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Introduction

Transfers of a debtor's interest or obligation in property to a third party, made to prevent creditors from reaching assets in a bankruptcy case, are known as fraudulent transfers. Under current law, there are two types of fraudulent transfers: actual fraud and constructive fraud. Actual fraud requires findings of a debtor's "intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted."[1] Constructive fraud does not require a finding of intent and occurs when a debtor receives "less than a reasonably equivalent value in exchange for such transfer or obligation and if the debtor was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation."[2] Under Section 548 of Title 11 of the United States Code (the "Bankruptcy Code"), trustees have the power to avoid fraudulent transfers made within two years of a bankruptcy proceeding.[3]

[1] 11 U.S.C. § 548(a)(1)(A) (2012).
[2] 11 U.S.C. § 548(a)(1)(B)(i)-(ii).
[3] 11 U.S.C. § 548(a)(1).

Under its avoidance powers, a trustee can undo fraudulent transfers made within a certain period of time before the bankruptcy petition date and return and redistribute the value of such transactions to the bankruptcy estate. Section 550 specifies that "…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 the initial transferee of such transfer or the entity for whose benefit such transfer was made."[4] For a trustee to recovery property transferred by the debtor under the Bankruptcy Code, the transfer must first be avoided under Section 544, 545, 547, 548, 549, 553(b) or 724(a).[5] This memorandum discusses the recovery of property from fraudulent transfers and obligations avoided by a trustee through Section 548.

Section 550(a)(1) places strict liability on initial transferees for fraudulent transfers received from a debtor.[6] Conversely, Section 550(b) prevents recovery from a good faith subsequent transferee.[7] However, regardless of good faith, if an accused party is found to be an initial transferee, they are held liable to the bankruptcy estate for the entire amount of the fraudulent transfer. Therefore, the identification of an initial transferee is necessary for determining the scope of a trustee's avoidance power under the Bankruptcy Code.

Since the Bankruptcy Code does not define "initial transferee," courts are tasked with developing their own interpretation for the term. This memorandum begins by addressing the Seventh Circuit's legal dominion test, the leading standard used for defining "initial transferee." Next, it addresses the various approaches circuit courts have developed as a result of the Seventh Circuit's standard. The "dominion test" is a strict approach of the legal dominion standard, where

[4] 11 U.S.C. § 550(a)(1).
[5] *Id.*
[6] *See* Christy v. Alexander & Alexander Inc. (*In re* Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey), 130 F.3d 52, 57 (2d Cir. 1997).
[7] 11 U.S.C. § 550(a)-(b).

an initial transferee is defined as a party with legal authority over funds. To the contrary, the "control test" uses a holistic approach to determine whether a party controlled the funds in question. Lastly, this memorandum discusses the mere conduit test and how it is used as a defense for initial transferee liability.

Discussion

I. Establishing the Standard

The Bankruptcy Code does not provide a definition nor useful legislative history for the term "initial transferee". Likewise, courts have held that a literal reading of Section 550(a) leads to inequitable results because it allows trustees to recover from parties who are innocent of wrongdoing.[8] Therefore, the Seventh Circuit developed the following standard for determining whether a party was an initial transferee: "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."[9] Thus, a party exercises dominion when they can invest funds freely.[10] Also, an agent does not exercise dominion over funds when it follows the instructions of its principal.[11] For example, the Seventh Circuit found a bank was not an initial transferee when instructed by a currency exchange to deposit $200,000 into their principal's bank account because the bank acted as a "financial intermediary", "received no benefit", and "held the check only for the purpose of

[8] *See, e.g.*, Gropper v. Unitrac, S.A. (*In re* Fabric Buys of Jericho, Inc.), 33 B.R. 334 (Bankr. S.D.N.Y. 1983) (rejecting the literal reading of the rule where a law firm acted as a "mere conduit" and not an initial transferee for funds funneled through its escrow account for business dealings with their client's debtor); *In re* Colombia Coffee Co., 75 B.R. 177, 179–80 (S.D. Fla. 1987) (exercising equitable discretion in rejecting the literal reading of Section 550(a) in determining a bank was not an initial transferee because it possessed no discretion with respect to the disposition of the funds).

[9] Bonded Fin. Servs. v. European Am. Bank, 838 F.2d 890 (7th Cir. 1988).

[10] *See id.* at 894 (emphasizing an entity has legal dominion over the money when it is free to invest that money in "lottery tickets or uranium stocks").

[11] *See* Taunt v. Hurtado *(In re* Hurtado*)*, 342 F.3d 528 (6th Cir. 2003) (quoting Bonded Fin. Servs., 838 F.2d at 893).

fulfilling an instruction to make the funds available to someone else."[12] Furthermore, courts have clarified that the term "transferee" is not self-defining and holds a greater meaning than "anyone who touches the money" under Section 550(a), because it diverges from being labeled as a "possessor", "holder", or "agent".[13]

The Seventh Circuit's framework for defining "initial transferees" is preeminent and has been adopted in various iterations among the circuit courts.[14] Accordingly, the following approaches have been adopted: (1) the "dominion test"; (2) the "control test"; (3) a combination of the "dominion test" and/or "control test"; and (4) the mere conduit test.

II. The "Dominion Test", "Control Test", and "Dominion and/or Control Test"

The "dominion test" and "control test" are two significant tests developed to determine whether a party is an initial transferee. Although the words 'dominion' and 'control' are synonymous, the Ninth Circuit explained that the "dominion test" and the "control test" are not merely different names for the same inquiry.[15]

Under the dominion test, courts focus on "whether an entity had legal authority over the money and the right to use the money however it wished" when defining "initial transferee".[16] When a party can invest funds as they see fit, they are considered an initial transferee.[17] Similarly, other circuits have determined that principals who direct debtor corporations to issue certified checks to pay personal debts are not initial transferees because those principals did not

[12] *See* Bonded Fin. Servs., 838 F.2d at 893 (articulating the bank was "no different from a courier or an intermediary on a wire transfer").
[13] Rupp v. Markgraf, 95 F.3d 936, 941 (10th Cir. 1996) (citing Bonded Fin. Servs., 838 F.2d at 894).
[14] *In re* Manhattan Inv. Fund Ltd., 397 B.R. 1, 14 (S.D.N.Y. 2007).
[15] Universal Serv. Admin. Co. v. Post-Confirmation Comm. (*In re* Incomnet, Inc.), 463 F.3d 1064, 1069 (9th Cir. 2006) (holding the two inquiries are not identical despite facial similarities).
[16] *See id.* at 1070 (quoting Abele v. Mod. Fin. Plans Servs. (*In re* Cohen), 300 F.3d 1097, 1102 (9th Cir. 2006)).
[17] *In re* Incomnet, Inc., 463 F.3d at 1070 (explaining that banks performing ordinary bank deposits are not initial transferees because "the bank will initially take title over the depositor's funds, but it will not have dominion over them because it has no discretion over the uses to which the depositor's money is to be put. Thus, the bank is not the transferee, but the conduit or agent for a general deposit").

have the ability to use the funds as they wished.[18] In addition, "[t]he first party to establish dominion over the funds after they leave the transferor is the initial transferee; other transferees are subsequent transferor."[19] Thus, courts acknowledge that defining the term "initial transferee" is a meaningful inquiry because a party with such status lacks affirmative defenses that would otherwise be available to a subsequent transferee.[20]

The control test takes a different approach. The control test views an entire transaction holistically to determine which party controlled the transferred funds when defining an initial transferee.[21] The control test is very flexible and pragmatic; it requires courts to "look beyond the particular transfers in question to the entire circumstance of the transactions."[22] Courts applying this test cautiously study the transaction from a broader perspective to ensure their conclusions are logical and equitable.[23] Thus, the Eleventh Circuit held a bank that received money for deposit into its customer's account to be used to reduce the customer's indebtedness to the bank was not an initial transferee because the bank never had actual control of the funds.[24]

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[18] Schafer v. Las Vegas Hilton Corp. (*In* re Video Depot), 127 F.3d 1195 (9th Cir. 1997) (ruling the principal of a bankrupt corporation was not an initial transferee because the principal never actually received funds when using funds of the corporation to purchase a certified check to pay its president's gambling debt to defendant); *In re* Coutee, 984 F.2d 138, 141 (5th Cir. 1993) (concluding a law firm was not an initial transferee because the firm's role regarding the funds in question was to accept the funds in settlement of its client's case, deposit the money in a trust, retain fees preapproved by the debtors, and pay the rest to the bank on behalf of the debtors of their loan).
[19] Mano-Y&M Ltd. v. Field (*In re* Mortgage Store), 773 F.3d 990, 995 (9th Cir. 2014). *See In re* Cohen, 300 F.3d at 1107 (finding a financing agency was an initial transferee when a debtor purchased a cashier's check to pay a debt owed by her husband to the agency because it was the first party to exercise "dominion" over the check).
[20] *See In re* Mortgage Store, 773 F.3d at 994 (citing 11 U.S.C. § 550(b)(1)).
[21] *See In re* Incomnet, Inc., 463 F.3d at 1069 (9th Cir. 2006) (citing Nordberg v. Societe Generale (*In re* Chase & Sanborn Corp.), 848 F.2d 1196, 1199 (11th Cir. 1988)) (finding the outcome of trustees seeking recovery of funds allegedly fraudulent transferred from banks revolves around whether the bank in question controlled the funds).
[22] *In re* Chase & Sanborn Corp., 848 F.2d at 1196 (quoting *In re* Chase & Sanborn Corp., 813 F.2d 1177, 1181–82 (11th Cir. 1987)) (concluding where a transfer to a non-creditor is disputed 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").
[23] *See In re* Bullion Reserve of N. Am, 922 F.2d 544, 549 (9th Cir. 1991) (quoting *In re* Chase & Sanborn Corp., 848 F.2d at 1199).
[24] *In re* Chase & Sanborn Corp., 848 F.2d at 1200 (holding inequitable results will result from allowing recovery against an entity that never controlled the funds it had technically received).

In addition to the "dominion test" and "control test," some circuits have combined the names of the two when developing their framework, creating either the "dominion and control test" or "dominion or control test".[25] Both the Tenth and Fourth Circuits have adopted the "dominion *and* control test" while the Fifth and Sixth Circuits follow the "dominion *or* control test".[26] The remaining circuits have yet to address the definition of an initial transferee.

III. The Mere Conduit Test

In formulating its definition of an initial transferee, the Second Circuit established the mere conduit test, in which the circuit's standard construes the dominion test and the control test negatively.[27] The mere conduit test is used as an equitable defense to shield mere conduits of funds from initial transferee status.[28] Under this test, parties who merely facilitated the transfer of funds from the debtor to a third party are not initial transferees because they do not exercise sufficient dominion and control.[29] Courts that follow the mere conduit test have distinguished the term "initial transferee" as referencing something more particular than an initial recipient.[30] As a result, the mere conduit test was applied, adding further meaning to the definition of an initial

[25] *See In re* Incomnent, Inc., 463 F.3d at 1064.
[26] Compare Bailey v. Big Sky Motors (*In re* Ogden), 314 F.3d 1190, 1202 (10th Cir. 2002), and Bowers v. Atlanta Motor Speedway (*In re* Se. Hotel Props. Ltd. Pshp), 99 F.3d 151, 156 (4th Cir. 1996), *with In re* Coutee, 984 F.2d 138, 140–41 (5th Cir. 1993), *and* First Nat'l Bank v. Rafoth (*In re* Banker & Getty Fin. Servs.), 974 F.2d 712, 722 (6th Cir. 1992).
[27] *See In re* Finley, 130 F.3d 52 (2d Cir. 1997).
[28] *See* Hooker Atlanta Corp. v. Hocker, 155 B.R. 332, 337 (Bankr. S.D.N.Y. 1993).
[29] *See In re* Finley, 130 F.3d at 58–59 (holding an insurance broker's business acted as a mere conduit through its business relationships with a law firm because the insurance broker did not have the right to put insurance premium to its own use).
[30] *See e.g., In re* Finley, 130 F.3d at 56; Rupp v. Markgraf, 95 F.3d 936 at 940 (finding a principal stockholder was not an initial transferee because he was simply a "courier" of check from debtor to principal's creditor, where his control over funds was limited before the transfer occurred); Malloy v. Citizens Bank (*In re* First Security Mortgage Co.), 33 F.3d 42 (10th Cir. 1994) (finding a bank was not an initial transferee when its mere purpose was to fulfill instructions "to make the funds available to someone else") (quoting Bonded Fin. Servs., 838 F.2d at 893); Security First Nat'l Bank v. Brunson (*In re* Coutee*)*, 984 F.2d 138 (5th Cir. 1993) (explaining that a law firm holding funds in trust account was not an initial transferee because the firm lacked the requisite dominion necessary. Here, the law firm's role consisted of accepting the funds in settlement of its client's case, depositing the money in the trust, keeping fees the debtor and firm agreed to, and paying the remainder to the bank on behalf of the debtor in satisfaction of their loan).

transferee, where "a commercial entity that, in the ordinary course of its business, acts as a mere conduit for funds and performs that role consistent with its contractual undertaking in respect of the challenged transaction, is not an initial transferee within the meaning of § 550(a)(1)."[31]

Conclusion

The Bankruptcy Code allows trustees to avoid and recover fraudulent transfers from initial transferees, holding such parties liable for funds received from a debtor. However, because the Bankruptcy Code does not define "initial transferee", courts are required to interpret and apply standards for the term's meaning. Legal dominion has long been recognized as the leading standard for determining an initial transferee. However, some circuits have adopted their own restatement of this approach. For example, the "dominion test" was created, where the focus is on an entity's legal status over the funds, and under the "control test", courts look to a party's control over funds throughout the entire transaction. Also, several circuits have aligned their interests somewhere in the middle of these two tests and use a hybrid approach toward defining "initial transferee". Lastly, the mere conduit test has grown into a defense to protect mere conduits from initial transferee status. Because Section 550(a) places strict liability on an "initial transferee", thereby allowing a trustee to implement its avoidance powers, a court's choice of which test it applies is critical.

[31] *In re* Finley, 130 F.3d 52, 59 (2d Cir. 1997).