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I'm a Conduit, You're Glue, Funds Flow Through Me and Stick to You: The Mere Conduit Defense in Bankruptcy Preference Claims and Its Application to Freight Factoring Companies

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COMMENTS

I'M A CONDUIT, YOU'RE GLUE, FUNDS FLOW THROUGH ME AND STICK TO YOU: THE MERE CONDUIT DEFENSE IN BANKRUPTCY PREFERENCE CLAIMS AND ITS APPLICATION TO FREIGHT FACTORING COMPANIES

*By: Jennifer S. McDaniel**

Abstract

Freight factoring companies provide much-needed cash flow and additional services to trucking companies. The trucking company sells its accounts receivable, or invoices, at a discount to the freight factoring company and receives an advance of funds in exchange. The freight factoring company will then begin collecting on these invoices from the trucking company's customers, or debtors. When a debtor sends funds to a freight factoring company, it is paying for the services rendered by the trucking company. As such, the freight factoring company is obligated to apply the funds it receives to its client's invoices in accordance with remittance attached to the debtor's payment.

When a debtor files bankruptcy, the bankruptcy trustee seeks to recover as much property as possible for the bankruptcy estate. Thus, it is not uncommon for freight factoring companies to find that funds it received from a debtor may be subject to a preferential claim under Bankruptcy Code section 547 for recovery by the bankruptcy estate. However, there is a judicially created exception from recovery called the mere conduit defense. This Comment explores the origins of that defense, its application in cases involving banks as financial intermediaries and as payees on loans, and advocates that freight factoring companies should be viewed as mere conduits in bankruptcy preference claims.

Table of Contents

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I. INTRODUCTION

Late Friday evening, after being gone for the past week hauling freight, Joe Smith made it home just in time to join his wife, Jane, at the kitchen table to sort through piles of bills and figure out how to make it through another week. Joe thought running his own trucking business would be a bit more glamorous than it has turned out to be. Even though Joe is able to find work and, actually, just delivered a load of freight, he will not see payment from that delivery for another month or so. Unfortunately, that is just standard payment terms for the trucking industry.

But on this evening, Jane hears an advertisement on the radio for a freight factoring company—a third party that purchases freight bills and advances money on those bills to help struggling trucking companies.[1] From the first phone call with the freight factoring company, things start looking up for the Smiths. By purchasing Joe's freight bills, the freight factoring company helps with cash flow, as well as auditing, available credit, and even collections services.[2] There is also an online

1. DAVID B. TATGE ET AL., AMERICAN FACTORING LAW 423 (2009).
2. *Id.*

account for instant access to all the additional services the freight factoring company offers.[3]

After some time, the freight factoring company receives an unsettling call. One of Joe's customers filed bankruptcy. Payments made to the freight factoring company over the last three months are now subject to a preference claim.[4] The debtor already benefitted from this earlier transaction—having received the service it desired. But now, the freight factoring company is being held liable based on the fact that it advanced funds on the freight bills, collected on them, and applied the payments as instructed by the debtor.[5]

The trustee for the debtor's bankruptcy estate pursues a recovery action against the freight factoring company merely because that is where the bankrupt debtor remitted payment.[6] The trustee, without regard for whom or what the bankrupt debtor was paying for, is seeking to restore as much property to the estate as quickly as possible.[7] Thus, for simply providing much-needed assistance to a struggling trucking company, the freight factoring company finds itself in the most inequitable of situations. Now, through no fault or carelessness of its own, the freight factoring company must return payments, delivered previously in anticipation of the payments to the trucking company who provided service, to the bankruptcy estate.[8]

II. Freight Factoring

A. *What is Freight Factoring?*

"Factoring is a type of financing where one business . . . sells its right to receive payment for goods sold or services rendered . . . to another business at a discounted price."[9] Factoring is common among many industries.[10] In the transportation industry, trucking companies

3. *See id.* at 121.

4. 11 U.S.C. § 547 (2012).

5. *See* Tatge et al., *supra* note 1; *see also Small-Business Financing: Why Are Companies Choosing to Factor and How Does It Work?*, FSW Funding 4, http://inbusinessmag.com/wp-content/uploads/2013/09/FSW_WhitePaper.pdf [http://perma.cc/EUY4-5ZRW] [hereinafter *Small-Business Financing*].

6. *See* § 547; *see also Small-Business Financing*, *supra* note 5.

7. *See* M. Gordon Hearn et al., *The Carrier Must Get Paid—Fact or Fiction*, 13 TTL 14, 17 (2012), http://www.scopelitis.com/scopelitis/assets/dynapsis/Carrier%20Must%20Get%20PaidFact%20or%20Fiction%20Tauscher.pdf [http://perma.cc/6K58-WDDM].

8. § 547; Michael R. Adele, *Avoidable Transfers: Recent Ninth Circuit Developments in Determining Transferee Status, the Conduit Defense and Related Burdens of Proof*, 29 Cal. Bankr. J. 347, 348 (2007).

9. New Century Fin., Inc. v. Olympic Credit Fund, Inc., 487 F. App'x 912, 913 (5th Cir. 2012); *see also* Express Working Capital, LLC v. Starving Students, Inc., 28 F. Supp. 3d 660, 668 (N.D. Tex. 2014).

10. *Frequently Asked Questions About Factoring*, Factoring Explorer, http://www.factoringcompanies.org/articles/frequently-asked-questions-about-factoring [http://perma.cc/XYH2-4UK2].

rely on factoring to finance their freight bills.[11] The companies that finance these freight bills, along with providing additional services, are called freight factoring companies.[12]

Freight factoring companies will purchase a trucking company's freight bills and advance the trucking company money on those bills.[13] By quickly converting its freight bills to cash, a trucking company "can better meet its debt obligations, including payroll, fuel, equipment, taxes, and other operating expenses."[14] Besides accelerated cash flow, freight factoring companies also provide trucking companies with additional services and tools to help them succeed.[15] These services and tools include, but are not limited to: freight bill auditing to ensure accuracy, credit information on potential customers, delivery and collection of factored invoices, cash application services once customer payment is received, online reporting for detailed recordkeeping, and savings on fuel expenditures.[16]

B. *Freight Factoring Companies and Account Debtors*

When a trucking company decides to sell its freight bills to a particular freight factoring company, the freight factoring company and the trucking company enter into a factoring agreement whereby the trucking company becomes a client of the freight factoring company and the freight factoring company obtains a security interest in the trucking company's accounts receivable (i.e., freight bills).[17] Under the Uniform Commercial Code ("UCC"), "a 'security interest' includes the interest of an outright buyer of 'accounts' . . . ."[18] Revised Article 9 of the UCC broadly defines an "account" to include "a right to payment for property sold."[19]

In order for a freight factoring company to preserve its collection rights against an account, it sends notification letters to its client's customers ("debtors").[20] The notification letters inform debtors of the freight factoring company's security interest and assignment of the client's accounts receivable and state that payment for freight bills should be remitted to the freight factoring company.[21] Once payment

11. *See* TATGE ET AL., *supra* note 1.
12. *See id.*
13. *Id.*
14. *What is Factoring?*, MATCH FACTORS, https://www.matchfactors.com/faq [http://perma.cc/XE93-XSKA].
15. *See Small-Business Financing*, *supra* note 5, at 6.
16. *See id.* at 3–6.
17. *Id.* at 2–3.
18. Barkley Clark, *Factoring: Key Issues Under the UCC*, COM. FACTOR (Int'l Factoring Ass'n, San Luis Obispo, Cal.) Spring 2004, at 1, 1 (quoting U.C.C. § 1-201(37) (AM. LAW INST. & UNIF. LAW COMM'N 2001)).
19. *Id.* (quoting U.C.C. § 9-102(a)(2) (AM. LAW INST. & UNIF. LAW COMM'N 2010)).
20. *Small-Business Financing*, *supra* note 5, at 3–4.
21. *Id.*

is received, the freight factoring company applies the payment to its client's invoices as directed by the debtor through remittance information.[22]

The factoring relationship between a freight factoring company and a trucking company is a "recourse" relationship, meaning that if an invoice purchased by the freight factoring company is not paid by the debtor, due to a dispute or insolvency of the debtor, the freight factoring company may charge back the invoice to the trucking company to recover funds advanced on that particular invoice.[23] This disciplined approach to identifying paid and unpaid invoices in a recourse factoring relationship has extreme significance as will be seen in Section VI.A.

C. *When Account Debtors File Bankruptcy*

When a trucking company has provided a service, and the freight factoring company receives payment from the debtor, one would be inclined to think the transaction is completed. Indeed, most anyone would assume this is the case. Unfortunately, it is not uncommon for payments received by a freight factoring company to be claimed as preferential when a debtor files for bankruptcy.[24] Thus, despite having purchased and advanced funds on a freight bill in good faith, a freight factoring company may have any payments it received within a ninety-day period prior to a debtor's bankruptcy subject to disgorgement and returned to the bankruptcy estate.[25] It is typical for the representative of a bankruptcy estate, charged with recovering as much transferred property as possible within a limited period of time, to involve freight factoring companies in preference claims.[26]

III. Background on Bankruptcy Preference Claims

Cases involving pre-petition avoidable transfers and preferential claims are governed by the federal Bankruptcy Code.[27] "Bankruptcy law inserts possible avoidability into a number of transaction types with debtors," especially those headed towards bankruptcy.[28] Among these are avoidable pre-petition transfer actions created by Bankruptcy Code section 547.[29] Section 547 defines pre-petition transfers as those made out of the debtor's estate before the filing of the bank-

22. *Id.* at 4.
23. Tatge et al., *supra* note 1, at 129, 183.
24. Hearn et al., *supra* note 7.
25. *Id.*
26. *See id.*
27. *See* 11 U.S.C. § 547 (2012) (defining pre-petition avoidable transfers subject to preference claim).
28. Douglass E. Barron, Stern v. Marshall *and the Bankruptcy Code's Transfer Avoidance Actions*, 32 Cal. Bankr. J. 563, 566 (2013).
29. *Id.* at 565–66.

ruptcy petition and classifies these transfers as "preferences" which allows the trustee to avoid them.[30]

A. *What Is a Preference Claim?*

> The representative of a bankruptcy estate, generally a trustee, has broad powers under the federal Bankruptcy Code to 'avoid' or set aside certain transfers of property made by the debtor . . . shortly before the filing of the bankruptcy petition, so that this property may be returned to the estate for the benefit of all persons who have valid claims against the debtor.[31]

One of the ways a trustee may avoid a transfer of property is by establishing a preference claim.[32] Under Bankruptcy Code section 547, a trustee may claim that transfers made by the debtor to another person or entity were preferential and, therefore, qualify for avoidance.[33] As a result, a trustee is permitted to recover payments from unsecured creditors within 90 days of the filing of its petition.[34] The purpose of this provision is to preclude an insolvent debtor from favoring particular creditors and causing other creditors to become nervous and pull their business away when bankruptcy seems inevitable.[35]

B. *Recovery of Avoided Preference Claim under Bankruptcy Code Section 550(a)(1)*

Where the grounds for avoidance are established under Bankruptcy Code section 547, the means of actually recovering the property in question is provided by Bankruptcy Code section 550(a)(1).[36] Section 550(a)(1) states:

> to the extent that a transfer is avoided under section . . . 547 . . . 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.[37]

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30. ZVI Guttman v. Constr. Program Grp. (*In re* Railworks Corp.), 760 F.3d 398, 402 (4th Cir. 2014).

31. John E. Theuman, Annotation, *What Constitutes "Initial Transferee" Under §550(a) of Bankruptcy Code, Which Permits Recovery of Property, or Value Thereof, from Initial Transferee of Property to Extent Transfer is Avoided*, 92 A.L.R. FED. 631, 634 (1989 & Supp. 2015).

32. *See* § 547 (outlining the requirements for an avoidable transfer via a preference claim).

33. *Id.*

34. *Id.*

35. Luper v. Columbia Gas of Ohio, Inc. (*In re* Carled, Inc.), 91 F.3d 811, 815 (6th Cir. 1996).

36. Theuman, *supra* note 31, at 634–35.

37. 11 U.S.C. § 550(a)(1) (2012).

The purpose of section 550 is "to restore the estate to the financial condition it would have enjoyed if the transfer had not occurred."[38] Under section 550(a)(1), an initial transferee is strictly liable.[39] Therefore, a trustee may always recover from the initial transferee regardless of the transferee's "good faith, value, or lack of knowledge of the voidability of the transfer."[40] Due to the potentially harsh consequences a party faces as an initial transferee, the bankruptcy courts' interpretation of section 550(a)(1) has become extremely important in situations faced by freight factoring companies.[41]

IV. Courts' Interpretation of Initial Transferee Under Section 550(a)(1)

If a trustee is going to hold a party liable as an initial transferee, it must first be determined who would qualify as an initial transferee. "The Bankruptcy Code does not [provide a definition] and the legislative history is silent on the issue as well."[42] While bankruptcy trustees favor a literal reading of the statutory language,[43] the courts have developed their own standards.[44]

A. *Literal Application of Section 550(a)(1)*

In *In re Fabric Buys of Jericho*, the trustee sought a literal interpretation of section 550(a)(1) of the Bankruptcy Code by claiming that "the initial recipient of an allegedly preferential transfer is liable as the 'initial transferee.'"[45] A bankruptcy court rejected this interpretation because of the potential inequity that would result.[46] "A literal application of section 550(a)(1) would permit the Trustee to recover from a party who is innocent of wrongdoing and deserves protection."[47]

38. Bruno Mach., Corp. v. Troy Die Cutting Co., LLC (*In re* Bruno Mach. Corp.), 435 B.R. 819, 848 (Bankr. N.D.N.Y. 2010) (quoting Hirsch v. Gersten (*In re* Centennial Textiles, Inc.), 220 B.R. 165, 176 (Bankr. S.D.N.Y. 1998)).

39. Askenaizer v. Wyatt (*In re* BeaconVision Inc.), 340 B.R. 674, 678 (Bankr. N.D.N.H. 2006).

40. *Id.*

41. *See In re* BeaconVision Inc., 340 B.R. 674.

42. CNB Int'l, Inc. v. Lloyds TSB Bank PLC (*In re* CNB Int'l, Inc.), 440 B.R. 31, 38 (Bankr. W.D.N.Y. 2010).

43. Gropper v. Unitrac, S.A. (*In re* Fabric Buys of Jericho, Inc.), 33 B.R. 334, 335 (Bankr. S.D.N.Y. 1983).

44. *See id.* at 337.

45. *Id.* at 335.

46. *Id.* at 337 ("In some circumstances, a literal application of section 550(a) would permit the Trustee to recover from a party who is innocent of wrongdoing and deserves protection. In such circumstances the bankruptcy court should exercise its discretion to use its equitable powers . . . to prevent an inequitable result.").

47. *Id.* (quoting 5 Collier on Bankruptcy ¶ 550.02, at 550-7–550-8 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev.)).

In *In re International Administrative Services, Inc.*, the Eleventh Circuit adopted the same position that a literal interpretation of section 550(a)(1) would yield "harsh and inflexible" results.[48] Construed literally, the statute would suggest that an initial transferee is "the first party which received possession of the property in question after it left the hands of the debtor."[49] But, the court was "disinclined to construe [section 550(a)(1)] in such a rigid manner" because of the numerous occasions where the initial recipient of funds "may have nothing to do with the debtor's property other than facilitating its transfer."[50]

Over twenty-five years later, a United States District Court in *In re CNB International* echoed the same opposition to a literal statutory interpretation of section 550(a)(1).[51] According to the court, such an interpretation—that the first entity in physical possession of funds or "anyone who touches the money" is an initial transferee—would lead to absurd and unintended results.[52]

B. *Standard for Initial Transferee Classification*

Refusing to construe section 550(a)(1) in a strictly literal manner, courts developed their own equitable standard for determining whether a party constitutes an initial transferee. This standard establishes two factors used to examine a potential initial transferee classification. These factors are: (1) the transferee's exercise of dominion or control over the property, and (2) a direct business relationship between the debtor and transferee.[53]

1. The Dominion and Control Test

The Seventh Circuit established the *dominion and control* test in *Bonded Financial Services, Inc. v. European American Bank*.[54] Numerous circuits have since adopted the Seventh Circuit's dominion and control test to determine whether a party is an initial transferee.[55]

48. IBT Int'l, Inc. v. Northern (*In re* Int'l Admin. Servs., Inc.), 408 F.3d 689, 704 (11th Cir. 2005) ("The strict interpretation of § 550(a) produces a harsh and inflexible result that runs counterintuitive to the nature of avoidance actions.").

49. *Id.* at 705.

50. *Id.*

51. *See* CNB Int'l, Inc. v. Lloyds TSB Bank PLC (*In re* CNB Int'l, Inc.), 440 B.R. 31, 38 (Bankr. W.D.N.Y. 2010).

52. *Id.* (quoting Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890, 893 (7th Cir. 1988)); *see also* Christy v. Alexander & Alexander of N.Y., Inc. (*In re* Finley), 130 F.3d 52, 57 (2d Cir. 1997) (holding that "the initial transfer is something other than the passing of mere possession. Indeed, if couriers and other mere conduits were deemed 'initial transferees,' some surely unintended consequences would ensue.").

53. *Bonded*, 838 F.2d at 893; Gropper v. Unitrac, S.A. (*In re* Fabric Buys of Jericho, Inc.), 33 B.R. 334, 337 (Bankr. S.D.N.Y. 1983).

54. *Bonded*, 838 F.2d at 893.

55. *In re CNB Int'l, Inc.*, 440 B.R. at 38 ("*Bonded* is the seminal case on the issue of initial transferees, and the Fourth, Fifth, Sixth, Ninth, Tenth and Eleventh Circuits

Dominion or control over money or some other asset is defined as "the right to put the money to one's own purposes."[56] Mere physical possession of property will not suffice.[57]

Even though the Bankruptcy Code does not specifically define initial transferee, courts have "consistently held that the [Seventh Circuit] dominion and control test is the appropriate test to apply when determining whether a person or entity constitutes an initial transferee under § 550[(a)(1)]."[58] Thus, the more dominion or control a party is deemed to possess, the more probable it is that the party will be considered an initial transferee.[59] The Seventh Circuit's decision is discussed more fully in Section V.A.

2. The Direct Business Relationship Test

Although the bankruptcy court developed the *direct business relationship* test in *In re Fabric Buys of Jericho, Inc.*,[60] the Fourth Circuit has continued to expand and advance this standard.[61] If a party has direct business dealings with a debtor, then that party is considered to be an initial transferee within the meaning of section 550(a)(1).[62] Where multiple parties are involved, the courts use this direct business relationship test to determine which party, in fact, has the relationship and is, therefore, an initial transferee, and which party, or parties, is merely an intermediary between the debtor and initial transferee.[63] "[A] party cannot be an initial transferee if he is a mere [intermediary] for the party who had a direct business relationship with the debtor."[64]

C. *The Mere Conduit Defense*

One potential defense to classification as an initial transferee, and thus liability under section 550(a)(1), is to show that the party in-

have also adopted some version of the *Bonded* standard referred to as the 'dominion' and/or 'control' test.").

56. *Bonded*, 838 F.2d at 893.

57. ZVI Guttman v. Assocs. Commercial Corp. (*In re* Furley's Transp., Inc.), 272 B.R. 161, 177 (Bankr. D. Md. 2001) (citing Bowers v. Atlanta Motor Speedway, Inc. (*In re* Se. Hotel Props. Ltd. P'ship), 99 F.3d 151, 154 (4th Cir. 1996)).

58. 718 Arch St. Assocs. v. Blatstein (*In re* Blatstein), 260 B.R. 698, 714 (Bankr. E.D. Pa. 2001) (quoting *In re Se. Hotel Props. Ltd. P'ship*, 99 F.3d at 154).

59. *See Bonded*, 838 F.2d at 893.

60. Gropper v. Unitrac, S.A. (*In re* Fabric Buys of Jericho, Inc.), 33 B.R. 334, 337 (Bankr. S.D.N.Y. 1983). In granting summary judgment for the firm, the court observed that an initial transferee is one who deals directly with the debtor. *Id.*

61. For example, the Fourth Circuit has held that the party with the direct business relationship is an initial transferee. *See* ZVI Guttman v. Constr. Program Grp. (*In re* Railworks Corp.), 760 F.3d 398, 404–05 (4th Cir. 2014); *see also* Lowry v. Sec. Pac. Bus. Credit, Inc. (*In re* Columbia Data Prods., Inc.), 892 F.2d 26, 29 (4th Cir. 1989).

62. *In re Columbia Data Prods., Inc.*, 892 F.2d at 28.

63. *Id.*; *see also In re Railworks Corp.*, 760 F.3d at 404.

64. *In re Railworks Corp.*, 760 F.3d at 404 (quoting *In re Columbia Data Prods., Inc.*, 892 F.2d at 28).

volved was no more than a mere conduit.[65] A conduit is "a party with actual or constructive possession of the asset before transferring it to another person."[66] Thus, a "mere conduit" is not an initial transferee under section 550(a)(1) of the Bankruptcy Code because it has no dominion or control over the transferred property,[67] and it does not have a direct relationship with the debtor.[68] By definition, "conduits can do no more than to transmit the transferred property received to another party."[69] For that reason, bankruptcy courts have found that a party acting as a mere conduit of funds is not an initial transferee "within the ambit of section 550[(a)(1)]" and, as such, "no recovery may be had from the [party]."[70]

V. Use of Mere Conduit Defense: Financial Intermediaries

As demonstrated *supra*, whether one is considered an initial transferee against whom a trustee may recover is a significant question that carries with it a profound effect on the actions of a trustee.[71] This is especially true for financial intermediaries who are involved in the transfers of funds, such as banks and other persons who handle money for third parties.[72] When a financial intermediary finds itself the subject of an avoidance action with a bankruptcy trustee seeking to recover pre-petition transfers from it, the financial intermediary often argues that it is not an initial transferee under the bankruptcy code, but rather a "mere conduit" that lacked dominion or control over the funds it received.[73]

A. *Banks as Intermediaries in Fund Transfers*

In *Bonded Financial Services, Inc. v. European American Bank*, European American Bank gave Michael Ryan a loan to run his business.[74] Bonded Financial Services sent European American a $200,000 check payable to its order with an instruction that the check was to be

65. *See* Kirschenbaum v. Leeds Morelli & Brown P.C. (*In re* The Robert Plan of N.Y. Corp.), 456 B.R. 150, 159 (Bankr. E.D.N.Y. 2011).
66. *Id.*
67. *Id.*; *see also* Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890, 893 (7th Cir. 1988).
68. *See* Gropper v. Unitrac, S.A. (*In re* Fabric Buys of Jericho, Inc.), 33 B.R. 334, 337 (Bankr. S.D.N.Y. 1983).
69. *In re The Robert Plan of N.Y. Corp.*, 456 B.R. at 159 (citing Authentic Fitness Corp. v. Dobbs Temp. Help Servs. (*In re* Warnaco Grp.), No. 01 B 41643(RLB), 2006 WL 278152, at *6 (Bankr. S.D.N.Y. Feb. 2, 2006)).
70. Salomon v. Nedlloyd, Inc. (*In re* Black & Geddes, Inc.), 59 B.R. 873, 875 (Bankr. S.D.N.Y. 1986) (citing *In re* Fabric Buys of Jericho, Inc., 33 B.R. 334).
71. Adele, *supra* note 8.
72. *Id.*
73. *Id.*
74. Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890, 891 (7th Cir. 1988).

deposited into Ryan's account.[75] European American followed the instruction and, ten days after depositing the check into Ryan's account, Ryan instructed European American to debit his bank account for $200,000 in order to reduce the outstanding balance on his loan with the bank. European American did as Ryan instructed.[76]

Shortly thereafter, Bonded Financial filed a petition in bankruptcy and its trustee sought to recover the $200,000 from European American under section 550(a)(1) of the Bankruptcy Code.[77] The trustee contended that European American, as payee of the check it received from Bonded Financial, was an initial transferee under section 550(a)(1).[78] The Seventh Circuit did not agree with the trustee's assertion.[79] Even though European American was the payee on the check, the Seventh Circuit determined that it was acting as a financial intermediary and "held the check only for the purpose of fulfilling an instruction to make the funds available to someone else."[80]

The Seventh Circuit established in *Bonded Financial Services* the minimum standard needed to be classified as an initial transferee.[81] This minimum standard is known as the *dominion and control* test (discussed *supra*, Section IV.B.1), which has been adopted by numerous circuits.[82] According to the *Bonded Financial Services* court, if one has the right to put money it receives to "one's own purposes," then it has dominion over the money and could be classified as an initial transferee.[83]

The Tenth Circuit employed this dominion and control test in *In re First Security Mortgage Co*.[84] In that case, Gary Hobbs opened a business checking account with Citizens Bank of Sapulpa.[85] Hobbs received various funds from First Security Mortgage Company that were deposited into his Citizens Bank account.[86] Within a year of those deposits being made, First Security filed bankruptcy.[87] The trustee over First Security's bankruptcy estate sought to recover the various deposits made to Hobbs's account from Citizens Bank claiming that Citi-

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75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.* at 893.
80. *Id.*
81. *Id.*
82. *See, e.g.*, CNB Int'l, Inc. v. Lloyds TSB Bank plc (*In re* CNB Int'l, Inc.), 440 B.R. 31, 38 (Bankr. W.D.N.Y. 2010) ("*Bonded* is the seminal case on the issue of initial transferees.").
83. *Bonded*, 838 F.2d at 893.
84. Malloy v. Citizens Bank (*In re* First Sec. Mortg. Co.), 33 F.3d 42, 44 (10th Cir. 1994).
85. *Id.* at 43.
86. *Id.*
87. *Id.*

zens Bank was an initial transferee within the meaning of section 550(a)(1) of the Bankruptcy Code.[88]

Because Citizens Bank was obligated to make the funds deposited by First Security available to Hobbs upon his request, the court found that Citizens Bank did not have dominion or control over the funds.[89] Additionally, the court noted that Citizens Bank had no direct business relationship with First Security and so Citizens Bank held the funds it received "only for the purpose of fulfilling an instruction to make the funds available to someone else."[90] Therefore, Citizens Bank acted only as a financial intermediary and was not an initial transferee.[91]

Similarly, in *In re Colombian Coffee*, a bank was found to not be an initial transferee because it did not exercise dominion and control over the funds it received.[92] During a four-week period, three separate transfers were made from Colombian Coffee Company, Inc.'s bank accounts in New York and Miami for deposit into General Coffee Corporation's bank account with First Alabama Bank of Mobile ("Mobile Bank").[93] Without delay, General Coffee used the transferred funds to pay for debt it owed to a third party.[94] Three months after these transfers occurred, Colombian Coffee and General Coffee filed bankruptcy.[95] The trustee for Colombian Coffee's bankruptcy estate sought to recover the funds transferred to Mobile Bank alleging that Mobile Bank was an initial transferee within the meaning of section 550(a)(1) of the Bankruptcy Code.[96]

The court noted that classifying Mobile Bank as an initial transferee would not only violate Congress's intention in passing this section of the Bankruptcy Code,[97] but would also provide Colombian Coffee's trustee with "a windfall from an innocent bystander."[98] The court found no rationale for forcing an "innocent link in the commercial chain [to] bear the loss of a . . . preferential transfer that has vanished beyond the trustee's reach."[99]

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88. *Id.*
89. *Id.* at 44 (citing Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890, 894 (7th Cir. 1988)).
90. *Id.* (quoting *Bonded*, 838 F.2d at 893).
91. *Id.*
92. *See* Metsch v. First Ala. Bank (*In re* Colombian Coffee Co.), 59 B.R. 643, 645 (Bankr. S.D. Fla. 1986).
93. *Id.* at 644.
94. Metsch v. City Nat'l Bank (*In re* Colombian Coffee Co.), 64 B.R. 585, 585 (Bankr. S.D. Fla. 1986).
95. *In re Colombian Coffee Co.*, 59 B.R. at 644.
96. *Id.*
97. *Id.* In passing section 550 of the Bankruptcy Code, Congress hoped to prevent frustration in recovering avoidable transfers by precluding "multiple transfers or convoluted business transactions." *Id.* at 644–45 (quoting Gropper v. Unitrac, S.A. (*In re* Fabric Buys of Jerico, Inc., 33 B.R. 334, 336–37 (Bankr. S.D.N.Y. 1983)).
98. *In re Colombian Coffee Co.*, 59 B.R. at 645.
99. *Id.*

However, the guiding principle behind the court's decision not to classify Mobile Bank as an initial transferee was the dominion and control test.[100] Since Mobile Bank did not have discretion to put the transferred funds it received to its own use, it did not exercise dominion and control over the funds.[101] According to the court, Mobile Bank merely

> served as a . . . conduit employed by the transferor in moving its property to another corporation. Its role in this transfer was indistinguishable from that of a messenger, the postal service, a common carrier, a warehouse . . . . It derived no benefit from the transfer, other than its customary fee for its banking services. It was granted no discretion with respect to the disposition of the property entrusted to it. It could not have refused to follow the debtor's instructions.[102]

Just as in *Bonded Financial Services*, where the bank had to follow the instructions it received from its customer regarding transferred funds, Mobile Bank was obligated to follow its customer's, Colombian Coffee's, instructions with regards to the funds it received.[103] Therefore, the court could not classify Mobile Bank as an initial transferee once lack of dominion and control was established.[104]

B. *Banks as Payees on Loans*

Banks do not always find themselves classified as "mere conduits," however. For example, federal courts have distinguished between banks acting as financial intermediaries and banks receiving payment as payees on loans.[105] In the former, the mere conduit defense applies; yet, in the latter, banks are classified as an initial transferee within the meaning of section 550(a)(1) of the Bankruptcy Code and subject to recovery of transferred funds.[106]

Even the Seventh Circuit in *Bonded Financial Services*, although holding that the bank was a mere conduit, discussed the distinction between banks acting as financial intermediaries versus recipients of loan payments.[107] The court held that since the bank followed the instructions attached to the check and deposited the funds into Ryan's account, it did not exercise dominion and control over the funds and was a mere conduit.[108] This is regardless of the fact that Ryan had an

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100. *See id.*
101. *Id.*
102. *Id.*
103. Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890, 893 (7th Cir. 1988); *In re Colombian Coffee Co.*, 59 B.R. at 645.
104. *See In re Colombian Coffee Co.*, 59 B.R. at 645.
105. Sec. First Nat'l Bank v. Brunson (*In re* Coutee), 984 F.2d 138, 141 (5th Cir. 1993); Theuman, *supra* note 31, at 641.
106. Theuman, *supra* note 31, at 641.
107. *Bonded*, 838 F.2d at 892–93.
108. *Id.* at 893.

outstanding loan account with the bank.[109] However, the court noted that if instead the instruction accompanying the check said, "use this check to reduce Ryan's loan," the outcome would have changed.[110] By specifically allocating the check for immediate use in paying down Ryan's debt to the bank, the bank, as payee on the loan, would be considered an initial transferee under section 550(a)(1).[111]

In a Fifth Circuit case, *In re Coutee*, Security First National Bank loaned nearly $25,000 to Thelton and Emogene Coutee to assist with legal costs regarding a personal injury case.[112] Once judgment was awarded to the Coutees, they endorsed the check to their law firm, who deposited it into a trust account.[113] From those funds, the firm claimed applicable legal fees, paid the loan from Security First in full, and then returned the remaining portion to the Coutees.[114] Within ninety days of full payment of the loan, the Coutees filed Chapter 7 bankruptcy.[115] Soon thereafter, the bankruptcy trustee brought an action against Security First to recover the loan payment funds claiming that the funds were preferential.[116]

The court adopted the dominion and control test from *Bonded Financial Services* and found that Security First was an initial transferee of the loan payment funds.[117] An initial transferee need not receive funds directly from the bankrupt debtor as long as it is the party that "gains actual dominion or control over the funds."[118] Even though Security First received the loan payment funds from the law firm on behalf of the Coutees, rather than directly from the Coutees, it still gained dominion and control over those funds once received.[119] As the payee on the loan, Security First had unrestricted legal control over the money it received and was free to do anything it wanted with the funds.[120] Even investing in something like "lottery tickets or uranium stocks," an example proffered by the *Bonded Financial Services* court.[121] This freedom to invest illustrated that Security First had dominion and control over those funds, thus making it an initial transferee.[122]

109. *See id.*
110. *Id.* at 892.
111. *Id.*; Nordberg v. Arab Banking Corp. (*In re* Chase & Sanborn Corp.), 904 F.2d 588, 599 (11th Cir. 1990).
112. Sec. First Nat'l Bank v. Brunson (*In re* Coutee), 984 F.2d 138, 139–40 (5th Cir. 1993).
113. *Id.* at 140.
114. *Id.*
115. *Id.*
116. *Id.*
117. *Id.* at 141.
118. *Id.*; *see also* Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890, 893–94 (7th Cir. 1988).
119. *See In re Coutee*, 984 F.2d at 141.
120. *See id.*
121. *See id.* (quoting *Bonded*, 838 F.2d at 894).
122. *See id.*

Security First opposed its classification as an initial transferee and urged the court to find that it was a mere conduit since the law firm was the party that initially received the endorsed check from the Coutees and deposited the funds.[123] The court disagreed with the bank's argument for two reasons.

First, the bank ignored the obvious fact that it did, indeed, loan money to the Coutees.[124] Regardless of the capacity in which the law firm assisted the Coutees in obtaining the loan, it was Security First that actually loaned the funds.[125]

Second, the law firm had no right to use the funds received from the Coutees to its own use and thus lacked the necessary dominion or control to be an initial transferee.[126] By placing the settlement funds into a trust account, the law firm acted merely in a fiduciary capacity for the Coutees.[127] Its role was to receive the settlement payment, deposit those funds into a trust account, retain its legal fees as agreed upon by the lawyers and the Coutees, and send payment to Security First on behalf of the Coutees to satisfy their loan.[128] At no point could the law firm keep or invest the money in whatever way it wanted, unlike Security First that did enjoy such freedom.[129] Therefore, the court found that Security First, and not the law firm, possessed dominion or control over the funds and was an initial transferee.[130]

In *In re Thurman Construction, Inc.*, the bankruptcy court also considered the dominion and control test in determining whether a bank was a mere conduit or initial transferee of avoided transfers.[131] In *In re Thurman*, Sun Bank of Ocala extended a revolving line of credit to James and Beverly Thurman, principals of Thurman Construction, Inc.[132] The purpose of the line of credit was to obtain working capital for Thurman Construction and any draws on the line were deposited directly into Thurman Construction's bank accounts.[133] Five years after the initial line of credit was established, James Thurman died in an automobile accident.[134] Less than a year later, Thurman Construction filed for bankruptcy.[135]

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123. *See id.* at 140.
124. *Id.* at 141.
125. *Id.*
126. *Id.*
127. *Id.*
128. *Id.*
129. *Id.*
130. *Id.*
131. Grant v. Sun Bank/N. Cent. Fla. (*In re* Thurman Constr., Inc.), 189 B.R. 1004, 1016 (Bankr. M.D. Fla. 1995).
132. *Id.* at 1008.
133. *Id.*
134. *Id.*
135. *Id.*

The bankruptcy trustee then filed a complaint against Sun Bank to recover pre-petition line of credit payments made by Thurman Construction to Sun Bank.[136] The trustee claimed that these payments were preferential transfers and had to be returned to the bankruptcy estate.[137] In its analysis, the court focused on the dominion and control test endorsed by the Eleventh Circuit that adopted its test from the Seventh Circuit in the *Bonded* case.[138] The court had to determine whether Sun Bank actually gained control over the funds or whether Sun Bank simply acted as a "mere conduit" for the Thurmans, who were directly responsible for paying the debt.[139]

Sun Bank received payments directly from Thurman Construction and credited those payments towards the line of credit established by the Thurmans, thereby reducing the outstanding balance.[140] The court found that as the payee on this revolving loan account, Sun Bank actually gained control over the funds received from Thurman Construction.[141] By earmarking these funds for immediate use in paying down Thurman Construction's line of credit (i.e., debt owed) and thereby exercising legal dominion and control over the funds, the court held that Sun Bank was an initial transferee under section 550(a)(1).[142] As a result, the bankruptcy trustee could recover preferential transfers from Sun Bank.[143]

VI. Freight Factoring Companies Fit Within the Meaning of Mere Conduit

Just as the financial intermediaries in the preceding cases, freight factoring companies find themselves involved in bankruptcy proceedings where trustees claim that payments made to the freight factoring companies were preferential and, thus, should be returned to the bankruptcy estate.[144] However, freight factoring companies should not be subject to preference claims because, when evaluated against the bankruptcy courts' criteria for an initial transferee, they consistently fall within the status of a mere conduit.

136. *Id.* at 1009.

137. *See id.*

138. *Id.* at 1016; Nordberg v. Arab Banking Corp. (*In re* Chase & Sanborn Corp.), 904 F.2d 588, 599 (11th Cir. 1990).

139. *In re Thurman Constr., Inc.*, 189 B.R. at 1016.

140. *See id.*

141. *See id.*

142. Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890, 892 (7th Cir. 1988); *In re Chase & Sanborn Corp.*, 904 F.2d at 599.

143. *See In re Thurman Constr., Inc.*, 189 B.R. at 1017.

144. *See* Salomon v. Nedlloyd, Inc. (*In re* Black & Geddes, Inc.), 59 B.R. 873, 874 (Bankr. S.D.N.Y. 1986).

A. *Freight Factoring Companies Are Similar to Banks Acting as Intermediaries*

Freight factoring companies, like banks acting as financial intermediaries, do not satisfy the dominion and control test or the direct business relationship standard established by the courts. Freight factoring companies are not free to invest transfers in whatever way they choose,[145] and they do not have the direct business relationships with debtors that give rise to the payments they receive. In this way, freight factoring companies are similar to banks acting as financial intermediaries and, in avoidance actions under section 550(a)(1), should not be found to be initial transferees, but rather mere conduits.

In *Bonded Financial Services*, the bank received and deposited a check from Bonded, but it was obligated to apply the payment as stated on "the instructions that came with the check."[146] Likewise, when a freight factoring company receives transfers from its client's debtors, the funds are applied to its client's invoices according to the remittance instructions accompanying the transfers.[147] The freight factoring company merely processes the payments without dominion or control over the funds, acting as a mere conduit.[148]

This same lack of dominion or control is why the court in *In re Colombian Coffee* found that Mobile Bank was not an initial transferee.[149] Mobile Bank received funds from a third party, deposited the funds, and made those funds available to their client, General Coffee.[150] General Coffee then used those same funds to pay another party.[151] Since Mobile Bank did not have discretion to put the transferred funds it received to its own use, it did not exercise dominion or control over the funds.[152]

Likewise, a freight factoring company receives payments from a third party and applies those payments to its client's invoices.[153] The freight factoring company must apply the funds according to the remittance it receives from the third party.[154] Paid invoices are identified in this way eliminating the freight factoring company's right to charge back the invoices to the client. A freight factoring company has

145. *See Bonded*, 838 F.2d at 894.
146. *Id.* at 891–93.
147. *Small-Business Financing*, *supra* note 5.
148. *See* Kirschenbaum v. Leeds Morelli & Brown P.C. (*In re* The Robert Plan of N.Y. Corp.), 456 B.R. 150, 159 (Bankr. E.D.N.Y. 2011).
149. Metsch v. First Ala. Bank (*In re* Colombian Coffee Co.), 59 B.R. 643, 645 (Bankr. S.D. Fla. 1986).
150. *Id.* at 644.
151. Metsch v. City Nat'l Bank (*In re* Colombian Coffee Co.), 64 B.R. 585, 585 (Bankr. S.D. Fla. 1986).
152. *See In re Colombian Coffee Co.*, 59 B.R. at 645.
153. *See Small-Business Financing*, *supra* note 5.
154. *Id.*

no discretion to put the payments it receives to its own use and, therefore, does not exercise dominion or control over those payments.

According to the court, Mobile Bank "derived no benefit from the [funds received], other than its customary fee for its banking services."[155] Mobile Bank was also "granted no discretion with respect to the disposition of the property entrusted to it [and Mobile Bank] could not have refused to follow the debtor's instructions."[156] Similarly, freight factoring companies derive no benefit from the payments they receive, other than their customary fees for factoring services.[157] Absent payments, freight factoring companies have the right to recover advances on unpaid invoices from their clients.[158] Freight factoring companies must apply the payments they receive according to the debtor's remittance instructions to eliminate this right of recovery from their client for unpaid invoices.[159] They have no discretion to apply or use the payments as they wish. Just as Mobile Bank, freight factoring companies cannot refuse to follow debtors' instructions with respect to the application of payments they receive.[160] Freight factoring companies are mere conduits just as banks are when acting as financial intermediaries.

In addition to lacking dominion or control over funds they receive from debtors, freight factoring companies also do not have direct business relationships with these debtors that give rise to the payments. The direct business dealing that leads to a freight factoring company receiving payment from a debtor occurs between a debtor and a trucking company. A trucking company transports freight for a debtor, and the debtor pays the trucking company for this service. This payment is simply redirected from the trucking company to a freight factoring company because of the factoring agreement entered into between those two parties. According to the Fourth Circuit, "a party cannot be an initial transferee if he is a mere conduit for the party who ha[s] a direct business relationship with the debtor."[161] Thus, the freight factoring company acts only as an intermediary between the trucking company and a debtor. Since "a party cannot be an initial transferee if it is a mere [intermediary] for the party who had the direct business relationship with the debtor,"[162] a freight factoring company should not be liable as an initial transferee under section 550(a)(1).

155. *In re Colombian Coffee Co.*, 59 B.R. at 645.
156. *Id.*
157. *See* TATGE ET AL., *supra* note 1.
158. *Id.* at 241.
159. *Small-Business Financing*, *supra* note 5; *see* TATGE ET AL., *supra* note 1, at 241.
160. *In re Colombian Coffee Co.*, 59 B.R. at 645; *Small-Business Financing*, *supra* note 5.
161. Lowry v. Sec. Pac. Bus. Credit, Inc. (*In re* Columbia Data Prods., Inc.), 892 F.2d 26, 28 (4th Cir. 1989).
162. ZVI Guttman v. Constr. Program Grp. (*In re* Railworks Corp.) 760 F.3d 398, 404 (4th Cir. 2014) (quoting *In re Columbia Data Prods.*, 892 F.2d at 28).

B. *Freight Factoring Companies Are Different from Banks as Payees on Loans*

Freight factoring companies differ from banks that are payees on loans because freight factoring companies do not lend money nor have discretion in applying payments.[163] As such, freight factoring companies do not exercise dominion or control over the funds they receive. Instead, freight factoring companies enter into transactions with trucking companies to purchase accounts receivable at a discount.[164] The parties' intention is to enter into a factoring agreement, not for the freight factoring company to provide a loan or line of credit to the trucking company.[165] Disciplined invoice-by-invoice and payment-by-payment processing occurs in a factoring relationship.[166] Conversely, banks as payees on loans have unrestricted legal control over the funds they receive, thereby satisfying the *Bonded Financial Services* dominion and control test and falling within the meaning of an initial transferee under section 550(a)(1).[167]

In *In re Coutee*, Security First loaned money to the Coutees and then was repaid in full on the loan once the Coutees received a settlement from a personal injury case.[168] Soon thereafter, an avoidance action for the loan payment funds was brought against Security First on the grounds that these funds were preferential.[169] The Fifth Circuit found that Security First was an initial transferee and liable to return the loan payment funds because, as the payee on the loan, Security First had complete legal control over the funds and was free to invest the funds in any way that it wanted.[170]

In contrast, freight factoring companies purchase accounts receivable and advance funds to trucking companies.[171] In collecting on payments, freight factoring companies must apply these funds based on the remittance information received from debtors.[172] So not only does a freight factoring company not lend money to its clients, it does not

163. *See* TATGE ET AL., *supra* note 1, at 423.

164. *Id.*

165. *See* Express Working Capital, LLC v. Starving Students, Inc., 28 F. Supp. 3d 660, 665–66 (N.D. Tex. 2014); Korrody v. Miller, 126 S.W.3d 224, 226 (Tex. App.—San Antonio 2003, no pet.) (citing TEX. FIN. CODE ANN. § 306.103(b) (West 2016)); § 306.103(a); *see also* TEX. FIN. CODE ANN. § 306.001(1) (West 2016).

166. Jim Wilkinson, *What is Factoring Receivables?*, THE STRATEGIC CFO (July 24, 2013), http://strategiccfo.com/wikicfo/what-is-factoring-receivables/ [http://perma.cc/4Q9S-GKQ4] (discussing the Collections Report and Reserve Report that details invoice and payment information for clients).

167. *See* Sec. First Nat'l Bank v. Brunson (*In re* Coutee), 984 F.2d 138, 141 (5th Cir. 1993) (quoting Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890, 893 (7th Cir. 1988)).

168. *Id.* at 139–40.

169. *Id.*

170. *Id.* at 139, 141–42 (quoting *Bonded*, 838 F.2d at 894).

171. TATGE ET AL., *supra* note 1.

172. *Small-Business Financing*, *supra* note 5.

have dominion or control over the payments it receives from debtors. An avoidance action against a freight factoring company on the grounds of preferential transfer should fail. Unlike banks as payees on loans, that extend credit and have dominion or control over funds received, freight factoring companies are mere conduits of the funds they receive without discretion to do what they wish with those funds. Bankruptcy courts have established that "a preference cannot exist in the absence of an extension of credit."[173]

C. *Case on Point: In re Black & Geddes, Inc.*

Black & Geddes, Inc. ("Geddes") was a freight forwarder that needed to transport some product to Pakistan by way of steamship.[174] Hoegh Lines was the ocean carrier that moved this freight for Geddes.[175] Nedlloyd, Inc. and Hoegh had a business relationship where Nedlloyd collected on payments due to Hoegh based on the freight that Hoegh delivered.[176] Once Nedlloyd received payment, it would deduct its commission from that payment and give the remainder of the freight payment over to Hoegh.[177] For the freight Hoegh moved to Pakistan, Geddes sent Nedlloyd a check in the amount of $21,785.73.[178] Sometime after this payment was made, Geddes filed for bankruptcy.[179] The bankruptcy trustee then brought an adversary proceeding against Nedlloyd seeking to recover the $21,785.73 as a preferential transfer.[180]

The court found that the transfer to Nedlloyd was not preferential because "the transfer was not in payment of any indebtedness, antecedent or otherwise, owed to Nedlloyd. The indebtedness was due to Hoegh, the ocean carrier which performed the services."[181] By simply receiving payment and forwarding it onto the carrier, Nedlloyd acted as a mere conduit of the funds and not as an initial transferee under section 550(a)(1) of the Bankruptcy Code.[182] Even the commission which Nedlloyd received would not be subject to a preference attack because Geddes did not owe this fee to Nedlloyd.[183] The fee was solely due from Hoegh, and the manner in which it was paid to Nedlloyd was agreed to by the parties.[184] Hoegh allowed Nedlloyd to de-

173. Salomon v. Nedlloyd, Inc. (*In re* Black & Geddes, Inc.), 59 B.R. 873, 875 (Bankr. S.D.N.Y. 1986) (quoting Eisenberg v. E. Carolina Ship Agencies (*In re* Timber Line, Ltd.), 59 B.R. 728, 731 (Bankr. S.D.N.Y. 1986)).
174. *Id.* at 874.
175. *Id.*
176. *Id.*
177. *Id.*
178. *Id.*
179. *Id.*
180. *Id.*
181. *Id.* at 875.
182. *See id.*
183. *Id.* at 874 n.2.
184. *Id.*

duct its fee from the payments it collected instead of sending the full payment to Hoegh and then waiting for Hoegh to send a check to Nedlloyd for its fee.[185]

The facts of *In re Black & Geddes* are remarkably analogous to daily transactions involving freight factoring companies. A debtor engages a trucking company to transport some sort of product (i.e., freight) in exchange for an agreed upon rate. Once the delivery of the freight has been completed, the trucking company factors its invoice with a freight factoring company that processes and advances funds to the trucking company. The freight factoring company then processes the payment owed to the trucking company. Once the payment is received, the freight factoring company deducts its fee and applies the remainder of the payment to the trucking company's invoices based on the debtor's instructions. These series of transactions are nearly identical to those between Geddes, Nedlloyd, and Hoegh. The only difference is the timing of when funds are received by the company that provided the transportation service. When Nedlloyd received payment from Geddes, it deducted its commission and forwarded the funds to Hoegh.[186] In a freight factoring relationship, funds are received by the trucking company that provided service in advance of payment by the debtor, subject to the risk of a chargeback if the payment is not made.[187] This slight variation in facts is not enough to change the underlying role of each party.

The court found that the funds Geddes sent Nedlloyd were not preferential because those funds were not sent as payment for any obligation Geddes owed Nedlloyd.[188] By accepting payment from Geddes and then passing it onto Hoegh, Nedlloyd acted as a mere conduit of the funds and not as an initial transferee under section 550(a)(1).[189] Similarly, a debtor does not send funds to a freight factoring company as payment for any indebtedness owed to the freight factoring company. By accepting payment from a debtor and applying it to a trucking company's invoice, a freight factoring company only acts as a mere conduit of the payment. Consistent with the court's reasoning, freight factoring companies should not be classified as initial transferees under section 550(a)(1).

VII. Conclusion

The mere conduit defense should extend to freight factoring companies when the funds received become the subject of an avoidable preference claim. Section 550(a)(1) of the Bankruptcy Code "imposes absolute liability on an initial transferee in possession of property

185. *Id.*
186. *Id.*
187. *See* Tatge et al., *supra* note 1, at 120–21, 241.
188. *In re Black & Geddes, Inc.*, 59 B.R. at 875.
189. *Id.* at 875–76.

which has been subject to avoidance."[190] Analyzing the "initial transferee" language in Bankruptcy Code section 550(a)(1), courts have shown concern that "the first person who touched the check . . . could be held liable."[191] When funds are sent from one party to another, the first person who receives that check may have nothing to do with it other than "facilitating its transfer from the debtor to a third party, and may thus be an entirely innocent party who could not equitably be held liable for the property."[192]

This potential inequity is why courts developed and continue to apply the dominion and control test and in doing so, formed the mere conduit defense.[193] Courts have found the mere conduit defense most appropriate and successful in situations where "the initial transferees are innocent parties such as banks, acting merely as innocent intermediaries in transferring assets."[194] Banks acting as financial intermediaries do not exercise dominion or control over the funds they receive and in many cases, no longer possess the funds when the bankruptcy trustee is seeking recovery.

In the same vein, freight factoring companies lack the requisite dominion or control when they receive funds from debtors. Freight factoring companies are obligated to apply the funds they receive to their client's invoices being paid by the funds. Therefore, freight factoring companies do not exercise dominion or control over the funds for their own benefit, have no right to use the funds for their own purposes, and have no discretion to use the funds in accordance with their own wishes. Once received by a freight factoring company, funds are applied according to the debtor's remittance advice and any remaining amount is distributed by the freight factoring company to its client, less its fee. A freight factoring company never possesses funds received from debtors. They are simply processors of payments that advance funds to clients in advance of payments from debtors.

Additionally, freight factoring companies do not have a direct business relationship with debtors. Rather, it is the freight factoring company's client who is receiving those funds as payment for a service rendered to the debtor. Therefore, the client and the debtor have the direct business relationship and, as a result, the freight factoring company cannot be classified as an initial transferee.

Looking at the dominion and control test as well as the direct business relationship test, freight factoring companies should be viewed as

190. Craig H. Averch, *Protection of the "Innocent" Initial Transferee of an Avoidable Transfer: An Application of the Plain Meaning Rule Requiring Use of Judicial Discretion*, 11 BANKR. DEV. J. 595, 595–96 (1995).

191. *Id.* at 616.

192. Theuman, *supra* note 31, at 635.

193. *See* Timothy A. Barnes, *Sections 548 and 550—Recent Developments in the Law of Fraudulent Transfers and Recoveries*, *in* NORTON ANNUAL SURVEY OF BANKRUPTCY LAW 31 (William L. Norton, Jr. et al. eds., 2007).

194. *Id.*

financial intermediaries that are mere conduits for the funds they receive. To "requir[e] financial intermediaries to 'return' funds to the estate, which they no longer possess and never really owned, seems particularly inequitable."[195] Consequently, the mere conduit defense should be successfully applied to freight factoring companies.

195. Adele, *supra* note 8.