

# Chapman Client Alert

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Current Issues Relevant to Our Clients

## “Mere Conduit” Defense is Alive and Well in the Eleventh Circuit

Providers of services acting as mere conduits for parties transferring money remain protected from fraudulent conveyance actions under the United States Bankruptcy Code (the “*Bankruptcy Code*”), at least according to a recent bankruptcy court decision in the Eleventh Circuit.<sup>1</sup> In *Taylor, Bean & Whitaker Plan Trust v. ADP, Inc. (In re Taylor, Bean, & Whitaker Mortg. Corp.)* 2018 WL 5784699 (Bankr. M.D. Fla. Nov. 1, 2018) (“*Taylor Bean*”), the United States Bankruptcy Court for the Middle District of Florida (the “*Bankruptcy Court*”) expanded the application of the mere conduit defense to protect a transferee-payroll company.<sup>2</sup>

In *Taylor Bean*, the bankruptcy trustee for Taylor, Bean & Whitaker (“*TBW*”) attempted to avoid and recover transfers to ADP, Inc. (“*ADP*”), *TBW*’s payroll services company, as fraudulent conveyances under Sections 544, 548(a)(1)(A), (B), and 550 of the Bankruptcy Code. Under Section 550 of the U.S. Bankruptcy Code, an avoided transfer may be recovered from, *inter alia*, “the initial transferee of such transfer or the entity for whose benefit the transfer was made.”<sup>3</sup> The case turned on whether ADP constituted an initial transferee of the transfer of \$34 million by *TBW* to ADP to pay *TBW*’s payroll and tax withholdings. Had the trustee established that ADP was the initial transferee of the \$34 million, the trustee could have recovered from ADP some or all of the amount that had been transferred.

### The Mere Conduit Defense in a Nutshell

A literal interpretation of the interpretation of “initial transferee” as used in Section 550(a)(1) would include those entities that merely accept money from one party and thereafter pass it along to a third party. Using their powers of equity, however, courts have created a defense known as the “mere conduit” defense, to exclude “pass through” entities from the scope of Section 550, and thereby deeming the entity or entities receiving funds remitted by the pass-through entity as the initial transferee. As set forth by the Bankruptcy Court, to establish a mere conduit defense, the party asserting the defense must prove that (a) it did not have control over the funds received from the debtor-transferor (i.e., the “conduit” merely served as a conduit for the funds that were under the actual control of the debtor), and (b) the “conduit” acted in good faith and as an innocent participant in the fraudulent transfer.<sup>4</sup> The analysis should consider the totality of the circumstances and is meant to be practical and fair, the Bankruptcy Court noted.

### The First Element - Lack of Control

The first element of the test that courts in the Eleventh Circuit have created is whether or not the entity had control of the funds. “A defendant is an initial transferee only if it ‘exercise[s] legal control over the assets received, such that [it] ha[s] the right to use the assets for [its] own purposes, and not if [it] merely served as a conduit for assets that were under the actual control of the debtor-transferor or the real initial transferee.’”<sup>5</sup> In reviewing the transactions which are the subject of the defense, [t]he court is directed to consider all aspects of the transaction . . . in [a] “flexible, pragmatic, equitable approach.”<sup>6</sup>

### The Second Element - Good Faith

Thereafter, the party seeking mere conduit status must show that it acted in good faith and as an innocent participant in the transfer. Upon making this showing, the debtor must rebut the the conduit’s assertion of good faith by demonstrating that the recipient had actual knowledge of the fraudulent purpose in

making the transfer or had knowledge of the facts and circumstances that would have put the defendant on inquiry notice.<sup>7</sup>

### Examples of Mere Conduits

Relationships where the alleged initial transferee have been determined by other courts to be a mere conduit include where (i) the person acted as a courier, delivering a certified check to a third party,<sup>8</sup> (ii) a bank was an intermediary to a transaction, such as when accepting a deposit for the account of a third party (as opposed to accepting a payment as a creditor such as for payment on a loan),<sup>9</sup> or (iii) funds are transferred to an insurance broker to pay the premium due an insurer under an insurance policy.<sup>10</sup> Extending the defense to a payroll processing company, however, was new ground in the Eleventh Circuit.

### ADP's Relationship with the Debtor

ADP's relationship with TBW was more complex and sophisticated than the typical relationship between a bank and its account depositors, or an insurance broker and its client. ADP's role, obligations and limitations were set forth in a Master Services Agreement that incorporated a number of service annexes, and involved the payment of TBW's payroll and related expenses.

Specifically, the Trustee's claims were based on approximately \$34 million that had been transmitted to ADP by TBW for the payment of TBW's wages, garnishments, and taxes and passed through to TBW's employees and various state and federal taxing authorities. TBW's payroll department generated a Payroll Master File (the "*Master File*") which tracked hours and gross pay and was updated by TBW each payroll period with new hires, terminations, transfer and pay rate changes using information provided by TBW's human resources department. The Master File was then provided to ADP by uploading the information to an ADP software application. After processing the information, ADP provided a "preview" of the Master File for the pay period to TBW, which was reviewed and corrected. Once approved, TBW's payroll department requested wire transfers to ADP from TBW's cash management department to fund the payroll with instructions to ADP for the application of the wire, including, but not limited to,

the total wages, taxes, and garnishments to be disbursed. Upon receipt of the wire, ADP would release the payroll and tax payments to the appropriate taxing authorities. A distribution report was generated by ADP and provided to TBW.

The wires received from TBW by ADP were deposited into a client account and comingled with transfers received from other clients. Fees received by ADP for services were deposited in a separate account maintained by ADP for such purpose. Funds in the comingled client account were used solely for the purpose of satisfying clients' obligations (such as payroll). ADP maintained a ledger system to account for each individual client's deposits into the account. ADP also loaned money from time to time to clients from the client account to cover any shortfalls in the amount transferred to make payroll with the expectation of an immediate wire payment from such client to cover the "overdraft." Finally, ADP refunded certain amounts deposited by clients for items such as uncashed payroll checks or tax refunds.

Based on these and other facts, the Bankruptcy Court found that TBW, and not ADP, maintained control of the funds throughout the process. The essence of the transactions set forth in the Master Services Agreement was that ADP was obligated to use TBW's funds to pay wages, garnishments, and taxes as directed by TBW. TBW's control over the the funds was facilitated by ADP's software. ADP followed TBW's instructions in moving TBW's funds to the tax authorities, designated employees, and respective garnishees. The funds merely passed through ADP to the intended recipients, and the short time the funds spent in ADP's client account did not change that fact, according to the Bankruptcy Court. Further, the use of funds of other clients to cover temporary shortfalls, the Bankruptcy Court found, was no different than a bank temporarily covering an overdraft.

Finally, the court found no basis in the facts adduced during discovery to find that ADP had any actual knowledge or fact that would put ADP on inquiry notice with respect to fraud at TBW. As a result, the Bankruptcy Court dismissed the trustee's fraudulent conveyance claims against ADP as ADP was a mere conduit and not the initial transferee for purpose of the avoidance actions.

## Conclusion

The case is another confirmation on the availability of the “mere conduit” doctrine defense to parties whose business is to “pass through” funds to other parties. Although the Bankruptcy Court indicated that the analysis should consider the totality of the circumstances and is fact-specific, the decision should provide additional comfort to banks, insurance brokers, couriers and similar businesses that they are not subject to initial-transferee liability under the Bankruptcy Code when facilitating pass-through transfers in their normal business operations.<sup>11</sup>

## For More Information

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- 1 11 U.S.C. §101 *et seq.*
- 2 This decision has been appealed.
- 3 *Id.* § 550(a)(1).
- 4 *Taylor Bean*, at \*2 (citing *Martinez v. Hutton (In re Harwell)*, 628 F.3d 1312, 1323 (11<sup>th</sup> Cir. 2010)).
- 5 *Id.* at \*12 (citing *Andreini & Co. v. Pony Exp. Delivery Services, Inc. (In re Pony Exp. Delivery Services, Inc.)*, 440 F.3d 1296 (11<sup>th</sup> Cir. 2006)). In the Second and Seventh Circuits the test is described as whether the transferee has “dominion and control” over the transferred funds.
- 6 *Luria* at page 27, citing *Menotte v. USA (In re Custom Contractors, LLC)* 745 F.3d 1342 at 1350 (11<sup>th</sup> Cir. 2014).
- 7 *Id.* at \*15 (citing *Welch v. Regions Bank (In re Mongelluzzi)* 587 B.R. 392, 411 (Bankr. M.D. Fla. 2018)).
- 8 *Rupp v. Markgraf*, 95 F.3d 936 (10<sup>th</sup> Cir. 1996)
- 9 *See, e.g., Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890 (7<sup>th</sup> Cir. 1988).
- 10 *Andreini*, 440 F.3d at 1298; *see also In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey*, 130 F.3d 52 (2<sup>nd</sup> Cir. 1997).
- 11 The decision has been appealed to the U.S. District Court for the Middle District of Florida.

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