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Second Circuit Insulates Innocent Friend from Corporate Debtor's Fraudulent Transfer Liability

By Michael L. Cook

The defendant "was a 'mere conduit' of [a] fraudulent transfer and cannot be liable to the bankruptcy estate for funds she never knew about," held the U.S. Court of Appeals for the Second Circuit on May 5, 2022. *In re BICOM N.Y., LLC*, 2022 WL 1419997 (2d Cir. May 5, 2022). Affirming the lower courts' granting of summary judgement to the defendant transferee, the court refused to "equate … mere receipt [of corporate debtor funds] with liability," reasoning that "mere conduits" of fraudulent transfers are not "initial transferees" under Bankruptcy Code §550(a)(1) ("trustee may recover" fraudulently transferred property from "the initial transferee of such transfer").

Relevance

The Code does not define "initial transferee", leading to a raft of fact-intensive appellate decisions on the subject. Generally, a financial intermediary or conduit would not be a "transferee" of the debtor's property because it does not have control over that property. *See*, *e.g.*, *In re Pony Express Delivery Servs. Inc.*, 440 F.3d 1296, 1304 (11th Cir. 2006) (insurance broker received premium payments from debtor more than three weeks after paying insurance carriers on debtor's behalf; *held*, insurance broker was not initial transferee under §550); *Christy v. Alexander & Alexander Inc.*, 130 F.3d 52, 59 (2d Cir. 1997) (insurance broker mere conduit), *cert denied*, 524 U.S. 912 (1998); *In re Red Dot Scenic, Inc.*, 351 F.3d 57, 58 (2d Cir. 2003) (debtor's purchasing shareholder paid personal debt with checks drawn on debtor's corporate accounts; held, recipient of checks was initial transferee "and was therefore required to return the funds regardless of any potential good faith defense"; purchasing shareholder was not initial transferee because "he exercised no control over funds at issue once they were transferred from [debtor's] account"); *Bonded Fin Servs., Inc. v. European AM Bank*, 838 F.2d 890, 893 (7th Cir. 1988) ("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").

Facts

The defendant in *BICOM* was a friend of the corporate debtor's principal and "opened a joint bank account with [the principal] that was intended to hold only her money and to facilitate her permanent residency in the United States." *BICOM*, 2022 WL 1419997, at *1. According to the lower courts, the "defendant believed (rightly or not) that she could not open a U.S. bank account on her own because she lacked a U.S. Social Security number." *In re BICOM NY, LLC*, 619 B.R. 795, 796 (Bankr. S.D.N.Y. 2020). When the debtor's principal "ran into financial troubles and needed to move funds between his businesses while keeping his lending banks in the dark," he "routed $1 million from [the corporate debtor] through the joint account, where it stayed for two days before [the principal] transferred it to his other business via a forged check in [the defendant's] name to hide the source." *BICOM*, 2022 WL 1419997, at *1.

The corporate debtor later sought bankruptcy relief. In his suit "to recover the $1 million in transferred funds" from the individual defendant, the bankruptcy trustee claimed that she was the "initial transferee" of the corporate debtor's funds. *Id.* Although the defendant could, in theory, have withdrawn and spent the transferred funds, she was utterly unaware of the funds, and never kept or used the money, "based on [her agreement with the debtor's principal] that the joint account was to hold only her money." *Id.*

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Also undisputed was the intentional fraudulent transfer from the corporate debtor to its affiliate, using the defendant's bank account as a screen to hide the transfer. According to the trustee, though, as an "initial transferee" of the funds, the defendant was "strictly liable" even if she received the funds "in good faith, and without knowledge of the voidability and the transfer avoided," relying on Code §550(a)-(b) and *In re Red Dot Scenic, Inc.*, 351 F.3d 57, 58 (2d Cir. 2003).

General Rule: Strict Liability for Initial Transferee

The Second Circuit confirmed the general rule: when "the recipient of debtor funds was the initial transferee, the bankruptcy code imposes strict liability and the bankruptcy trustee may recover the funds. " *Id.* at *1, quoting *In re Red Dot Scenic Inc.*, 351 F.3d 57, 58 (2d Cir. 2003). The "trustee's right to recover from the initial transferee is absolute." *Schaffer v. Las Vegas Hilton Corp.* (*In re Video Depot, Ltd.*) 127 F.3d 1195, 1197-99 (9th Cir. 1997) (An "initial transferee is exposed to stricter liability than a subsequent transferee because an initial transferee is in the best position to evaluate whether the conveyance is fraudulent."). *Accord In re Harwell*, 628 F.3d 1312-13,1324, (11th Cir. 2010) (reversed bankruptcy court; held, attorney who assumedly had "schemed with" the debtor "to have the debtor's funds placed in [the attorney's] trust account and then distribute it to" the debtor "personally, his family members, and selected creditors" was liable as the initial transferee of the fraudulent transfer); *Paloian v. LaSalle Bank, M.A.*, 619 F.3d 688, 691 (7th Cir. 2010) (Easterbrook, J.) (trustee of securitized investment pool can be an initial transferee because it is "the legal owner of the trust's assets"; despite trustee's "duties to the trust's beneficiaries (the investors) concerning the application of funds, the assets' owner remains the appropriate subject of [a] n … avoidance action"; any liability imposed on defendant bank would come from the "corpus of the trust, not from the Bank's corporate assets …. [T]he money really comes from the trust's investors — the persons 'for whose benefit [the] transfer was made.' Instead of requiring the bankruptcy trustee to sue thousands of investors who may have received interest payments …, a single suit suffices ….")

Mere Conduit Defense

The Second Circuit previously "described who may qualify as an 'initial transferee'" in *Christy v. Alexander & Alexander of New York, Inc.* (*In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey*), 130 F.3d 52 (2d Cir. 1997). It explained there that "the term 'initial transferee' references something more particular than the initial recipient." *Id.* at 57. The court thus declined to "equate… mere receipt with liability", holding that "mere conduits" of fraudulent transfers are not "initial transferees." *Id.* It reasoned that the insurance broker in *Christy* was a mere conduit because it had "no discretion or authority to do anything else but transmit the money" from the debtor to the insurer, and that there was "no question" that it "was acting only to channel the funds" to the insurer. *Id.* at 59.

The Sixth Circuit stressed the fact-intensive nature of the inquiry *In re Hurtado*, 342 F.3d 528, 535 (6th Cir. 2003). It followed the Second Circuit's analysis, holding that once legal title to the funds has passed, the transferee can ordinarily not be deemed a mere conduit. In the case before it, the defendant was liable as an initial transferee because she "had control over the [funds] for a number of years, exercising control to write checks…" and the debtor transferor would have no "legal recourse … if [the defendant transferee] had chosen to use the funds for her own benefit." *See also, In re Internat'l. Mgmt Assoc.*, 399 F.3d 1288, 1292 (11th Cir. 2005) (no initial transferee liability under §550(a) if no benefit received from transfer; "unquantifiable advantage is not the sort of 'benefit' contemplated by [Code] §550(a).").

Comment

The court's sensible opinion in *BICOM* is based on the defendant's thorough development of the facts in the bankruptcy court. Because the plaintiff trustee could not refute these hard facts, the bankruptcy court had properly granted the defendant's motion for summary judgment. As Dickens's Mr. Gradgrind stressed, "[f]acts alone are wanted in life." Charles Dickens, *Hard Times* (1854). And the facts here overcame the general rule of strict liability.

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