* * * Unpublished Opinion * * *

IN THE UNITED STATES DISTRICT COURT
DISTRICT OF UTAH - CENTRAL DIVISION

Big Sky Motors, Ltd., a Utah corporation, Appellant, vs. Steven R. Bailey, Trustee of the estate of Wayne Ogden, Appellee.	**MEMORANDUM OPINION & ORDER** Case No. 2:99-CV-270 B Judge Dee Benson

I. INTRODUCTION

Presently before the Court is appellant Big Sky Motors, Ltd.'s (Big Sky's) bankruptcy appeal. On March 2, 1999, the United States Bankruptcy Court for the District of Utah granted summary judgment in favor of appellee, Steven R. Bailey, acting as the trustee in bankruptcy (Trustee). The bankruptcy court held that Big Sky received a $300,000 preferential transfer from debtor Wayne Ogden, which the Trustee was entitled to avoid and recover from Big Sky as the initial transferee. Big Sky now appeals, arguing that the bankruptcy court should not have granted summary judgment because the transfer was not preferential under 11 U.S.C. § 547(b), and even if it was, Big Sky should not be strictly liable as the initial transferee under 11 U.S.C. § 550(a)(1) of the Bankruptcy Code. This Court has jurisdiction to review the bankruptcy court's decision pursuant to 28 U.S.C. § 158(a).

II. FACTUAL BACKGROUND

On February 26, 1997, Wayne Ogden approached Douglas Durbano, owner of Big Sky, with a business proposition. Ogden wanted to borrow $400,000 for a real estate transaction that would allegedly generate a $200,000 profit within sixteen days. Durbano, along with another individual, Blake Hazen, visited the subject property that same day. They decided that even if they had to foreclose on the loan, the value of the property would match or exceed the loan amount. As a result, Big Sky agreed to loan Ogden $400,000. Blake Hazen provided $100,000 of the loan in Big Sky's name, however, only the remaining $300,000 that Big Sky provided is at issue in this adversarial proceeding. In return for the $400,000, Ogden executed a $600,000 promissory note on February 26, 1997 in favor of Big Sky.

On March 2, 1997, Big Sky deposited $396,000, the loan amount minus a one-percent loan fee, and Ogden deposited the promissory note for $600,000 with Avis & Archibald Title Insurance Agency, L.C., an escrow company (Avis & Archibald). Big Sky included instructions requiring that certain conditions take place before Ogden could receive the money. On March 7, 1997, Big Sky requested that Avis & Archibald return the funds to Big Sky, and three days later, Big Sky again sent a $396,000 check to fund the escrow account. This second check was accompanied by a letter of instruction, incorporating the previous escrow instructions. An escrow officer at Avis & Archibald, Jason Cherry, initially held the check, uncertain whether the transaction would happen. On April 8, 1997, Ogden came to Avis & Archibald and instructed Cherry to release the $396,000, even though Big Sky's written conditions had not been satisfied.

Cherry claims that Ogden told him that the deal had changed and that the escrow instructions no longer applied. After Ogden asserted, as Cherry describes, "a lot of pressure" on him, Cherry deposited Big Sky's check into the appropriate escrow account, and immediately disbursed $396,000 to Ogden.[1] This transfer took place without Big Sky's consent or knowledge. After a couple of weeks, Avis & Archibald became aware, through a third party, that Ogden had lied in order to obtain the money. Cherry contacted Ogden and demanded the immediate return of the money to Avis & Archibald, threatening that if Ogden did not return the funds in several days he would report him to the "State Real Estate Commission," the "State Title Commission," and the

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[1]In his deposition, Cherry specifically testified how Ogden convinced him to release the $396,000 to him, stating:

> A. Mr. Ogden came to me, and he told me that Doug [Durbano] had — they had changed the investment. That Doug — he was to use the money for a different investment, and he was going to have Doug's money within a week, all of it, by changing the investment. Well, I kind of talked to him. That didn't sound right to me.
> . . .
> Q. So he sat across the desk from you and said that?
> A. Yes, and after, he started getting a little steamed.
> Q. What did you say back when he —
> A. I said, "I don't know how this works." I mean I said, "Are you sure this is the way it goes?" And he says, "Yes." Then I said "well, let me call Doug. He says, "Go ahead." Well, I called Doug, and Doug was out of town and so I get off the phone, and Wayne [Ogden] goes, "Jason, I wouldn't lie." He just put a lot of pressure on me, and so I finally went in and got the check, wrote a check to Wayne Ogden.
> . . .
> Q. Did he say anything to you besides what you've already told me in that meeting, he, being Wayne Ogden?
> A. He got a little upset saying, "Are you calling me a liar?" He goes, "I'm the number one realtor in the area." He was at that time. I totally believed that.

Cherry Depo. at 35-39.

"attorney's office in Weber." *See* Cherry Depo. at 41-42.

Between May 7, 1997 and May 14, 1997, Ogden borrowed $449,500 from various individuals, who thought they were investing with Ogden. Without the investors' knowledge, Ogden used the borrowed funds to repay the $396,000 that he took from the escrow account. Upon determining that Ogden's real estate transaction would not occur, Big Sky instructed Avis & Archibald to return the full amount held in escrow. On May 23, 1997, nine days after the final repayment of money from Ogden to the escrow company, Avis & Archibald returned the $400,000 to Big Sky, issuing two checks from the escrow account, $300,000 directly to Big Sky and $100,000 to Blake Hazen. Big Sky was unaware that any of the money had ever been disbursed to Ogden. On June 13, 1997, Big Sky filed a civil action in Weber County state court against Ogden for the remaining $200,000 of the $600,000 promissory note.

On June 16, 1997, an involuntary petition for bankruptcy was filed against Ogden under Chapter 7 of the Bankruptcy Code. *See* 11 U.S.C. § 303(b). On December 31, 1997, Big Sky filed a proof of claim in Ogden's bankruptcy case asserting a claim for $200,000. Big Sky now asserts that this was done under the mistaken impression that the underlying real estate transaction at issue might have been closed by Ogden without Big Sky's knowledge.

The Trustee appointed in Ogden's bankruptcy determined that the $300,000 Big Sky received from the escrow account on May 23, 1997 was an avoidable preferential transfer under the Bankruptcy Code. On December 27, 1997, the Trustee asked Big Sky to return the $300,000 to the debtor's estate. When Big Sky refused to return the $300,000, the Trustee filed an adversarial proceeding in bankruptcy court on May 29, 1998, seeking to avoid the $300,000

transfer pursuant to § 547(b) of the Bankruptcy Code and to recover the money from Big Sky as the initial transferee under section 550(a)(1). *See* 11 U.S.C. §§ 547(b), 550(a)(1). Big Sky filed a second proof of claim in an unknown amount for the transfer avoidance claim asserted by the Trustee. On March 24, 1999, the bankruptcy court granted the Trustee's motion for summary judgment, finding that the Trustee was entitled to his requested relief. Big Sky appealed the bankruptcy court's ruling to this Court, seeking review on two main issues: (1) whether the bankruptcy court correctly ruled that Big Sky received a $300,000 preferential transfer avoidable under 11 U.S.C. § 547(b), and (2) whether the bankruptcy court correctly ruled that the Trustee may recover the $300,000 from Big Sky as the initial transferee pursuant to 11 U.S.C. § 550(a)(1).

III. DISCUSSION

Upon reviewing the factual findings of the bankruptcy court, this Court is bound by those findings unless they are clearly erroneous. *See In re Branding Iron Motel, Inc.*, 798 F.2d 396, 399 (10th Cir. 1988). The legal conclusions of the bankruptcy court are subject to *de novo* review. *See In re Mullet*, 817 F.2d 677, 678 (10th Cir. 1987). Acting as an appellate court in reviewing the bankruptcy court's summary judgment ruling, this Court reviews the appeal in the same manner as the bankruptcy court. Accordingly, the Court must determine if while examining the record in the light most favorable to the nonmoving party, any genuine issue of material fact is in dispute and if the bankruptcy court correctly applied the substantive law, with all reasonable factual inferences drawn in the nonmovant's favor. *See Mountain Fuel Supply v. Reliance Ins. Co.*, 993 F.2d 882 (10th Cir. 1991). Summary judgment is proper if the moving

party can demonstrate that there is no genuine issue of material fact and that he is entitled to judgment as a matter of law. *See* Fed. R. Civ. P. 56(c).

The Court recognizes that Big Sky's appeal turns on whether Big Sky should be strictly liable as the initial transferee under 11 U.S.C. § 550(a) to repay the transferred funds to the Trustee or whether it should be entitled to invoke the defenses of § 550(b) that are available to mediate or immediate transferees. However, before the Court can address these issues the Court must first determine whether Ogden's $300,000 transfer was a preferential transfer that can be avoided by the Trustee.

A. Preferential Transfers Under Section 547(b)

The Bankruptcy Code provides a mechanism for a trustee to avoid any transfers that a debtor makes that are considered preferential to or for the benefit of a creditor. The purposes behind avoidance of preferential transfers are twofold: (1) to prevent individual creditors from dismembering the debtor prior to bankruptcy, and (2) to facilitate bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to return the payment so that all may share equally, getting no more than they would in a fair settlement. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-78 (1977). Accordingly, the Bankruptcy Code creates an expansive statutory scheme, enabling a trustee to avoid preferential transfers and achieve a fair result for all creditors.

The bankruptcy court found that the Trustee could avoid as a preferential transfer Ogden's May, 1997 payments to Avis & Archibald, totaling $300,000 which were ultimately given to Big Sky. In so ruling, the bankruptcy court ordered Big Sky to return the funds it

received to the Trustee. Big Sky argues that this Court must reverse the bankruptcy court's ruling and remand the case back to bankruptcy court, contending that the Trustee did not fully satisfy the requisite requirements of 11 U.S.C. § 547(b).

Section 547(b) states in relevant part:

> the trustee may avoid any transfer of an interest of the debtor in property—
> (1) to or for the benefit of a creditor;
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made—
> (A) on or within 90 days before the date of the filing of the petition;
> . . .
> (5) that enables the creditor to receive more than such creditor would receive if—
> (A) the case were a case under chapter 7 of this title;
> (B) the transfer had not been made; and
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b). Unless the Trustee proves each one of these elements, a transfer is not avoidable as a preference under this section.

As a preliminary matter, the Court must first identify the relevant transaction for purposes of determining if the Trustee can avoid the transfer of funds to Big Sky. The transaction in question occurred when Ogden borrowed money from various investors between May 7, 1997 and May 14, 1997 to repay the escrow account the money that Avis & Archibald inappropriately released to Ogden. The ability of the Trustee to avoid this transfer under § 547(b) is not dependent upon the subsequent transfer from Avis & Archibald's account to Big Sky on May 23, 1997. What is relevant to this preference analysis is whether each element of § 547(b) can be satisfied at the time Ogden transferred the $300,000 from his estate to Avis & Archibald.

It is undisputed that the transfer from Ogden to Avis & Archibald, and ultimately to Big Sky, was within ninety days of Ogden's bankruptcy, that Ogden was insolvent at the time of the transfer, and that none of Ogden's creditors will receive one-hundred cents on the dollar for their claims against Ogden's estate. *See* 11 U.S.C. § 547(b)(3)-(5). What is disputed is whether Ogden had the requisite interest in the funds pursuant to § 547(b) at the time the funds were transferred to Avis & Archibald, and whether Big Sky had creditor status pursuant to § 547(b)(1)-(2).

1. "Interest of the Debtor in Property"

A transfer is preferential only if the property transferred belongs to the debtor. Big Sky contends that Ogden did not have an interest in the money at the time it was transferred because he obtained the funds fraudulently. To repay the escrow account, Ogden borrowed money from "investors," who thought they were investing with Ogden in various business transactions.

The fundamental inquiry as to whether Ogden had an interest in the funds transferred is whether the transfer diminished or depleted the debtor's estate to which other creditors can legally resort for the payment of their debts. *See* 5 LAURENCE P. KING, COLLIER ON BANKRUPTCY ¶ 547.03[2] (15th ed. 1999). Generally, when a third person makes a loan to a debtor specifically to satisfy the claim of a designated creditor, no preference is created. *See id.* However, a payment by a debtor with borrowed money may constitute a preference when the loan was not made upon the condition that it should be applied to the particular creditor to whom it was paid. *See id.* This is the case regarding the instant facts. Ogden's investors did not know their funds would be directed to Avis & Archibald and ultimately Big Sky. The investors' funds

came into Ogden's estate, and when those funds were transferred to Big Sky, Ogden's estate was diminished. Thus, the only remaining question as to this issue is whether Ogden's fraudulent inducement of the funds negates his interest in that property.

A debtor has an interest in the funds he acquires through fraud. *See*, *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843 (D. Utah 1987) (holding that misappropriated money becomes "property of the debtor" when the defrauded party fails to timely avoid the transaction and accepts benefits under the contract); *Merrill v. Dietz (In re Universal Clearing House Co.)*, 62 B.R. 118 (D. Utah 1986) (stating that a defrauded party who fails to take affirmative steps to avoid a contract induced by fraud becomes a mere creditor while the defrauder takes sufficient interest in the property for bankruptcy purposes). There is no evidence in the record that Ogden's investors did anything to avoid the investment transaction. Ogden's investors became creditors as a result of Ogden's fraudulent acquisition of the funds. Consequently, Ogden gained sufficient rights in the money he obtained from them. The bankruptcy court correctly determined that Ogden had the requisite interest in the money to satisfy §547(b).

2. "To or for the Benefit of a Creditor"

Big Sky next argues that the bankruptcy court erred in finding that Big Sky was a creditor of Ogden. The Trustee, however, contends that Big Sky was a creditor and asserts that the Bankruptcy Code supports such a finding. The Bankruptcy Code defines the term "creditor" broadly to mean an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(10)(A). The Code then defines

"claim," again very broadly, meaning:

> (A) right to payment, whether or not such a right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured;
> (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

11 U.S.C. § 101(5)(A)-(B). According to these definitions, a transfer of the debtor's property to or for the benefit of virtually every kind of creditor may be avoided as a preference so long as all the other requirements of § 547(b) are satisfied.

Although creditor is defined broadly, the question remains as to whether one can become a creditor without knowledge or permission. Indeed, Big Sky argues that a debtor-creditor relationship cannot exist because Big Sky neither had any knowledge of the debt nor consented to the release of its funds to the debtor. Initially, the Court recognizes that in a preference analysis, it is generally the effect of the transaction, rather than the debtor's or creditor's intent, that is controlling. *See Barash v. Public Finance Corp.*, 685 F.2d 504, 510 (7th Cir. 1981) (stating that the creditor's knowledge or state of mind is not relevant); *see also* H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-78 (1977) (stating that a "creditor's state of mind has nothing whatsoever to do with the policy of equality of distribution"). While Big Sky only intended that the money go to Ogden upon satisfaction of the escrow conditions, when the money was released to Ogden from Avis & Archibald, Ogden owed a debt to Big Sky and that debt was secured by a promissory note.

It has been stated that "[w]hen a debtor has stolen, misappropriated, converted, or

obtained property belonging to another, the question of whether a debtor-creditor relationship results is dependent upon the election of the owner of the property." 5 COLLIER ON BANKRUPTCY ¶ 547.03[3]. According to this bankruptcy treatise, "[i]f the owner elects to treat the loss as a debt, then the owner becomes a creditor, and any transfer of the debtor's property to the owner to make good the loss caused by the misappropriation, conversion, or fraud may constitute a preference." *Id.* (citing *Burgoyne v. McKillip*, 182 F. 452 (8th Cir. 1910)). However, if the owner of the property elects, he may stand on his rights as owner and demand its return, rescinding the transaction in which the fraud or breach of trust was committed and ask for restoration of his property; so long as the property can be identified, the return will not constitute a preferential transfer of the property to a creditor because its return does not result in a diminution of the debtor's estate. *See id.* If the property cannot be traced or identified, "the injured party becomes a mere creditor of the debtor to the extent of that property, and the debtor's payment of or giving of security for the creditor's claim will constitute a preference if the other elements under the Code are satisfied." *Id.* (citing *Wootton v. Barge (In re Cohen)*, 875 F.2d 508 (5th Cir. 1989)).

Although Big Sky appears to be attempting to rescind the transaction, there is no evidence that the funds taken by Ogden from Big Sky can be identified, or that Ogden returned the same funds that he took from Avis & Archibald. In fact, the evidence is to the contrary; the funds were those Ogden fraudulently obtained from other investors, which he then used to replenish the escrow account. Those defrauded investors likely became general unsecured creditors, and thus, the funds transferred to the escrow account diminished Ogden's estate, to which those creditors

have a claim. Consequently, Big Sky must be viewed as a creditor of Ogden.[2] At the moment Ogden fraudulently obtained Big Sky's funds from the escrow account on April 8, 1997, Ogden owed a debt to Big Sky, despite Big Sky's ignorance of that fact. The repayments to the escrow account between May 7 and May 14, 1997 constituted payment on Ogden's debt to Big Sky. For purposes of § 547(b), the instant facts support the bankruptcy court's finding that Big Sky was a creditor of Ogden.

Big Sky claims, however, that Avis & Archibald in reality became Ogden's creditor when it wrongfully disbursed Big Sky's escrow funds to Ogden and that any preferential transfer was made to Avis & Archibald rather than to Big Sky. Under this theory, Big Sky claims that Avis & Archibald acted as a creditor when it notified Ogden that he had to replenish the account and demanded that Ogden return the money. While there may be some merit to Big Sky's assertion, the Court finds that in light of the Trustee's broad powers to avoid transfers made by the debtor prior to bankruptcy, it is irrelevant under § 547(b) whether Avis & Archibald could be deemed Ogden's creditor. What is relevant is that a transfer did take place from Ogden to a creditor and that transfer came to rest in Big Sky's account. The Court finds that each element of § 547(b) was satisfied, and thus, the Trustee was authorized to avoid the transfer of Ogden's funds that

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[2]Big Sky's creditor status is further supported by the business relationship that existed between the parties and by Big Sky's actions in attempting to recover payment from Ogden. The nature of the proposed transaction between Big Sky and Ogden provided that Big Sky would receive a $200,000 return within sixteen days if it would loan Ogden $400,000. Big Sky acted like a creditor throughout its dealings with Ogden, having him sign a $600,000 promissory note, taking a loan origination fee from the $400,000 it put in escrow, and filing a proof of claim for the remaining $200,000 owed on the promissory note when Ogden filed for bankruptcy. Big Sky even initiated a civil suit in state court to enforce the $200,000 balance owed on the promissory note against Ogden at the time he filed for bankruptcy.

ultimately went to Big Sky. As to whether recovery is appropriate from Big Sky or Avis & Archibald, that matter is best handled by (1) finding that the transfer from Ogden was a preferential transfer to a creditor and then (2) applying 11 U.S.C. § 550 to determine which party the Trustee may recover from and which party may be entitled to assert a defense. *See Billings v. Key Bank of Utah (In re Granada, Inc.)*, 156 B.R. 303, 306 (D. Utah 1990) (holding that is was unnecessary to reexamine the bankruptcy court's conclusion that the transfers were preferences under § 547, because even if they were not preferential as to one party they were to the other, and continuing its analysis under § 550 to determine who was the initial transferee); *see also Commerce Security Corp. v. Brandon (In re Harbor)*, 845 F.2d 1245, 1255 (4th Cir. 1988) (finding that once a transfer is deemed voidable, the next decision must be "voidable as to which parties?").

B. Recovery Under § 550

After determining that the $300,000 payment from Ogden was a preferential transfer under § 547, the bankruptcy court held that the Trustee could recover the transfer from Big Sky because Big Sky was the initial transferee under 11 U.S.C. § 550(a)(1). The bankruptcy court's ruling was premised on the conclusion that Big Sky received the debtor's funds through the commercial conduit of Avis & Archibald. Big Sky appeals, contending that even if the Trustee is permitted to avoid the transfer, the bankruptcy court erred in allowing the Trustee to recover the money from Big Sky as the initial transferee under § 550(a). Big Sky argues that Avis & Archibald's wrongful actions led to the Trustee's ability to avoid the transfer, and Avis & Archibald should not escape liability because of its status as a financial intermediary, but rather

should be held liable as the initial transferee. The Trustee, however, asserts that the bankruptcy court was correct in its finding. This dispute turns on the interpretation and application of § 550 and its commercial conduit exception.

After the avoidance of a transfer, § 550 of the Bankruptcy Code authorizes a trustee to recover the property transferred. Section 550 specifies who the trustee may recover from, as well as defining the rights and liabilities of transferees, and in some cases, protecting them against recovery by the trustee. *See* 5 COLLIER ON BANKRUPTCY ¶ 550.01[1]. In essence, § 550 enunciates the separation between the concepts of avoiding a transfer and recovering the transfer from the transferee. *See id.* (citing H. Rep. No. 595, 95th Cong., 1st Sess. 375 (1977)).

Section 550(a) specifically allows a trustee to recover from "initial transferees." Section 550(b) protects transferees subsequent to the initial transferee that have taken for value, in good faith, and without knowledge of the viability of the transfer. In relevant part, § 550 reads:

> (a) . . . to the extent a transfer is avoided under section . . . 547 . . . of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—
>
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
>
> (2) any immediate or mediate transferee of such initial transferee.
>
> (b) The trustee may not recover under subsection (a)(2) of this section from—
>
> (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the viability of the transfer avoided; or
>
> (2) any immediate or mediate good faith transferee of such transferee

11 U.S.C. § 550(a)-(b).

Delineating between initial transferees and subsequent transferees is critical in this case. If Big Sky were the initial transferee for purposes of § 550, its liability would be strict. If not,

Big Sky could invoke § 550(b)'s defenses to possibly defeat recovery. As to an initial transferee, it makes no difference whether the transferee gave value, acted in good faith, or was ignorant of the transfer's voidable character. *See Rupp v. Markgraf*, 95 F.3d 936, 938 (10th Cir. 1996). Indeed, neither innocence in an action nor unfairness in result is a defense. *See Levesque v. Salem, Inc. (In re Mainely Payroll, Inc.)*, 233 B.R. 591, 596 (Bankr. D. Me. 1999) (noting that "[t]he statute leaves no room to fashion a remedy that treats the initial transferee 'equitably' under the circumstances of any given case"); *Richardson v. F.D.I.C. (In re M. Blackburn Mitchell, Inc.)* 164 B.R. 117, 125 (Bankr. N.D. Cal. 1994) (concluding that "[u]nder § 550 . . . , it is crystal clear that even the 'innocent' initial transferee is liable for the fraudulently transferred funds"). Subsequent transferees, however, may avoid liability under § 550(b) upon a showing of status analogous to that of a bona-fide purchaser. *See Leonard v. First Commercial Mortgage Co. (In re Circuit Alliance, Inc.)*, 228 B.R. 225, 232 (Bankr. D. Minn. 1998). It is under this statutory framework, that the Court now proceeds in its analysis of determining which party was the initial transferee.

The Bankruptcy Code does not define "initial transferee," and difficulties have arisen in determining the correct identity of an initial transferee, especially when a debtor gives money to an intermediary before transferring it to a creditor and when that intermediary appeared to be the initial transferee. The courts have developed a "commercial conduit" exception to the strict liability assessed to an initial transferee in an effort to avoid unfairness that might result from the literal application of § 550(a). *See Billings v. Key Bank of Utah (In re Granada)*, 156 B.R. 303, 306 (D. Utah 1990). The theory was initially developed under the Bankruptcy Act of 1898, as

illustrated in *Cason v. Federal Reserve Bank*, 172 N.E. 475 (N.Y. 1930), where a New York court addressed the theory's underlying concerns:

> The person to be charged with liability, if he has parted before the bankruptcy with title and possession, must have been more than a mere custodian, an intermediary or conduit between the bankrupt and the creditor. Directly or indirectly he must have had a beneficial interest in the preference to be avoided, the thing to be reclaimed.

Id. at 482.

"The origin of the conduit theory is the desire to protect the 'mere conduit,' not to expand the trustee's avoidance powers." *Ragsdale v. South Fulton Machine Works, Inc. (Whitacre Sunbelt, Inc.)*, 200 B.R. 422, 426 (Bankr. N.D. Ga. 1996). While the commercial conduit exception was developed as a defensive tool to protect innocent and passive participants from liability, some courts have allowed the conduit theory to be applied offensively to deprive subsequent transferees of the defenses of § 550(b). *See Lowry v. Security Pacific Business Credit, Inc. (In re Columbia Data Products, Inc.)*, 892 F.2d 26 (4th Cir. 1989). In the case at bar, the Trustee has essentially deemed Avis & Archibald a conduit in its attempt to hold Big Sky liable as the initial transferee. Because the offensive use of the conduit theory has no independent equitable underpinnings, the Court recognizes that it should be applied carefully and in a limited fashion as to whether Avis & Archibald was a commercial conduit. *See Thompson v. Jonovich (In re Food & Fibre Protection, Ltd.)* 168 B.R. 408, 420 (Bankr. N.D. Az. 1994).

The commercial conduit theory has evolved in recent case law, and the United States Court of Appeals for the Seventh Circuit has articulated a "dominion and control" test that has been widely adopted in deciding whether a party is entitled to this conduit status for purposes of

§ 550. *See Bonded Fin. Servs. v. European Am. Bank*, 838 F.2d 890, 893-95 (7th Cir. 1988). In a case involving the transfer of funds from a debtor to a bank payable to the bank's order, along with instructions to deposit the money into the account of a third party, the Seventh Circuit, determined that the bank was a financial intermediary acting in an administrative capacity and should be characterized as a commercial conduit exempt from the trustee's authority to recover, rather than be found liable as the initial transferee. *See id.* at 894. The court reasoned that "the minimum requirement of status as a[n initial] 'transferee' is dominion over the money or other asset, the right to put the money to one's own purposes." *Id.* at 893. Since *Bonded*, the commercial conduit theory and its dominion and control test have been read into the application of section 550 in determining the identity of the initial transferee. Under this exception, 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. *See id.*

The United States Court of Appeals for the Tenth Circuit adopted the Seventh Circuit's dominion and control test and conduit theory in *Malloy v. Citizens Bank of Sapulpa (In re First Security Mortgage Co.)*, 33 F.3d 42 (10th Cir. 1994), and later expounded upon it in *Rupp v. Markgraf*, 95 F.3d 936 (10th Cir. 1996). In *Rupp*, the court dealt with a situation where a bank received funds from a debtor and then issued a cashiers check to a creditor of the debtor. The court, recognizing that the dominion and control test must be applied correctly to determine the identities of the initial transferee and any commercial conduits, found that the bank was not an initial transferee, but a commercial conduit. *See id*. at 939. Implicit in the court's holding is that the dominion and control test must be applied to the transaction that gave rise to the Trustee's

authority to recover the money under 11. U.S.C. § 550(a), not surrounding events. *See id.* at 940 ("It is clear that the *Bonded* court's discussion of dominion and control refers to dominion and control over *the funds* after the disputed transfer, not dominion and control over the *transferor* before the transfer."). As the Seventh Circuit stated, the initial transferee must be free to invest the money in "lottery tickets or uranium stocks." *Bonded*, 838 F.2d at 894.

The Court acknowledges that in most of the conduit cases, such as in *Rupp* and *Bonded*, the initial recipients of the transfer were acting as mere financial intermediaries or conduits in an administrative manner so that they were not deemed initial transferees for purposes of § 550(a)(1). *See also, e.g., In re Williams,* 104 B.R. 296 (Bankr. C.D. Cal. 1989) (finding that an escrow company was not an initial transferee); *In re Moskowitz*, 85 B.R. 8, 11 (Bankr. E.D. N.Y. 1988) (finding that a title company was not an initial transferee). In these cases, there was no evidence that the defendants' handling of the debtor's funds in any way departed from their normal handling of commercial transactions. Indeed, these transferees acted innocently in preforming their administrative duties as they were obligated to perform. *See Bonded*, 838 F.2d at 893 (noting that "[u]nder the law of contracts, the Bank had to follow the instructions that came with the check").

There are cases where the courts have found that alleged conduits exercised sufficient dominion and control so that initial transferee status was appropriate under § 550. In *Billings v. Key Bank of Utah (In re Granada)*, 156 B.R. 303 (D. Utah 1990), a general partner transferred funds through certain partnerships to pay obligations of the partnerships to a bank. Upon the general partner's filing for bankruptcy, the trustee sought to bypass the partnerships and recover

from the bank as the initial transferee, arguing that the partnerships were mere conduits. Judge Winder of this Court stated:

> The dominion and control test as set out in *Bonded* requires only that an entity have the 'right to put the money to [its] own purposes.' In the present case, the partnerships had the right and did, in fact, put the money to their own purposes. They used the funds to reduce their debt to Key Bank. In contrast, the conduits in *Bonded* and the cases following *Bonded* had no right, power, or claim of any kind to the funds transferred through them. The partnerships in the present case were simply not financial intermediaries and couriers in the same way as were the conduits in *Bonded* and the cases following it.

Id. at 308. Unlike the typical conduit, the partnerships in *Granada* received something that they could call their own. "They received funds with which they were able to reduce their liability to Key Bank." *Id.* (finding that the partnerships did have dominion over the funds received from the debtor until payments were made to the bank). *See also Thompson v. Jonovich (In re Food & Fibre Protection, Ltd.)* 168 B.R. 408, 421-22 (Bankr. N.D. Az. 1994) (holding that because the alleged conduit used money given to him to reduce a debt he owed, he was the initial transferee); *Ragsdale v. South Fulton Machine Works, Inc. (Whitacre Sunbelt, Inc.)*, 200 B.R. 422, 425 (Bankr. N.D. Ga. 1996) (finding that to obtain a release of a guarantee constituted using money for its own purposes sufficient to find dominion and control and negate any conduit protection).

The instant facts fall somewhere between the cases involving innocent financial intermediaries carrying out their administrative duties and those cases in which the alleged conduits exercised control over funds to their advantage. Avis & Archibald did derive some advantage from this transfer and was more involved than the typical financial intermediary. When Avis & Archibald wrongfully released the funds to Ogden, Avis & Archibald breached its

fiduciary duty owed to Big Sky,[3] and as a result, became liable to Big Sky. *See* RESTATEMENT (SECOND) OF AGENCY § 14D at 67 (1958) ("If the escrow holder loses or disposes of an escrow, the one having the legal title to it at the time has the risk of loss and a corresponding claim against escrow holder if the loss is caused by the latter's fault."). When Avis & Archibald found out that it should not have released the funds to Ogden, it undertook direct dealings with Ogden in an attempt to eliminate the liability it incurred to Big Sky by demanding that Ogden return the money. Big Sky focuses on Avis & Archibald's involvement in its application of the dominion and control test, arguing that Avis & Archibald exercised sufficient dominion over the escrow funds when it disbursed them to Ogden and later required their return to the escrow account. While Avis & Archibald may have had some control over Ogden and an interest in replenishing Big Sky's funds, the Tenth Circuit has made clear that the initial transferee must have actual control over the funds. Indeed, Big Sky confuses the very issue the Tenth Circuit attempted to clarify in *Rupp* when the court held that "dominion and control refers to dominion and control over the funds after the disputed transfer, not dominion and control over the transferor before the

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[3]Utah law imposes certain restrictions on title insurance companies like Avis & Archibald:

> All funds deposited with the agent in connection with any escrow, settlement, or closing are deposited in a federally insured financial institution in a separate trust accounts, with the funds being the property of the persons entitle to them under the provisions of the escrow, settlement, or closing. . . . These funds are not subject to any debts of the agent and *may only be used to fulfill the terms of the individual escrow*, settlement or closing under which the funds were accepted. *None of the funds may be used until all conditions of the escrow, settlement, or closing have been met.*

Utah Code Ann. § 31A-23-307(2)(a) (emphasis added).

transfer." *Rupp*, 95 F.3d at 940.

It cannot be said that Avis & Archibald had dominion and control over the funds Ogden transferred for purposes of replenishing the escrow account. Despite Avis & Archibald's wrongdoing in giving Ogden the escrow money, Avis & Archibald acted as a mere conduit during the transaction that gave rise to the Trustee's authority to avoid and recover the transfer. When Ogden returned the funds to Avis & Archibald, Big Sky's account was immediately credited. During this time, Avis & Archibald did not exercise the requisite dominion over the funds as the initial transferee; it merely held the funds in escrow as a financial intermediary until Big Sky exercised its rightful dominion and control over the account and requested the funds be returned. In order to be considered an initial transferee "one must (1) actually receive the funds, and (2) have full dominion and control over them for one's own account, as opposed to receiving them in trust or as agent for someone else." *Id.* at 942 (quoting *Richardson v. FDIC (In re M. Blackburn Mitchell Inc.)*, 164 B.R. 117 (Bankr. N.D. Cal.1994)). Avis & Archibald's involvement does not rise to the level of dominion and control as required under the current law, which this Court is bound to follow. Although Avis & Archibald may not be a true innocent conduit, it nevertheless was acting as a conduit between Ogden and Big Sky. Accordingly, the Court finds that the bankruptcy court was correct in finding that Big Sky was the initial transferee for purposes of § 550(a)(1).

While requiring Big Sky to relinquish the $300,000 to the Trustee when Big Sky never knew that Ogden fraudulently obtained its money may appear inequitable, as noted previously, neither innocence in an action nor unfairness in result is a defense to the liability imposed by §

550(a)(1) of the Bankruptcy Code. Big Sky will have to stand in line with the other general creditors to receive its pro-rata share and then, if it desires, seek the remainder of its loss from Avis & Archibald in another forum.

IV. CONCLUSION

For the reasons stated above, the Court finds that the bankruptcy court correctly determined that the Trustee could avoid the $300,000 transfer to Big Sky under § 547(b) and recover the money from Big Sky under § 550(a)(1). Thus, the bankruptcy court's order granting the Trustee's motion for summary judgment is AFFIRMED, and Big Sky is ORDERED to remit the $300,000 preferential transfer to the Trustee.

DATED this _____ day of February, 2000.

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Dee Benson
United States District Judge