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Exercising Dominion and Control; An Initial Transferee's Liability for Avoidable Transfers

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# Exercising Dominion and Control; An Initial Transferee's Liability for Avoidable Transfers

**Shelley Fredericks, J.D. Candidate 2019**

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## Introduction

Under section 550(a)(1) of the Bankruptcy Code, a bankruptcy trustee may collect the full amount of an avoidable transfer from the initial transferee of a fraudulent or avoidable transfer. Specifically, it provides that, "[e]xcept as otherwise provided in this section, to the extent that a transfer is avoided…the trustee may recover, for the benefit of the estate, the property transferred or…the value of such property, from the initial transferee of such transfer or the entity for whose benefit such transfer was made."[1] This section of the Bankruptcy Code gives power to bankruptcy trustees seeking to collect improperly transferred funds, for the benefit of creditors, where a debtor in bankruptcy has attempted to insulate the funds from distribution.[2]

In order for section 550(a)(1) to be applicable, the underlying transfer at issue must have been avoidable. Additionally, the language of section 550(a)(1) makes clear that not only can the bankruptcy trustee go after the initial transferee for the full amount of the transferred funds, but the trustee is still free to go after the party or entity for whose benefit the transfer was made.[3] The power this grants to the bankruptcy trustee is substantial because it gives them two distinct

[1] 11 U.S.C. §550(a)(1) (2012).
[2] *See* 11 U.S.C. §550(a)(1).
[3] *See* 11 U.S.C. §550(a)(1).

avenues to collect improperly transferred funds, protecting the rights of creditors and favoring an equitable distribution of the debtor's assets.

This rule imposes strict liability on the initial transferee.[4] Once a party is determined to be an initial transferee, the fact that they accepted the fraudulent transfer in good faith does not protect them from liability for the full amount of the transfer.[5] For these reasons, the test to determine whether a party is an initial transferee is of utmost importance, both to the bankruptcy trustee and the party accused of being an initial transferee.

The Bankruptcy Code does not define "initial transferee." Courts have adopted a number of tests to determine whether a party is an initial transferee. The prevailing test now used in a majority of U.S. circuit courts is the Dominion and Control Test, created by the 7th Circuit Court of Appeals.

First, this Article will explain the elements underlying section 550(a)(1) applicability in greater detail. Secondly, this Article will discuss the Dominion and Control Test and show how the test is applied in bankruptcy cases. Finally, this Article will compare the Dominion and Control Test to the tests used in other courts.

## I. Liability of an Initial Transferee of a Fraudulent or Avoidable Transfer

"The trustee of a bankrupt estate has broad powers under the Bankruptcy Code to avoid certain transfers of property made by the debtor either after or shortly before the filing of the bankruptcy petition. In this way, the transferred property is returned to the estate for the benefit of all persons who have presented valid claims."[6] One such power a trustee has is the ability to

[4] *See* Hurtado v. Hurtado (*In re* Hurtado), 342 F.3d 528, 532 (6th Cir. 2003).
[5] *See* Matter of Criswell, 102 F.3d 1411, 1418 (5th Cir. 1997).
[6] *In re* Finley, 130 F.2d 52, 55 (2nd Cir. 1997).

collect the full amount of a fraudulent or avoidable transfer from an initial transferee.[7] Applicability of section 550(a)(1) in bankruptcy actions can be broken down into two main elements: 1) the transfer at issue was avoidable; and 2) the party who accepted the transfer is an initial transferee. If the party is an initial transferee, they are strictly liable for the full amount of the transferred funds.[8] The initial transferee accepting the transfer in good faith does not protect them from liability for the full amount of the transfer.[9]

First, "[t]he liability of a transferee under section 550(a) applies only 'to the extent that a transfer is avoided.'"[10] A transfer can be avoided under sections 544, 545, 547, 548, 549, 553(b) or 724(a) of the Bankruptcy Code.[11] For example, section 548 states that "[t]he trustee may avoid any transfer…of an interest of the debtor in property, or any obligation…if the debtor voluntarily or involuntarily; (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor…was indebted; or (B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation."[12] Whether a transfer meets the criteria for being avoidable under these sections of the Bankruptcy Code is a fact sensitive determination made by the judge presiding over the case. The parties in the underlying action can also concede that the transfer in issue was avoidable.[13]

Once the transfer in issue is found to be avoidable under one of the applicable sections of the Bankruptcy Code, the court will look to whether the party who received the transfer is an initial transferee. "The Code does not define 'initial transferee.'"[14] The courts, however, have found that an initial transferee is a party who receives a transfer of funds, including property or

[7] *See* 11 U.S.C. §550(a)(1).
[8] *See* Whitlock v. Lowe, 569 B.R. 94, 100 (W.D. Tex. 2017).
[9] *See id.*
[10] *Id.*
[11] *See* 11 U.S.C. §550.
[12] 11 U.S.C. §548.
[13] *See* Whitlock, 569 B.R. at 100.
[14] *Id.*

obligations, directly from the debtor in the underlying bankruptcy case. The transfer is made in order to benefit the debtor who initiated the transfer. Thus, "[a]n initial transferee is one who receives money from a person or entity later in bankruptcy, and has dominion over the funds."[15]

"As is plain from its text, section §550(a)(1) holds initial transferees strictly liable for any fraudulent transfers they receive."[16] If the accused party is found to be an initial transferee, they are precluded from asserting a defense of good faith in their acceptance of the fraudulent transfer to avoid liability.[17] Even if an initial transferee had no knowledge that the transfer they were accepting was avoidable, they are still liable to the bankruptcy trustee and the debtor's estate for the full amount of the transferred funds. Subsequent transferees may assert a good faith defense under section 550(b) of the Bankruptcy Code if they receive a transfer from the initial transferee in good faith for the value of the transfer, but an initial transferee "cannot avail itself of the good faith transferee for value defense allowed to subsequent transferees under §550(b)."[18]

## II. Use of the Dominion and Control Test to Determine Initial Transferee Status

Under the Dominion and Control Test, "a party that receives a transfer directly from the debtor will not be considered the initial transferee unless that party gains actual dominion or control over the funds."[19] This Dominion and Control Test is the prevailing test used in a majority of circuit courts across the country to determine initial transferee status.[20] The 2nd, 3rd, 4th, 5th, 6th, 7th, 8th and 10th Circuits have all adopted the Dominion and Control Test.[21] The

[15] Baker & Getty Fin. Servs., Inc. v. Rafoth (*In re* Baker & Getty Fin. Servs., Inc.), 974 F.2d 712, 722 (6th Cir. 1992).
[16] *In re* Hurtado, 342 F.3d 528, 532 (6th Cir. 2003).
[17] *See id.*
[18] *In re* Criswell, 1997 U.S. App. LEXIS 12784 at *6 (5th Cir. 1997).
[19] *In re* Coutee, 984 F.2d 138, 140 (5th Cir. 1993).
[20] *See* Finley, 130 F.3d at 57-58.
[21] *See id.*

Dominion and Control Test finds a party to be an initial transferee when they have sole legal control over the transferred funds, which is a fact sensitive determination.

"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."[22] Whether the party has dominion over the transferred assets is centered around factors such as whether the party can freely invest, distribute or use the transferred funds personally.[23] "[A]n entity does not have dominion over the money until it is, in essence, 'free to invest the whole [amount] in lottery tickets or uranium stock' if it wishes."[24] The test also considers whether the party who received the transferred funds is legally bound to follow the debtor's instructions concerning those funds.[25] If the party who received the transfer can personally use or discharge the funds without owing any legal obligation to the debtor or another entity, they are found to be an initial transferee for purposes of section 550(a). The Dominion and Control Test relies heavily on the facts of the particular case it is being applied to. It looks directly to the circumstances surrounding an avoidable transfer and the control that the accused party had over the transferred funds.

Parties have been found to be initial transferees in cases where the accused party deposits an avoidable transfer they received into a bank account that they alone have sole ownership of and access to. For example, In *Whitlock v. Lowe*, the United States District Court for the Western District of Texas held that the defendant Whitlock was an "initial transferee" under section 550(a) because she had sole dominion and control over the transferred funds when they were deposited into her personal bank account.[26] The debtor in the case had filed for voluntary

[22] Bonded Fin. Serv., Inc. v. European American Bank, 838 F.2d 890, 893 (7th Cir. 1988).
[23] *See id.* at 894.
[24] *In re* Coutee, 984 F.2d 138, 141 (5th Cir. 1993) (citing *Bonded*).
[25] *See Bonded Financial Services*, 838 F.2d at 893.
[26] *See* Whitlock v. Lowe, 569 B.R. 94 (W.D. Tex. 2017).

Chapter 7 bankruptcy.[27] Before filing, the debtor's wife and Cheri Whitlock (the debtor's sister-in-law) opened a joint bank account, into which they endorsed and deposited a $275,000 check from the debtor.[28] Shortly thereafter, the debtor's wife relinquished ownership interest in the account, leaving it solely under the name and control of Whitlock.[29] Whitlock then transferred the money to various entities based on the instructions she received from the debtor.[30] Whitlock claimed she was unaware that she was the sole holder of the account, and she asserted that, although she signed the wire transfers, she had no control over whom the money was going to or how much, which was all decided by the debtor.[31] The bankruptcy trustee assigned to the debtor's bankruptcy estate then filed a complaint against Whitlock with the bankruptcy court to recover the funds from Whitlock as an initial transferee.[32]

The court, applying the Dominion and Control Test, determined that Whitlock was an initial transferee because she had sole legal dominion and control over the transferred funds once she became the sole owner of the account.[33] Legally, the funds belonged to her under her name, due to her endorsement of the checks and wire transfers.[34] Once she became the sole owner, and was the only one authorized to draw from the account, she had dominion and control over the funds.[35] While Whitlock argued that she was acting at the direction of the debtor, she had no legal obligation to listen to his directions.[36] There was no legal impediment that limited her ability to access the account; rather, there was merely personal pressure to follow the directions

[27] *See id.* at 96.
[28] *See id.* at 97.
[29] *See id.*
[30] *See id.* at 98.
[31] *See id.*
[32] *See id.* at 96.
[33] *See id.* at 100.
[34] *See id.*
[35] *See id.*
[36] *See id.* at 101.

of Debtor. As a result, Whitlock was liable to the trustee for the full value of the funds as an initial transferee.

Use of the Dominion and Control Test has led to the same results in other similar cases. In the case of *In Re Hurtado*, the mother of the debtor was found to be an initial transferee. The mother accepted a fraudulent conveyance made by her son and daughter-in-law and placed the funds in her personal bank account.[37] As a result, she was given full legal title to the funds, in an effort by her son to insulate said funds from distribution. The debtors (her son and daughter-in-law) could not reach the funds without going through her first, as her name was the only name on the bank account.[38] She could use the funds as she saw fit and she had no legal obligation to obey the commands of the debtor concerning the use of the funds.[39] In the case of *In Re Lacina*, "the mother of a debtor who received a fraudulent transfer from her daughter and son-in-law into her bank account over which she had sole ownership and dominion was an initial transferee because she 'was freely given the funds, effectively eliminating the payment as an asset of the debtors, and she had actual and complete dominion over the funds.'"[40]

On the other hand, a party that is found to be a mere conduit or recipient of a transfer will not be considered an initial transferee under the Dominion and Control Test.[41] A mere conduit is an entity that never had legal title to the funds, but "merely possessed the funds and were acting as agents for the principals, who retained legal right to the funds."[42] Thus, "[t]he statutory structure [of § 550(a)] confirms that the term 'initial transferee' references something more particular than the initial recipient."[43] As a result, those who act as financial intermediaries and receive no

[37] *See In re* Hurtado, 342 F.3d at 534-35.
[38] *See id.*
[39] *See id.*
[40] Whitlock, 569 B.R. at 101 (citing *In re* Lancina, 451 B.R. 485, 492 (Bankr. D. Minn. 2011)).
[41] *See In re* Finley, 130 F.3d at 57.
[42] *In re* Hurtado, 342 F.3d at 534 (citations omitted).
[43] *In re* Finley, 130 F.3d at 57.

personal benefits from the transfer do not fall under the strict liability imposed by section 550(a) and are not considered initial transferees.[44] "Every Court of Appeals to consider this issue has squarely rejected a test that equates mere receipt with liability."[45]

Courts have found that accused parties in the following situations did not have sufficient dominion and control over transferred funds to be considered initial transferees for section 550(a) purposes, because they were acting as mere conduits or initial recipients: 1) a financial institution that received funds for deposit or transfer to another financial institution; 2) an insurance agent of the debtor passing premiums from the debtor to an insurer; 3) a corporate shell to which the debtor transferred funds before causing them to be transferred on to other parties; and 4) a law firm that held the funds it received from a debtor in escrow.[46]

**III. The Minority View Distinguishes Between the Dominion Test and the Control Test**

Although a majority of the circuit courts use the Dominion and Control Test, there are certain jurisdictions that apply a different standard. The majority's application has combined the concepts of "dominion" and "control" into one singular test, viewing the two concepts as indistinguishable. The 9th Circuit and the 11th Circuit, however, see it differently. The 9th Circuit has held that the "Dominion Test" and the "Control Test" are not the same, and established that the concepts create two separate and distinguishable tests. In the holding of *In re Incomnet, Inc.*, the 9th Circuit stated that:

> 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… the two tests do differ, and the fact that the dominion test is sometimes stated as an inquiry into who had legal "control" over funds does not mean that the two standards are indistinguishable.

[44] *See id.*
[45] *Id.*
[46] *See, e.g.,* Bailey v. Big Sky Motors, Ltd., 314 F.3d 1190, 1202 (10th Cir. 2002); *In re* Finley, 130 F.3d 52, 57 (2d Cir. 1997); Luker v. Reeves, 65 F.3d 670, 676 (8th Cir. 1995); Gropper v. Unitrac, S.A., 33 B.R. 334 (Bankr. S.D.N.Y. 1983).

> While we have not always been careful with our terms, we have applied the dominion test several times, but have declined to adopt the control test.[47]

The difference between the two standards is that, "[t]he 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…[t]he control test takes a more gestalt view of the entire transaction to determine who, in reality, controlled the funds in question."[48] The 9th Circuit has "explicitly adopted the more restrictive dominion test," while the 11th Circuit has adopted both the Dominion Test and Control Test.[49]

Under the more restrictive 9th Circuit Dominion Test, parties were found to be initial transferees in the following varied circumstances: 1) the accused party was the beneficiary of the trust fund which received the initial transfer; 2) the accused party retained a portion of the transferred funds as its fee; and 3) the accused party, a broker, received transfers into a margin account for a hedge fund as part of a Ponzi scheme.[50]

The Control Test adopted by the 11th Circuit appears to consider the same issues as the majority exception from initial transferee liability for parties who were acting as mere conduits or intermediaries.[51] In *In Re Custom Contractors*, the 11th Circuit Court of Appeals stated that:

> To meet the mere conduit or control test and avoid liability as an initial transferee under § 550, an initial recipient of the debtor's fraudulently-transferred funds must show "(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 as an innocent participant in the fraudulent transfer."[52]

The Control Test forces the court to take a "'flexible, pragmatic, equitable approach,' considering the transaction in its entirety, rather than focusing in on the particular transfer in

[47] *In re* Incomnet, 463 F.3d 1064, 1069 (9th Cir. 2006).
[48] *Id.* at 1071 (internal citations omitted).
[49] *Id.*
[50] *See, e.g., In re* California Trade Technical Schs., Inc., 923 F.2d 641 (9th Cir. 1991); *In re* Mill Street, Inc., 96 B.R. 268 (B.A.P. 9th Cir. 1989); *In re* Incomnet, Inc., 463 F.3d 1064 (9th Cir. 2006).
[51] *See In re* Custom Contractors, LLC, 745 F.3d 1342 (11th Cir. 2014).
[52] *Id.* at 1349 (quoting *In re Harwell*, 628 F.3d 1312, 1323 (11th Cir. 2010)).

question."[53] While the Control Test, like the Dominion Test, still focuses on whether the accused party had legal control over the transferred funds, it adds another level to its inquiry. The 11th Circuit, using the Control Test, "consider[s] both the initial recipient's legal rights to the funds at issue as well as any existing obligations [to the debtor]. 'To ascertain these rights and obligations, . . . [we] look at all the circumstances of the transaction that resulted in the avoidable transfer.'"[54]

**Conclusion**

The Dominion and Control Test has been widely adopted by many circuit courts to determine whether a party who has received a fraudulent or avoidable transfer from a debtor in bankruptcy is an initial transferee. Because the Bankruptcy Code does not provide a definition for "initial transferee," the importance of this test and its function in assigning liability for an avoidable transfer is highlighted even further. The determination of whether an accused party is an initial transferee is of utmost importance, because if they are found to be an initial transferee they are liable to the bankruptcy estate for the full amount of that avoidable transfer under section 550(a) of the Bankruptcy Code, regardless of whether they acted in good faith. The use of this test proves that legal control of the transferred funds and the ability of the transferee to put the funds to their own personal use trumps the good faith of the initial transferee in accepting the funds.

Because the Dominion and Control Test is a fact sensitive determination, seeing it applied in practice to the facts of a particular case is essential to understanding what protections section 550(a) seeks to establish. Also, while some circuit courts do not apply the test in the same way as others, all versions of the test look to similar factors in making the determination on

[53] *Id.* at 1350 (quoting *Harwell*, 628 F.3d at 1322).
[54] *Id*. (quoting Andreini & Co. v. Pony Express Delivery Servs., 440 F.3d 1296, 1301 (11th Cir. 2006)).

initial transferee status. The most important things to consider when applying the test are whether the transferee had the ability to put the funds legally to their own use, or whether they were merely an initial recipient of the transferred funds before passing them along to another transferee. If it can be found that the accused party had the right to invest or use the transferred money or assets in any way they saw fit, then the strict liability of section 550(a) attaches.