circuit Court of Appeals adopted what it called a “dominion and control test,” noting that dominion and control means legal dominion or control.\textsuperscript{68} Thus, the fact that the firm could have violated its fiduciary obligation to the debtors by taking the money out of the trust account and spending it as it pleased would make no difference in the analysis.\textsuperscript{69}

\begin{itemize}
  \item \textsuperscript{59} \textit{Id.} at 139.
  \item \textsuperscript{60} \textit{Id.} at 139-140.
  \item \textsuperscript{61} \textit{Id.}
  \item \textsuperscript{62} \textit{Id.} at 140.
  \item \textsuperscript{63} \textit{Id.}
  \item \textsuperscript{64} \textit{Id.}
  \item \textsuperscript{65} \textit{Id.}
  \item \textsuperscript{66} \textit{Id.}
  \item \textsuperscript{67} \textit{Id.}
  \item \textsuperscript{68} \textit{Id.} at 141.
  \item \textsuperscript{69} \textit{Id.} at 141, fn 4.
\end{itemize}
Applying the legal dominion or control test, the court held that the bank, not the firm, was the initial transferee of the funds.\textsuperscript{70} Because the funds were held in the firm’s trust account (as was the requirement under applicable state law) and not its business account, they were held merely in a fiduciary capacity for the debtors.\textsuperscript{71} The firm could keep only those funds as fees that the debtors agreed to.\textsuperscript{72} Thus, the firm did not have dominion or control over the funds.\textsuperscript{73} The only control exercised over the funds, the court found, was the control delegated to the law firm by the debtors.\textsuperscript{74}

The bank urged the court to “disregard [its] role in order to identify who in fact was the creditor,” arguing that it was the firm, not the bank, that actually loaned the money.\textsuperscript{75} The court rejected this argument, noting that “no matter how instrumental the firm was in assisting the [debtors] in obtaining the loan, it was still the bank that loaned them the money.”\textsuperscript{76} The court reasoned:

the firm’s role with respect to the received money was to accept the funds in settlement of its client’s case, deposit the money in trust, keep as fees only what the [debtors] agreed to, and pay the rest to the bank on behalf of the [debtors] in satisfaction of their loan.\textsuperscript{77}

Because the law firm had no legal right to put the funds that were held in the trust account to its own use, the court concluded, it lacked the requisite dominion and control required to be the initial transferee.\textsuperscript{78}

\textbf{B. \textit{In re First Security Mortgage Co.}}

\textsuperscript{70} \textit{Id.} at 141.
\textsuperscript{71} \textit{Id.}
\textsuperscript{72} \textit{Id.}
\textsuperscript{73} \textit{Id.}
\textsuperscript{74} \textit{Id.}
\textsuperscript{75} \textit{Id.}
\textsuperscript{76} \textit{Id.}
\textsuperscript{77} \textit{Id.}
\textsuperscript{78} \textit{Id.}
In *In re First Security Mortgage Company*, the Tenth Circuit Court of Appeals applied *Bonded’s* “dominion test,” although the Court referred to it as a “dominion or control test.” In that case, the attorney for the debtor opened a business checking account with a bank styled “Gary B. Hobbs, Attorney at Law, Trust Account.” As the only signatory on the account, the attorney exercised complete discretion regarding deposits to and disbursements from the account, and he was entitled to possession of all funds upon demand. Pre-petition approximately $60,000 of the debtor’s funds were fraudulently transferred to the bank, with instructions to deposit them in the attorney’s trust account. The funds were deposited in the attorney’s trust account and, thereafter, the attorney dispersed the funds to third parties to pay debts unrelated to the bank.

The debtor commenced its bankruptcy case within a year after the transfer of these funds and the trustee sued the bank as the initial transferee. The bankruptcy court found that the bank was not the initial transferee and the district court affirmed. The sole issue on appeal was whether the bank was the initial transferee with respect to the transferred funds.

Following the Fifth Circuit’s lead, the Tenth Circuit Court of Appeals adopted a “dominion or control test,” citing to the *Bonded* and *Coutee* opinions, to determine who is an

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79 Malloy v. Citizens Bank of Sapulpa (*In re First Security Mortgage Co.*), 33 F.3d 42 (10th Cir. 1994).
80 *Id.* at 43.
81 *Id.*
82 *Id.*
83 *Id.* at 44, fn. 4.
84 *Id.* at 43.
85 *Id.*
86 *Id.*
initial transferee holding 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."\(^87\)

Applying that test to the facts before it, the court held that the bank was not the initial transferee of the funds because it “was obligated to make the funds available to [the attorney] upon demand.”\(^88\) Therefore, it acted only as a financial intermediary.\(^89\) The court reasoned that the bank had no business relationship with the debtor and, as was the case in *Bonded*, held the funds it received “only for the purpose of fulfilling an instruction to make the funds available to someone else.”\(^90\)

**C. In re Southeast Hotel Property, L.P.**

In *In re Southeast Hotel Property, L.P.*,\(^91\) the Fourth Circuit Court of Appeals gave its interpretation of the mere conduit defense focusing on whether the transferee had legal dominion over the funds. In that case, Southeast Hotel Properties (“SEHP”) and Florida Hotel Properties (“FHP”) owned 25 hotels throughout the southeast.\(^92\) Commercial Management Corporation (“CMC”) managed both entities.\(^93\) Both FHP and SEHP operated as debtors in possession in the summer of 1991.\(^94\) In October 1991, Atlanta Motor Speedway (“AMS”) provided a hospitality suite to Team III Racing (a corporation owned by the president of CMC) and, thereafter, issued an invoice to Team III.\(^95\) CMC issued one check from FHP and one check from SEHP to a bank

\(^{87}\) *Id.* at 43-44.

\(^{88}\) *Id.* at 44.

\(^{89}\) *Id.*

\(^{90}\) *Id.*

\(^{91}\) Bowers v. Atlanta Motor Speedway, Inc. (*In re Southeast Hotel Properties, L.P.*), 99 F 3d. 151 (4th Cir. 1996).

\(^{92}\) *Id.* at 152.

\(^{93}\) *Id.* at 153.

\(^{94}\) *Id.*

\(^{95}\) *Id.*
with instructions to issue a cashier’s check to AMS, which would pay the invoice. The president of SEHP and FHP then fraudulently had the corporate documents of CMC altered to reflect that the money paid constituted refunds of guest deposits for group tours.  

Thereafter the trustee for FHP and SEHP filed suit to avoid the payments to AMS as unauthorized post-petition transfers within the scope of section 549 of the Bankruptcy Code. The bankruptcy court concluded that the transfers were avoidable and that AMS was the initial transferee of the funds. AMS appealed, arguing that the initial transferee was either CMC or its president, but the district court affirmed.

The Fourth Circuit Court of Appeals began its analysis by recognizing that the Bonded approach had been “employed by every circuit that has subsequently considered the question” of whether a recipient was a transferee or a mere conduit. That said, the court noted:

While courts have consistently held that the Bonded dominion and control test is the appropriate test to apply when determining whether a person or entity constitutes an initial transferee under § 550, those same courts have disagreed about the type of dominion and control that must be asserted. For example, some courts have held that a principal or agent acting in his or her representative capacity is an initial transferee where that person exercised physical control over the funds. Most courts, however, have held that an agent or principal does not constitute the initial transferee of a transfer from the debtor where the agent or principal is acting in his or her representative capacity, even if the agent or principal has physical dominion or control over the funds. These courts have required the principal or agent to have legal dominion and control over the funds transferred in order to constitute the initial transferee of the funds.

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96 Id.  
97 Id.  
98 Id.  
99 Id. at 153-154.  
100 Id. at 154.  
101 Id. at 154-155.  
102 Id. at 155 (internal citations omitted).
Having considered these decisions, the Fourth Circuit held that the dominion and control test requires *legal* dominion and control over the funds transferred.\(^{103}\)

Applying the “dominion and control test” to the facts before it, the Fourth Circuit held that AMS was the initial transferee because, at the time of the transfer, CMC was acting as an agent for FHP and SEHP.\(^ {104}\) Therefore, CMC did not have authority to exercise legal dominion and control over the funds.\(^ {105}\)

AMS argued that it was inequitable to hold it responsible for a post-petition transfer when it acted in good faith and provided value in exchange for the funds.\(^ {106}\) The court noted, however, that decisions as to who should bear the loss incurred by a post-petition transfer are made in the Bankruptcy Code:

There is almost always some injustice or hardship which attends transactions occurring after the filing of a petition in bankruptcy … because the loss must fall either upon the third person or upon the creditors of the bankrupt. Whether the line which has been drawn is the best possible solution is not for the courts to say.\(^ {107}\)

Moreover, the court pointed out that the check itself indicated that FHP was the remitter. In other words, AMS was on notice that it was receiving funds from a debtor in bankruptcy.\(^ {108}\)

Accordingly, because AMS was the first entity to have legal dominion of the funds following their transfer, the court found that it was the initial transferee of such funds under section 550(a) of the Bankruptcy Code.\(^ {109}\)

**D. *In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson and Casey.***

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\(^{103}\) *Id.* at 156.

\(^{104}\) *Id.* at 156-157.

\(^{105}\) *Id.*

\(^{106}\) *Id.* at 157.

\(^{107}\) *Id.* (citing Lake v. New York Life Ins. Co., 218 F.2d 394, 399 (4th Cir. 1955)).

\(^{108}\) *Id.* at 157-158.

\(^{109}\) *Id.* at 158.
In In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey,110 the Second Circuit Court of Appeals addressed the application of the mere conduit defense in the context of an insurance broker, and adopted the “dominion test.” In that case, shortly prior to a law firm’s decision to dissolve, and while the firm was insolvent, the partners decided to extend their professional liability insurance for a period of time beyond the dissolution of the firm, based in part on the recommendation of its insurance broker.111 The broker collected funds from the firm and, thereafter, paid the insurance premiums on its behalf.112

Thereafter, the firm’s creditors filed an involuntary petition. The firm’s trustee sought to avoid the premium payments as fraudulent transfers because the additional coverage obtained was, in his view, unnecessary.113 Moreover, the trustee sought to recover such amount from the broker as the initial transferee of the funds.114 The broker contended that it was a conduit and filed a motion to dismiss the complaint.115 Utilizing the Bonded test, the district court held that the broker was not an initial transferee.116 On appeal, the trustee argued that Bonded was not applicable in the Second Circuit and, moreover, that the broker could not be a mere conduit because it was an active participant in the design and execution of the insurance program.117

The Second Circuit Court of Appeals began its analysis by noting that certain bankruptcy courts have concluded that the owner of the first pair of hands to touch the property is the initial

111 Id. at 54-55.
112 Id.
113 Id.
114 Id. at 55.
115 Id.
116 Id.
117 Id.
Those courts, the court noted, then “look to the exercise of their equitable powers to excuse innocent and casual “initial transferees” from responsibility under § 550(a).”\textsuperscript{119} The court, like the \textit{Bonded} Court, criticized this approach noting:

> Under this construction, every courier, every bank and every escrow agent may be subjected to a great and unimagined liability that is mitigated only by powers of equity. This comes close to making equity a principle of statutory construction. The effect of such a principle would be to render every conduit vulnerable to nuisance suits and settlements.\textsuperscript{120}

Instead, the court adopted the “dominion and control test” for determining who is an initial transferee.\textsuperscript{121} The court reasoned that the wording of section 550(a) is not so plain as to compel the principle that every conduit is an initial transferee.\textsuperscript{122} Rather, it is the party who benefits from the transfer that is the initial transferee.\textsuperscript{123}

Turning to the specific facts of the case, the court held that the broker was a mere conduit with respect to the funds. The trustee argued that the broker should not qualify as a mere conduit because the broker had a commercial relationship with the debtor and was not a stranger to the events leading to the transfers.\textsuperscript{124} The court noted that the broker performed more than one role for the debtor in that it: (i) transferred premiums to the insurer; and (ii) served as an advisor on risk management issues.\textsuperscript{125} Nevertheless, the court rejected the trustee’s argument, noting:

> No doubt, [the broker’s] relationship with [the debtor] transcended that of a mere courier. However, once the decision had been made - however it was made - to cancel the primary and excess policies, and to transfer the premiums to [the

\textsuperscript{118} \textit{Id.} at 56 (citing Metsch v. First Alabama Bank of Mobile (\textit{In re Columbian Coffee Co.}), 75 B.R. 177, 179-80 (S.D. Fla. 1987); Huffman v. Commerce Sec. Corp. (\textit{In re Harbour}), 845 F.2d 1254, 1257-58 (4th Cir. 1988)).
\textsuperscript{119} \textit{Id.}
\textsuperscript{120} \textit{Id.}
\textsuperscript{121} \textit{Id.} at 58.
\textsuperscript{122} \textit{Id.}
\textsuperscript{123} \textit{Id.}
\textsuperscript{124} \textit{Id.}
\textsuperscript{125} \textit{Id.}
insurer] to purchase the discovery tail, [the broker’s] role in the transfers of the funds was that of a mere conduit.\textsuperscript{126}

The court noted that as the debtor’s agent, not the insurer’s, the broker “had no discretion or authority to do anything else but transmit the money, which is just what it did.”\textsuperscript{127}

Finally, the court noted that its analysis was simplified because the broker received no commission for its transfer of funds to the insurer.\textsuperscript{128} The court seemed to suggest, however, that a different result might have been reached if the broker had received or retained a commission for its transfer of the funds to the insurer, at least with respect to those funds that it had retained.\textsuperscript{129}

\textbf{E. \textit{In re Anton Noll, Inc.}}

In \textit{In re Anton Noll, Inc.},\textsuperscript{130} the Bankruptcy Appellate Panel of the First Circuit utilized an approach which combined both the “dominion test” and the “control test.” In that case, the president and sole shareholder of the debtor personally owed the IRS a large sum.\textsuperscript{131} Prepetition, he caused the debtor to issue a check to “cash” that he then used, just hours later, to purchase a bank check for the IRS.\textsuperscript{132} The check to “cash” indicated on the memo line that it was to be paid to the IRS.\textsuperscript{133} The IRS accepted the check and released the tax lien against the president’s personal property.\textsuperscript{134} At the time of the withdrawal of its funds, the debtor was not indebted in any way to the IRS.\textsuperscript{135}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{126} Id. at 59.
\item \textsuperscript{127} Id.
\item \textsuperscript{128} Id.
\item \textsuperscript{129} Id.
\item \textsuperscript{130} Noll v. IRS (\textit{In re Anton Noll, Inc.}), 277 B.R. 875 (1st Cir. BAP 2002).
\item \textsuperscript{131} Id. at 877.
\item \textsuperscript{132} Id.
\item \textsuperscript{133} Id.
\item \textsuperscript{134} Id.
\item \textsuperscript{135} Id.
\end{itemize}
\end{footnotesize}
Within a year, an involuntary chapter 7 petition was filed against the debtor. The trustee in the debtor’s bankruptcy case attempted to avoid the withdrawal and subsequent payment to the IRS as a fraudulent transfer under section 548 of the Bankruptcy Code and sought to recover the payment from the IRS under section 550. The parties stipulated that all of the elements of a fraudulent transfer had been met. Nevertheless, the IRS asserted that it was not the initial transferee of the funds. The bankruptcy court ruled that the president and not the IRS was the initial transferee and the trustee appealed.

On appeal, the trustee conceded that the IRS acted in good faith and gave value. Thus, in the event that the IRS was deemed to be a subsequent transferee (as opposed to an initial transferee) with respect to the funds, the trustee acknowledged that he could not recover the funds from the IRS. Nevertheless, the trustee maintained that the IRS, not the president, was the initial transferee.

Noting that the First Circuit had not addressed transferee status under section 550 of the Bankruptcy Code, the Bankruptcy Appellate Panel adopted the “dominion test” first articulated in Bonded. Thus, the court held: “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 purpose.” The court noted that dominion “refers to legal, as opposed to mere physical possession of the property transferred” and concluded that “a transferee must have the legal right to use the funds...

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136 Id.
137 Id.
138 Id.
139 Id.
140 Id.
141 Id. at 878.
142 Id.
143 Id.
144 Id. at 878-879.
145 Id. at 879.
to whatever purpose he or she wishes, be it to invest in ‘lottery tickets or uranium stocks.’\textsuperscript{146}

The court then expanded on Bonded’s “dominion test,” adopting an analysis similar to that which was articulated by the Eleventh Circuit in \textit{In re Chase \& Sanborn Corp.}, by stating that courts should “step back and evaluate a transaction in its entirety to make sure that their conclusions are logical and equitable.”\textsuperscript{147}

Turning to the particular facts of the case, the court held that the president was the initial transferee of the funds.\textsuperscript{148} In doing so, the court noted that it was necessary to determine whether the transaction which resulted in receipt of the funds by the IRS was a one-step transaction (where a principal causes the debtor to issue a check directly payable to the principal’s creditors) or a two-step transaction (where the principal first acquires legal title to the funds) and therefore must be deemed to be an initial transferee.\textsuperscript{149}

Interpreting state law dealing with negotiable instruments, the court found that because the check was made out to “cash,” it was payable to the bearer (\textit{i.e.} the person in possession of the instrument). In this case, that was the president.\textsuperscript{150} Because the check was negotiable upon delivery to the president, the president had obtained legal ownership and possession of the debtor’s funds.\textsuperscript{151} Thus, the court concluded, this was a two-step transaction. That the president chose to use the funds to purchase a treasurer’s check to satisfy his tax liability with the IRS didn’t change this fact.\textsuperscript{152}

\textsuperscript{146} \textit{Id.}
\textsuperscript{147} \textit{Id.} (citing Danning v. Miller (\textit{In re Bullion Reserve of N. Am.}), 922 F.2d 544, 549 (9th Cir. 1991)).
\textsuperscript{148} \textit{Id.} at 881.
\textsuperscript{149} \textit{Id.} at 880.
\textsuperscript{150} \textit{Id.}
\textsuperscript{151} \textit{Id.} at 880-881.
\textsuperscript{152} \textit{Id.} at 881.
The court rejected the trustee’s argument that the fact that the president had held the check for only a few hours (and never actually held the cash) before trading it in for the bank check payable to the IRS indicated that he lacked possession of the funds.\textsuperscript{153} The court reasoned, “dominion and control” under Bonded means legal, not physical dominion and control of the funds.\textsuperscript{154} Thus, “whether [the president] held the check for a mere eight hours or for ten days, as in Bonded, is irrelevant.”\textsuperscript{155} Moreover, the fact that the memo line of the check indicated that the funds were to be used to pay the IRS was also irrelevant because, under applicable state law, “instructions on the memo portion of a check do not affect the negotiability of the instrument.”\textsuperscript{156} Accordingly, the court found, the president was the initial transferee and the IRS was a subsequent transferee entitled to the defenses set forth in section 550(b) of the Bankruptcy Code.\textsuperscript{157}

\textbf{F. In re Hurtado.}

In \textit{In re Hurtado},\textsuperscript{158} the Sixth Circuit Court of Appeals adopted the “dominion test” when faced with a much simpler fact pattern. In that case, the defendant, Hurtado, was the mother of the debtors, a husband and wife that had filed for protection under chapter 7 of the Bankruptcy Code.\textsuperscript{159} Prepetition, the debtors received substantial funds from the sale of their home and the settlement of a lawsuit.\textsuperscript{160} Because they had substantial creditors, the debtors sent the proceeds to Hurtado, who deposited the checks into her savings account.\textsuperscript{161}

\begin{flushleft}
\textsuperscript{153} Id.  \\
\textsuperscript{154} Id.  \\
\textsuperscript{155} Id.  \\
\textsuperscript{156} Id.  \\
\textsuperscript{157} Id.  \\
\textsuperscript{158} Taunt v. Hurtado (\textit{In re Hurtado}), 342 F.3d 528 (6th Cir. 2003).  \\
\textsuperscript{159} Id. at 530.  \\
\textsuperscript{160} Id.  \\
\textsuperscript{161} Id.  \\
\end{flushleft}
Although the funds remained in Hurtado’s account, she spent them only as directed by the debtors including, but not limited to, payment of the debtors’ living expenses and payments to certain preferred creditors. Hurado kept the funds separate from her own and never received compensation for her assistance. The funds were depleted over two years before the debtors declared bankruptcy.

Upon the commencement of the bankruptcy case, the debtors’ bankruptcy trustee sought to avoid and recover the transfer of the funds to Hurtado as a fraudulent transfer under sections 544 (which allows the trustee to step into the shoes of a creditor in order to nullify transfers voidable as fraudulent transfers under applicable state law) and 550 of the Bankruptcy Code. While the parties stipulated that the transfers were fraudulent, Hurtado alleged that she was not an initial transferee because she acted merely as the debtors’ agent and at their discretion. While, as a matter of raw power, she argued, she could have absconded with the debtor’s funds, the money in reality continued to belong to the debtor. The bankruptcy court agreed finding that Hurtado was a mere conduit and, thus, not liable under section 550. The district court reversed.

On appeal, the Sixth Circuit Court of Appeals held that Hurtado was the initial transferee with respect to the funds. The court adopted the “dominion and control” test, noting that it had previously adopted and applied that test in First National Bank of Barnesville v. Rafoth (In re

162 Id.
163 Id.
164 Id.
165 Id. at 531.
166 Id. at 531-532.
167 Id. at 534.
168 Id. at 531.
169 Id.
Baker & Getty Fin. Servs., Inc.).\textsuperscript{170} The court distinguished the facts before it from Bonded and Baker & Getty, noting that those cases turned on the distinction between mere possession and ownership of funds.\textsuperscript{171} The parties found to be conduits in those cases never had legal title to the funds, “they merely possessed the funds and were acting as agents for their principals, who retained legal right to the funds.”\textsuperscript{172}

Conversely, Hurtado was given legal title to the funds.\textsuperscript{173} This was, in fact, the very purpose (\textit{i.e.} to insulate the funds from the debtors’ creditors) of the fraudulent conveyance.\textsuperscript{174} Moreover, the court noted, the parties’ financial statements and tax filings indicated that such funds were her property, not the debtors’.\textsuperscript{175} The court explained:

\begin{quote}
The funds were placed in Hurtado’s bank account (which the debtors could not access without going through Hurtado). With that established, [she] had legal authority to do what she liked with the funds; she could have invested the funds in “lottery tickets or uranium stocks.” This fact distinguishes both Bonded and Baker & Getty, where [the recipients of the transfers] had legal obligations to follow the commands of their respective principals. Here, Hurtado was not under any legal obligation to follow the debtors’ directions. The funds placed in her account were presumptively hers under Michigan law, and there has been no evidence of some formal contractual arrangement that required her to obey the debtors’ commands. Even if such an arrangement existed, it would have been void because it lacked consideration, and because the very purpose of the contract would have been to carry out a fraudulent conveyance illegal under Michigan law. Hurtado had control over the bank account in this case for a number of years, exercising control on many occasions to write checks on the account; she points to no legal recourse that the debtors would have had if she had chosen to use the funds to her own benefit. The fact that she did not choose to use the funds in that manner in no way undercuts the fact that she had that ability.\textsuperscript{176}
\end{quote}

\begin{itemize}
\item \textsuperscript{170} \textit{Id.} at 533 (discussing First National Bank of Barnesville v. Rafoth (\textit{In re} Baker & Getty Fin. Servs., Inc.), 974 F.2d 712 (6th Cir. 1992)).
\item \textsuperscript{171} \textit{Id.} at 534.
\item \textsuperscript{172} \textit{Id.}
\item \textsuperscript{173} \textit{Id.} at 535.
\item \textsuperscript{174} \textit{Id.}
\item \textsuperscript{175} \textit{Id.}
\item \textsuperscript{176} \textit{Id.} (internal citations omitted).
\end{itemize}
Summarizing its holding, the Sixth Circuit rejected Hurtado’s argument that she was a mere conduit because she “was vested with legal authority to do what she liked with the funds.”\textsuperscript{177} As the initial transferee of the funds, she was strictly liable to repay the fraudulent transfers to the estate.\textsuperscript{178}

\section*{G. In re Incomnet.}

In \textit{In re Incomnet},\textsuperscript{179} the Ninth Circuit Court of Appeals first noted that although combined at times, the “dominion test” and the “control test” are actually two separate tests. Thereafter, applying Ninth Circuit precedent, the court adopted the “dominion test.” In that case, the debtor was a telecommunications provider that was required under federal law to advance certain funds to the Universal Service Administrative Company (“USAC”), a non-profit entity established to collect such funds on behalf of a trust established by the Federal Communications Commission to ensure that acceptable telecommunications services were available to low-income and rural schools.\textsuperscript{180} The post-confirmation committee in the debtor’s bankruptcy case sought to set aside and recover $470,161.52 in payments made to the USAC as preferential transfers made during the ninety days before the bankruptcy filing.\textsuperscript{181}

The USAC contended that it was not a transferee under section 550(a) but was instead a “mere conduit” with respect to the funds as they were transferred to the trust.\textsuperscript{182} The bankruptcy court agreed, holding that USAC did not have the requisite degree of control over the funds to be

\begin{flushleft}
\textsuperscript{177} \textit{Id.} at 536.  \\
\textsuperscript{178} \textit{Id.}  \\
\textsuperscript{179} Universal Service Administrative Company v. Post-Confirmation Committee of Unsecured Creditors of Incomnet Communications Corporation (\textit{In re Incomnet}), 463 F.3d 1064 (9th Cir. 2006).  \\
\textsuperscript{180} \textit{Id.} at 1066-1067.  \\
\textsuperscript{181} \textit{Id.} at 1067.  \\
\textsuperscript{182} \textit{Id.} at 1067-1068.  
\end{flushleft}
a transferee.\textsuperscript{183} The Ninth Circuit Bankruptcy Appellate Panel reversed, holding that the “dominion or control” test did not apply because it was adopted to distinguish financial intermediaries from true recipients, and that the transaction at issue could not be a “conduit” transfer because the USAC was, in fact, the actual recipient of the transfer.\textsuperscript{184}

The Ninth Circuit Court of Appeals affirmed. The court began its analysis by noting that two separate standards have emerged with respect to the issue of whether a party was an initial transferee, the “dominion test” and the “control test.”\textsuperscript{185} The court explained: “While the words ‘dominion’ and ‘control’ are synonyms when used in their lay sense, the ‘dominion test’ and the ‘control test,’ as originally stated, are not merely different names for the same inquiry.”\textsuperscript{186} The court noted that although it has not always been careful with its terms, the Ninth Circuit had adopted the dominion test, as set forth in \textit{Bonded}, but had declined to adopt the control test, as set forth in \textit{In re Chase & Sanborn Corp}.\textsuperscript{187}

Regarding the “dominion test,” the court stated, “a transferee is one who … has ‘dominion over the money or other asset, the right to put the money to one’s own purposes.’”\textsuperscript{188} The inquiry focuses, the court continued, on whether an entity had legal authority over the money and the right to use the money however it wished.\textsuperscript{189} The court noted that legal authority strongly correlates with legal title to the funds.\textsuperscript{190}

\begin{footnotes}
\footnote{\textit{Id.} at 1068.}
\footnote{\textit{Id.}}
\footnote{\textit{Id.} at 1069.}
\footnote{\textit{Id.}}
\footnote{\textit{Id.}}
\footnote{\textit{Id.} at 1070 (citing Bonded Fin. Servs. Inc. v. European American Bank, 838 F.2d at 893).}
\footnote{\textit{Id.}}
\footnote{\textit{Id.}}
\footnote{\textit{Id.}}
\end{footnotes}
Conversely, the court continued, the “control test” instructs courts to view the entire transaction as a whole to determine who truly had control of the money.\textsuperscript{191} The test requires courts to step back and evaluate a transaction in its entirety “to make sure that their conclusions are logical and equitable.”\textsuperscript{192} The analysis, the court found, turns on whether the intermediary actually controlled the funds or merely served as a conduit, holding money that was in fact controlled by either the transferor or the real transferee.\textsuperscript{193}

Regarding the insertion of equitable considerations by the “control test” to the mere conduit analysis, the Ninth Circuit noted as follows:

It is interesting to note just how starkly the Eleventh Circuit’s reliance on equity, exemplified by the direct incorporation of equitable principles into the control test, contrasts with the approach taken by the Seventh Circuit in Bonded Financial Services. In its opinion the Seventh Circuit expressed concern over “the use of equitable powers under § 550(a)” by a number of bankruptcy courts and remarked on “the propriety of judges’ declining to enforce statutes that produce inequitable results.” The court also expressed dismay at courts using equity to relive certain actors from a literal construction of § 550.\textsuperscript{194}

The court then noted that a number of circuits (specifically referencing the 2\textsuperscript{nd}, 4\textsuperscript{th}, 5\textsuperscript{th}, 6\textsuperscript{th} and 10\textsuperscript{th} circuits) had combined these tests, or at least their names, creating a “dominion and control test” to determine whether a party is an initial transferee.\textsuperscript{195} However, while the inquiries are similar, the court found, they are not indistinguishable because:

The dominion test focuses on whether the recipient of the funds has legal title to them and the ability to use them as he sees fit. The control test takes a more gestalt view of the entire transaction to determine who really controlled the funds.\textsuperscript{196}

\textsuperscript{191} Id. (citing In re Chase & Sanborn Corp., 848 F.2d at 1199).
\textsuperscript{192} Id.
\textsuperscript{193} Id. at 1071.
\textsuperscript{194} Id. at 1071, fn. 7.
\textsuperscript{195} Id. at 1071.
\textsuperscript{196} Id. (internal citations omitted).
Since the Ninth Circuit had previously adopted only the more restrictive dominion test, it indicated that it would be cautious not to apply the more lenient “control test” put forth by the Eleventh Circuit or, in other words, *not to consider equitable considerations*.197

Applying the “dominion test,” the court held that the USAC which, as administrator of the trust, “had discretion over if, when and how it disburses the funds” to beneficiaries, had dominion over the funds and, thus, was the initial transferee.198 Although the FCC held substantial power over the trust and the USAC indirectly (USAC did not have the ability to make policy, interpret provisions of the applicable statute or rules, or determine contribution amounts from telecommunications providers), it had no ability to control the trust fund through direct seizure or discretionary spending.199

Rather, the USAC, which as administrator of the trust fund had discretion over if, when and how it disbursed universal service funds to beneficiaries, had dominion over the USF and the transferred funds.200 The USAC, the court noted, was more than just an agent for the FCC or for the fund’s beneficiaries.201 It took legal title to the contributions it received.202 Legal title, the court found, is often the deciding factor: “The dominion test we have crafted strongly correlates with legal title…. In the vast majority of cases, possessing legal title to funds will equate to having dominion over them.”203

Finally, rejecting the USAC’s argument that it must be a conduit because its ability to use the funds was restricted by applicable law, the court noted: “it is of no consequence that USAC

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197 Id. (emphasis added).
198 Id.
199 Id. at 1072.
200 Id.
201 Id. at 1073.
202 Id.
203 Id. at 1073-1074
cannot invest funds in – to use the Seventh Circuit’s colorful phrase – ‘lottery tickets or uranium stocks.’”\textsuperscript{204} Although the USAC’s use of the funds was restricted by law, these legal restrictions merely limited how the USAC will exercise its dominion over the funds; they did not preclude the USAC from having dominion at all.\textsuperscript{205} Accordingly, the USAC was deemed to be an initial transferee with respect to the funds.

VI. \textit{Throwing a Wrench into the Gear - Paloian v. LaSalle Bank and In re Harwell.}

As evidenced by the cases discussed above, there were generally two schools of thought with respect to the mere conduit defense: the “dominion test” and the “control test.” Given the variety of tests and prongs that present themselves with various aspects of bankruptcy law, the fact that two distinct tests exist to wrestle with a particular issue should not be a surprise (consider the daunting intellectual escapades brought about by the challenges of determining something as basic as “what is a claim?”). Nevertheless, the fact that different tests existed did present a challenge for both practitioners and the courts. It is only fitting, then, that the Seventh Circuit Court of Appeals, which years earlier had first established the “dominion test,” and the Eleventh Circuit Court of Appeals, which first articulated the “control test,” would muddy the waters even further with their recent decisions in \textit{Paloian v. LaSalle Bank}\textsuperscript{206} and \textit{In re Harwell.}\textsuperscript{207}

\textbf{A. Paloian v. La Salle Bank: “Life Does Not Stop and Start at Your Convenience”}\textsuperscript{208}

Some background is necessary to understand the \textit{Paloian v. La Salle Bank} decision, but bringing its holding to the forefront will illuminate how the facts stacked up against the bank. In

\begin{thebibliography}{99}
\item \textsuperscript{204} Id. at 1075.
\item \textsuperscript{205} Id.
\item \textsuperscript{206} Paloian v. LaSalle Bank, 619 F.3d 688 (7\textsuperscript{th} Cir. 2010).
\item \textsuperscript{207} Martinez v. Hutton (In re Harwell), 628 F.3d 1312 (11\textsuperscript{th} Cir. 2010).
\item \textsuperscript{208} The Big Lebowski (1998).
\end{thebibliography}
short, the Seventh Circuit determined that the defendant bank was an “initial transferee” of funds because it served as trustee of a securities pool rather than the more typical trust or bank account. The court was also persuaded by the convenience of suing the bank with direct access to funds rather than investors. Securities pools, however, are not a unique beast. With increasing frequency, companies on the brink turn to non-bankruptcy options in an effort to salvage the business. Due in part to a tight credit market and the difficulty in obtaining post-petition financing, the primary objective is to isolate the assets or collateral that will generate a payout to investors while keeping the business afloat. In the typical transaction, assets are transferred to a bankruptcy-remote vehicle (or special purpose entity) that is limited by its articles of incorporation to only the acquisition of the assets and the corresponding issuance of securities backed by those assets.

The banks that lend to these businesses originate commercial mortgage loans flowing from the assets of the bankruptcy-remote vehicle (“BRV”). Those mortgages are then pooled into a securitization creating commercial mortgage-backed securities (“CMBS”). In many instances, mortgage loans are conveyed to a trust for which the bank is trustee. Pass-through certificates are issued to pools of investors. In effect, the mortgage loans are sliced and diced like a sushi roll and distributed amongst the hungry investors.

The relationship between the parties – the troubled company, the BRV, the lender, and the investment pool – can be successful, but if the arrangement cannot keep the company out of bankruptcy, the specter of failure looms large. At the forefront of concern is whether a trustee (or debtor in possession) can unwind the CMBS and claw the assets back into the estate. Section 548 of the Bankruptcy Code provides that a bankruptcy trustee may avoid any transfer if the debtor: (1) made the transfer with actual intent to hinder, delay or defraud any creditor; or (2)
received less than a reasonably equivalent value in exchange for such transfer and either (a) was insolvent at the date of transfer or became insolvent as a result thereof, (b) was engaged in business for which its remaining capital was unreasonably small, or (c) intended to incur debts beyond its ability to pay.\textsuperscript{209}

The conventional wisdom has been that when a lender acts as a trustee for funds destined to a downstream investment pool in one of these transactions, the lender is a mere conduit and, thus, is not liable in a fraudulent transfer suit.\textsuperscript{210} \textit{Paloian v. LaSalle Bank} seems to have drowned out that general rule.

In \textit{Paloian}, the Seventh Circuit vacated the decisions of the bankruptcy and district courts, and held that a bank-trustee of the CMBS pass-through certificates may qualify as an initial transferee of certain repayments on the certificates from which the trustee could recover those amounts.\textsuperscript{211} The facts of \textit{Paloian} show a long and troubled road to bankruptcy. Between 1992 and 2000, Doctors Hospital of Hyde Park (“Hospital”) was controlled by James Desnick, “an ophthalmologist with a checkered past.”\textsuperscript{212} In 1999 and 2000 Desnick paid civil penalties of some $18.5 million to the Medicare and Medicaid programs on account of the Hospital’s fraudulent billing practices. Among other things, the hospital sought reimbursements for “upcod[ed]” services that put procedures in categories that earned greater payouts and submitted claims for medically unnecessary procedures or work never completed in the first place.\textsuperscript{213} Beyond the false claims quagmire, the Hospital suffered from a crumbling facility and patient

\begin{footnotes}
\item[210] \textit{In re International Administrative Services, Inc.}, 408 F.3d 689, 706 (11th Cir. 2005).
\item[211] \textit{Id.} at 691-692.
\item[212] \textit{Id.} at 689.
\item[213] \textit{Id.} at 689-690.
\end{footnotes}
stays far above the national average. These persistent problems sunk revenues and the Hospital shut its doors 2000.214

Three years before its August 2000 bankruptcy filing, the Hospital took out two loans.215 The first loan consisted of a $25 million revolving credit line extended in March 1997 by Daiwa Healthco to MMA Funding, L.L.C.216 MMA – a nondebtor affiliate – was intended to serve as a BRV. The structure of the transaction provided for the Hospital to transfer all its current and future accounts receivable to MMA. In return, Daiwa took a security interest in the accounts.217

The layers of debt grew with an August 1997 loan from Nomura Asset Capital Corporation. Nomura loaned $50 million to the Hospital through HPCH LLC, another non-debtor affiliate of the Hospital that owned its building and land.218 HPCH directed the funds to the Hospital in exchange for additional rent, and Nomura was granted a security interest in the rent.219 After issuance, a third party packaged and securitized the Nomura loan with several billion dollars of commercial credit available for resale to investors.220 The notes and accompanying security interests were then conveyed to a trust, of which LaSalle National Bank (“LaSalle”) was trustee.221

The bankruptcy court determined that the increased rent payments to HPCH were more properly characterized as debt service by the Hospital on the Nomura loan, and recoverable from LaSalle as fraudulent transfers because the Hospital had been insolvent at the time the loan was

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214 Id. at 690.
215 Id.
216 Id.
217 Id.
218 Id.
219 Id.
220 Id.
221 Id.
issued. Notwithstanding the conclusion that the transaction was a fraudulent conveyance, the bankruptcy court limited the Hospital’s recovery by finding that any payments on the loan made by MMA rather than the Hospital were outside the bankruptcy and not recoverable as fraudulent transfers. The district court affirmed the bankruptcy court’s decision.

Ten years after the bankruptcy was filed, the Seventh Circuit Court of Appeals took up the case and considered three questions: (i) whether the Hospital was insolvent when the Nomura loan was made; (ii) whether LaSalle bank was an “initial transferee” subject to liability in a fraudulent transfer action; and (iii) whether the Hospital’s accounts receivable had been sold to MMA or if they remained assets of the Hospital that could be pursued in a fraudulent transfer suit.

The second issue—whether the bank qualified as an initial transferee—is the primary import of this case, although insolvency of the transferor is also a factor in the overall calculus of liability. The trustee has two bites at the apple to demonstrate it: either insolvency at the time of the transfer or insolvency as a result of the transfer. The bankruptcy court concluded that the Hospital was insolvent in August 1997 irrespective of its positive financial statements and current payments to creditors. As a result, certain payments the Hospital made on the Nomura Loan were deemed preferential. The Seventh Circuit rejected the bankruptcy court’s finding of insolvency and remanded the unresolved question of whether the Hospital slipped into

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223 Id. at 853
225 Paloian v. LaSalle Bank, N.A., 619 F.3d 688 (7th Cir. 2010).
227 Paloian v. LaSalle Bank, N.A., 619 F.3d at 691.
insolvency at some point after the August 1997 loan but before the bankruptcy filing in April 2000.\textsuperscript{228}

The critical question in \textit{Paloian} was not insolvency, however. The larger issue was whether LaSalle was an “initial transferee” pursuant to section 550(a)(1) of the Bankruptcy Code. LaSalle attempted to argue that it served as a mere conduit for the payments which were then held in trust for the benefit of the pool of investors. The Seventh Circuit was not persuaded by LaSalle’s argument.

The determination that LaSalle was an “initial transferee” hinged on LaSalle’s role as trustee of a securities pool as opposed to a traditional trust or bank account.\textsuperscript{229} To the court, the relationship functioned more like a lender receiving payments on a loan instead of a formulaic payment of funds.\textsuperscript{230} Here, the court found, LaSalle had the status of a “real recipient” of the funds because it was the legal owner of the assets of the trust.\textsuperscript{231} Additionally, the court noted that from a practical standpoint, it made sense to allow the bankruptcy trustee to recoup funds from the trustee who could directly access funds from the corpus of a trust.\textsuperscript{232} Otherwise, the bankruptcy trustee \textit{would be required to bring suit against potentially thousands of investors}.\textsuperscript{233}

Finally, the Court examined the use of MMA as a legitimate BRV that had purchased the Hospital’s accounts receivable in a true sale. If the answer was in the negative, the bankruptcy trustee could recover the payments made through MMA to LaSalle in addition to those made directly by the Hospital. The court remanded this issue to the bankruptcy court as well, but noted the blurred lines between MMA and the Hospital including a lack of corporate formalities.

\textsuperscript{228} Id. at 695.
\textsuperscript{229} Id. at 692.
\textsuperscript{230} Id.
\textsuperscript{231} Id.
\textsuperscript{232} Id.
\textsuperscript{233} Id. (emphasis added).
and the Hospital retaining the accounts receivable on its own books.\textsuperscript{234} Simply put, the arrangement didn’t pass the court’s smell test.

The \textit{Paloian} court’s holding – that a securities pool trustee may be an “initial transferee” for fraudulent transfer purposes – has potential consequences for trustees serving in that capacity. This seems to be a broadly decided case, based more upon convenience than strict statutory interpretation. In a marketplace that has experienced an uptick in distressed businesses seeking alternative financing methods (including securities pools), there could be vast implications for lenders who take on trustee responsibilities. Indeed, while the Seventh Circuit opined that the trustee could draw from the corpus of the trust to repay the bankruptcy estate, it failed to address what would happen if payments couldn’t be taken directly from the trust, forcing the trustee to cover the payments with its own funds and later seek reimbursement from a wide universe of investors.

\textbf{B. \textit{In re Harwell}: “What Did He Know and When Did He Know It?”\textsuperscript{235}}

On the heels of \textit{Paloian}, the Eleventh Circuit Court of Appeals returned to the mere conduit fray with a bang, holding that an attorney could be deemed an initial transferee of a fraudulent transfer by temporarily holding settlement proceeds in its client trust account if the attorney failed to act in good faith.\textsuperscript{236} Reasonable debate exists as to whether \textit{Harwell} is a broader holding that injects good faith into the §550(a) defense, and, like \textit{Paloian}, the series of events may in fact contribute to the notion of a narrow holding. The facts in \textit{In re Harwell} are lengthy, but far less convoluted than \textit{Paloian}. In July 2005, a creditor obtained a Colorado

\begin{footnotesize}
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\item \textsuperscript{234} \textit{Id.} at 696.
\item \textsuperscript{235} Howard Baker (referring to Richard Nixon during Watergate). The authors would like to thank Professor Nancy B. Rapoport at the William S. Boyd School of Law, University of Nevada Las Vegas for highlighting how apropos this quote is in the grand scheme of fraudulent transfer actions.
\item \textsuperscript{236} \textit{In re Harwell}, 628 F.3d 1312 (11th Cir. 2010).
\end{itemize}
\end{footnotesize}
judgment of $1.396 million against the debtor, Billy Jason Harwell. Several weeks later, the creditor filed papers in Sarasota County, Florida, in an attempt to domesticate his Colorado judgment against Harwell. Harwell’s attorney represented him in the domestication proceeding.

When the Colorado judgment became final in July 2005, the debtor owned interests in two Florida businesses. Harwell served as a shareholder of the Center for Endoscopy, Inc. (“CFE”), and a member of Sarasota Endo Investors, LLC (“SEI”). Harwell hired the same attorney to represent him in disputes with other investors in CFE and SEI. The attorney negotiated buyouts from the companies for Harwell. By August 2005, Harwell was embroiled in the domestication litigation with the Colorado creditor. In answering interrogatories, Harwell failed to disclose both the buyout settlements and the nearly $550,000 he would receive from them. On September 1, 2005, funds from the one of the buyouts were deposited directly into the attorney’s trust account.

On the same day, Harwell directed – and the request was obliged – his attorney to disburse $100,000 in five checks, payable to, among others, Harwell’s wife and attorney. The attorney did this with full knowledge of the judgment creditor’s collection attempts. Several

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237 Id. at 1314.
238 Id.
239 Id.
240 Id.
241 Id.
242 Id.
243 Id.
244 Id.
245 Id. The court noted here that the attorney had no hand in drafting Harwell’s responses to the interrogatories.
246 Id. at 1315.
247 Id.
248 Id.
days later, the attorney wrote a letter to SEI’s counsel to request that a payment of $46,837 be made directly to Harwell's wife. On September 9, 2005, SEI sent its final $400,000 settlement payment directly to the attorney’s trust account.249 That same day, again at Harwell's direction, the attorney disbursed the $400,000 in seventeen checks, payable to a car dealer, credit card companies and Harwell’s father.250

Before the new set of checks cleared, the judgment creditor obtained a turnover order from the Colorado court requiring the debtor to (1) turn over any payments from SEI; and (2) turn over any funds Harwell received after July 12, 2005, that were still within his control.251 On September 19, 2005, the judgment creditor served the attorney with a writ of garnishment for any amounts held in trust for the debtor.252 In response, the attorney stopped payment on a total of $125,000 in checks, but not on other checks that had been written and for which funds still remained in the attorney’s trust account.253 On September 28, 2011, a Florida court quashed the garnishment as defective on technical grounds. The same day the Florida court quashed the writ of garnishment, the attorney issued a check on his trust account to the Bank of Commerce for Harwell’s remaining $125,000.254 The attorney personally went to the bank, delivered the $125,000 check, and received seven cashier’s checks in return, including ones payable to Harwell's wife, his father, and another creditor.255

On October 10, 2005, Harwell filed for bankruptcy in the District of Colorado.256 Soon after the filing, the attorney again assisted Harwell in converting the $30,000 cashier’s check that

249 Id.
250 Id.
251 Id. (emphasis added).
252 Id.
253 Id.
254 Id.
255 Id.
256 Id.
had been payable to the other creditor) into a check payable to Harwell personally.\textsuperscript{257} In turn, the bankruptcy trustee filed a complaint against the attorney in Colorado, seeking return of the $500,000 from the SEI and CFE settlements under sections 548(a)(1) and 550(a)(1) of the Bankruptcy Code.\textsuperscript{258} Harwell’s attorney responded with a motion to transfer the case to Florida, which the bankruptcy court in Colorado granted.\textsuperscript{259}

The attorney moved for summary judgment on the fraudulent transfer case, and the bankruptcy court granted that motion. The bankruptcy court succinctly framed the issue as: “Are there theories in which a … trustee can go after the lawyer for personal liability where the lawyer is the mastermind and facilitator of the fraudulent conveyances?”\textsuperscript{260} For purposes of the attorney’s summary judgment motion, the bankruptcy court assumed that the attorney served as “the mastermind and the marionette that was driving all the pieces of what was a huge fraudulent conveyance of hundreds of thousands of dollars that would have been [otherwise] available for creditors.”\textsuperscript{261} The bankruptcy court also assumed that the attorney “managed to coordinate things in a fashion that the settlement was concluded and the money funneled through [his] trust account to various preferred creditors and insiders in either preferential or fraudulent conveyances.”\textsuperscript{262}

In granting the attorney’s summary judgment motion, however, the bankruptcy court concluded that he did not qualify as an initial transferee of Harwell’s money under section 550(a)(1) of the Bankruptcy Code because the attorney never had dominion and control over the

\textsuperscript{257} Id.
\textsuperscript{258} Id. at 1316.
\textsuperscript{259} Id.
\textsuperscript{260} Id.
\textsuperscript{261} Id.
\textsuperscript{262} Id.
money the attorney kept in his trust account for Harwell. In other words, the attorney merely functioned as a conduit for the funds. Consequently, the trustee was precluded from recovering the fraudulently-transferred $500,000 from the attorney. The bankruptcy court further concluded that the presence or lack of good faith played no role in determining whether the attorney qualified as a mere conduit. The district court affirmed the bankruptcy court’s decision and the trustee appealed.

The Eleventh Circuit began its analysis by noting (as many courts have) that the Bankruptcy Code lacked a clear definition of the term “initial transferee.” The court then turned its attention to its prior precedent on initial transferees and the development of its control test in In re Chase & Sanborn Corp. Through a survey of its pertinent decision, the Eleventh Circuit examined the term “initial transferee” in several contexts in order to refine and perhaps enhance the applicability of the control test.

The court recognized that a strict, literal reading of section 550(a)(1), requires that the first recipient of the debtor’s funds be held liable for the fraudulent transfer as an initial transferee. In In re Harwell, that first recipient was the attorney. The court then described the “equitable exception” to the strict interpretation of section 550(a)’s “initial recipient” criterion: the mere conduit defense with a slight twist. The Eleventh Circuit enunciated the new control test as:

\[ \text{control test} \]

\[ \text{equitable exception} \]

\[ \text{mere conduit defense} \]

\[ \text{slight twist} \]

\[ \text{new control test} \]
[G]ood faith is a requirement under this Circuit’s mere conduit or control test. Accordingly, initial recipients of the debtor’s fraudulently-transferred funds who seek to take advantage of equitable exceptions to § 550(a)(1)’s statutory language must establish (1) that they did not have control over the assets received, i.e., that they merely served as a conduit for the assets that were under the actual control of the debtor-transferor and (2) that they acted in good faith and as an innocent participant in the fraudulent transfer.\textsuperscript{272}

Thus, with one fell swoop, the Eleventh Circuit rejected any preconceived notions that the requirement of good faith in the mere conduit defense was simply passing dicta. For the first time in \textit{In re Harwell}, the Eleventh Circuit expressly held that \textit{good faith} is required under that court’s articulation of the mere conduit defense to initial transferee liability.\textsuperscript{273} The court based this conclusion on \textit{In re Chase & Sanborn Corp.} and its progeny which, according to the court, set forth a “clear pattern” that “adopted a flexible, pragmatic, equitable approach of looking beyond the particular transfer in question to the circumstances of the transaction in its entirety.”\textsuperscript{274} The court reconciled the discrepancy between its practice and the precise statutory language by noting that the mere conduit defense is a “judicial creation … based on the bankruptcy courts’ equitable powers.”\textsuperscript{275}

Indeed, as \textit{In re Harwell} recognized, equitable considerations perform the central role in the mere conduit or control test “because it would be inequitable to hold an initial recipient of the debtor's fraudulently-transferred funds liable where that recipient could not ascertain the transferor debtor’s solvency, lacked any control over the funds, or lacked knowledge of the

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\item \textsuperscript{272} \textit{Id.} at 1323.
\item \textsuperscript{273} \textit{Id.}
\item \textsuperscript{274} \textit{Id.} at (citing Nordberg v. Societe Generale (\textit{In re Chase & Sanborn Corp.}), 848 F.2d 1196, 1199 (11th Cir. 1988); \textit{In re Pony Exp. Delivery Services, Inc}, 440 F.3d 1296, 1302 (11th Cir. 2006); \textit{In re International Administrative Services, Inc.}, 408 F.3d 689, 705 (11th Cir. 2005)).
\item \textsuperscript{275} \textit{Id.} (citing Nordberg v. Societe Generale (\textit{In re Chase & Sanborn Corp.}), 848 F.2d at 1199 (“This approach is consistent with the equitable concepts underlying bankruptcy law.”)).
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source of the funds.” As such, the court “tempered” a strict application of section 550(a)(1) and explicitly required what it deemed to be inherent in the equitable analysis: good faith on the part of the initial transferee. Consequently, under In re Harwell, only the most deserving of initial transferees may avail themselves of the defense. Needless to say, in the Eleventh Circuit, In re Harwell made clear that “the conduit rule presumes that the facilitator of funds acts without bad faith, and is simply an innocent participant to the underlying fraud.” As a result, in order to avail oneself of this exception, a defendant has an affirmative duty to prove that he or she acted in good faith, as a blameless bystander to the transfer. Because of this, the court remanded the case back to the bankruptcy court for findings as to whether the attorney acted in good faith.

The Eleventh Circuit’s pronouncement in In re Harwell, however, would not be the last gasp of the case. On remand, the bankruptcy court revisited the issue of good faith, as required by the Eleventh Circuit. The bankruptcy court acknowledged the Eleventh Circuit’s clarification of the mere conduit test by noting:

[I]n order to take advantage of the equitable exceptions to Section 550’s statutory language, the initial transferee must establish, one, that the initial transferee did not have control over the assets, that is that the initial transferee merely received the transfers as a conduit for the assets that were under the actual control of the Debtor transferor and, two, that the initial transferee acted in good faith and as an innocent participant in the fraudulent transfer.

276 Id. at 1322.
277 Id.
278 Id.
279 Id. at 1322 (quoting IBT, 408 F.3d at 705).
280 Id.
281 Id.
283 Id. at *4.
In assessing the attorney’s requisite good faith, the bankruptcy court first noted that it found the attorney to be “a credible and impressive witness” with “a distinguished career.”284 The bankruptcy court observed that the attorney was under a duty to transfer the funds in trust at the direction of a client.285 The court recognized that the attorney “had no discretion in picking and choosing who would receive Mr. Harwell’s money” in the trust account.286 The bankruptcy court’s generosity, however, ended there.

Although the bankruptcy court appreciated the competing conflicts between the client and the judgment creditor, the court determined that the attorney’s duty did not encompass an obligation “to make his trust account available to Mr. Harwell so that Mr. Harwell could effect transfers intended to delay, hinder or defraud a creditor.”287 The bankruptcy court concluded that the attorney possessed the ability to “simply [refuse] to be the recipient of the settlement proceeds and could have insisted that the settlement agreement not make him the initial transferee of those funds.”288

The bankruptcy court also noted that the attorney retained his own legal counsel to advise him about his obligations, but the advice only pertained to the attorney’s obligations as a holder of the garnished funds.289 As it turned out, the advice ultimately proved to be shortsighted because the attorney failed to appreciate that “the entire mechanism of payment of Harwell's settlement funds to his trust account and then to other persons was all being done with the intent

284 Id. at *6.
285 Id.
286 Id. (noting that “[a]s a general proposition, under the rules regulating the Florida Bar, attorneys are bound to follow the instructions of their clients in distributing trust funds.”).
287 Id.
288 Id.
289 Id. at *7.
to delay and hinder [the judgment creditor] in his collection efforts. Thus, the bankruptcy court entered into an analysis of “whether or not simply missing the issue is enough to support a finding that [the attorney] acted in good faith and was an innocent participant in the fraudulent transfers.”

The bankruptcy court then made clear that In re Harwell was not the case “of a bank, or for that matter an attorney, being unwittingly involved as the initial transferee of funds used as part of a scheme to defraud creditors under circumstances that would put the bank or attorney on notice of the intent to hinder or delay a creditor.” This carve out seems to have insulated those transactions that occur in the ordinary course of business and raise no concerns “or put the attorney on notice that the attorney is playing a critical role in accomplishing a fraudulent transfer.”

Taken together, both Paloian and In re Harwell represent significant departures on the tests previously relied upon by the Seventh and Eleventh Circuits, amongst others. These recent pronouncements of the mere conduit defense demonstrate that more than just mere conduit status is needed. Indeed, the cases seem to add a “plus” prong to the mere conduit inquiry. In the Seventh Circuit, the “dominion plus” inquiry injects considerations of convenience for the bankruptcy trustee into the equation. In the Eleventh Circuit, the “control plus” test adds in a good faith requirement. Such discrepancies run afoul of one of the goals of the Bankruptcy Code: a uniform system of debtor-creditor relationship that is consistent across Circuit lines. Mere conduit case law falls far short of that goal. Nonetheless, we submit that if any test should

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290 Id.
291 Id.
292 Id.
293 Id.
be the law of the mere conduit landscape, it would be that set forth by the Eleventh Circuit in In re Harwell.

VII. Application of the Various Tests to Our Hypothetical.

Recall our hypothetical debtor, the automotive supply company. Depending on the test utilized by the court, the broker may or may not be liable for the alleged fraudulent transfer. The bankruptcy trustee successfully avoided the transfer under section 548(a), but the complication comes with the recovery of those funds pursuant to section 550(a) from the broker as the initial transferee. Because the broker has asserted that it was a mere conduit with respect to those funds, the question becomes: how does the broker fare under the different permutations of the mere conduit defense?

A. The “Dominion Test” Under Bonded.

Applying the Bonded “dominion test” to the facts set forth in our hypothetical above, the insurance broker would likely be deemed a mere conduit despite its bad faith. In fact, our hypothetical is similar, in many respects, to the facts set forth in In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson and Casey294 where the Second Circuit Court of Appeals, applying the Bonded “dominion test,” held that an insurance broker was a mere conduit and, thus, not an initial transferee.

There, as here, if the court were to apply a strict “dominion test,” thereby ignoring equitable factors, the court would likely find that despite the fact that the insurance broker acted in bad faith and performed more than one role for the debtor (i.e. by transferring premiums to the insurer and serving as an advisor on risk management issues), it was a mere conduit (at least with

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respect to the premium payments) because once the decision had been made to transfer the premiums to the insurer, the broker’s role in the transaction was essentially that of a courier.

As a courier, a court would likely find that the broker had no discretion or authority to do anything else but transmit the money to the insurer. Because it could not legally put the money to its own use, it did not have dominion with respect to the money. In other words, using the Seventh Circuit’s colorful phrase, the broker could not legally invest the funds “in lottery tickets or uranium stocks” and, therefore, was a mere conduit.

Nevertheless, at least one notable distinction exists between this hypothetical and the 

Finley, Kumble fact pattern. In our hypothetical, the broker had the right to, and in fact did, retain a portion of the funds advanced by the debtor as its commission/consulting fee. In Finley, Kumble, the court noted that its analysis was simplified because the broker received no commission for its transfer of funds to the insurer and suggested that a different result might have been reached if the broker had received or retained a commission, at least with respect to those funds that it had retained.295

Given this language, and the fact that our hypothetical broker apparently did have dominion with respect to those funds that it kept as commissions, we believe that a court would likely conclude that although the broker was a conduit with respect to the premium funds advanced to the insurer, it was not a conduit with respect to those funds that it retained for purposes of satisfying its commission.

B. The “Dominion Plus Test” Under Paloian.

Applying the “dominion test” through the lens of the Paloian opinion likely leads to the same result. The insurance broker would likely be deemed a mere conduit, at least with respect

295 Id. at 59.
to the premiums advanced to the insurer, because it was not the legal owner of the funds. The fact that the same result is reached should not be surprising because both opinions were issued by the Seventh Circuit Court of Appeals and penned by Judge Easterbrook.

Nevertheless, *Paloian* did throw one new wrinkle into the analysis, namely consideration of the plaintiff’s convenience in suing one party as opposed to several parties. Recall that the *Paloian* Court noted that, from a practical standpoint, it made sense to allow the bankruptcy trustee to recoup funds from LaSalle because the alternative result would require the bankruptcy trustee to bring suit against potentially thousands of investors. Applying this analysis to our hypothetical, a plaintiff might argue that, from a practical standpoint, it makes sense to allow the plaintiff to sue the broker instead of the many insurers who received the premium payments. That said, we think this argument is probably not strong enough to carry the day. Therefore, we think it likely that a court, applying the “dominion test” as further explained in the *Paloian* case, would still conclude that the insurer was a mere conduit with respect to the funds advanced to the insurers.

C. The “Control Test” Under *In re Chase & Sanborn Corp*.

*In re Chase & Sanborn Corp.* clearly established that that “where a transfer to a noncreditor is challenged as fraudulent, more is necessary to establish the debtor’s control over the funds than the simple fact that a third party placed the funds in an account of the debtor with no express restrictions on their use.”296 The court emphasized that it was required to examine the “entire circumstances of the transactions” as opposed to the particular transfers in question.297 This holding seems to presume that equitable considerations play a role in the control test. Certainly, the subsequent control test cases in the Eleventh Circuit bear that out.

296 *In re Chase & Sanborn Corp.*, 813 at 1181.
297 *Id.* at 1181-82.
Consequently, under *In re Chase & Sanborn Corp.*, there is but one question: do the totality of the circumstances indicate that the broker had actual control over funds? We will assume that good faith is not an express element of the totality of circumstances inquiry given the ambiguity of the factors housed in that component. Here, although there is no clear-cut answer, the circumstances of the transaction demonstrate that the broker likely did not control the funds transferred to the insurers. The original source of the funds was the debtor’s own account and, although they were transferred through the broker’s accounts, such funds were promptly used to pay insurance premiums as was required per the contract between the broker and the debtor. In this context, the actual connection between the funds and the broker was “quite tangential.”\(^{298}\) So, as to the funds directed to the insurers, *In re Chase & Sanborn Corp.* likely would dictate a result that finds the broker to be a mere conduit.

*In re Chase & Sanborn Corp.* does, however, add a slight obstacle to our hypothetical because the court seemed persuaded by the fact that the bank was not a creditor of the debtor. Rather, the funds simply had a “two-day layover” in the account.\(^{299}\) That is not the case with our broker. The broker arguably had a creditor relationship with the debtor since it had an interest in its commission/consulting fee funds. So, much like the result under the “dominion test,” a court likely would segregate the commission/consulting fee funds from the premiums directed to other insurers, and determine that the broker was not a mere conduit of those funds.

**D. The “Control Plus Test” Under *In re Harwell.***

Under *In re Harwell*, the broker is on the losing end of the deal because it likely will not be able to “equitably escape” its initial transferee status for either the premiums or the

\(^{298}\) *Id.* at 1182.

\(^{299}\) *Id.*
commissions.\textsuperscript{300} As the initial recipient of the funds, \textit{In re Harwell} operates to deny the broker mere conduit status irrespective of the fact that it likely lacked control over such funds and just paid them out to insurers as directed by the debtor.

The problem for the broker is that \textit{In re Harwell} clarifies that the “control test” is an “equitable doctrine” which requires consideration of a party’s good faith.\textsuperscript{301} Thus, the broker would need to establish that it acted in good faith and was really “an innocent participant in the transfers” from the debtor to the insurers.\textsuperscript{302} Given the facts in our hypothetical, including the evidence suggesting that the broker encouraged the debtor to obtain the coverage at issue even though it knew that liquidation of the debtor was imminent so that it could obtain higher fees, we think it is unlikely that the broker would be able to establish that it acted in good faith. As a result, the broker would likely not be entitled to the mere conduit defense and would be deemed the initial transferee.

\textbf{VIII. Conclusion.}

We agree with the decision in \textit{In re Harwell}, and the outcome that it produces. As courts across the circuits note, the Bankruptcy Code does not explicitly include the mere conduit defense in the language of section 550. The defense comports to the set of policy objectives found in the Bankruptcy Code, one of which includes the equitable distribution of assets among creditors. In order to accomplish such objectives, the mere conduit defense takes into account the innocence of an initial transferee because culpability affects recovery and the equity of distribution. This is evidenced by the Bankruptcy Code’s consistent warehousing of good faith provisions throughout the avoidance actions set forth in chapter 5.

\textsuperscript{300} \textit{In re Harwell}, 628 F.3d at 1324.
\textsuperscript{301} \textit{Id.}
\textsuperscript{302} \textit{Id.}
As courts grapple with fraudulent transfers, they have promulgated various iterations of the mere conduit defense. As a result, there is a stark difference between a mere conduit in the Seventh Circuit and one in the Eleventh Circuit. These disparities in mere conduit law fail to serve either fairness or administrative efficiency, especially as courts have reached ever less consistent conclusions about who should be protected. Of course, those courts that strictly interpret the mere conduit defense as one firmly tied to the language of section 550(a) would view the good faith supplement as one that creates a slippery slope that subjects “every courier, every bank and every escrow agent … to a great and unimagined liability that is mitigated only by powers of equity.” But the reality is, as In re Harwell aptly notes, that “[i]n the vast majority of cases, a client’s settlement funds transferred in and out of a lawyer’s trust account will be just like bank transfers, and lawyers as intermediaries will be entitled to mere conduit status because they lack control over the funds.” In re Harwell does not place an affirmative duty on lawyers and banks “to investigate the underlying actions or intentions of the transferor.” Rather, In re Harwell’s true import is that in those cases where bad faith is evident, the initial transferee functions more as a conspirator than a conduit and should thus be held liable for the fraudulent transfer.

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303 In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey), 130 F.3d at 55.
304 In re Harwell, 628 F.3d at 1324.
305 Id.