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## Seventh Circuit Holds Securitization Trustee Liable as “Initial Transferee” in Fraudulent Conveyance Action

As a general rule, a bank acting as a “mere conduit” for funds, without any control over their ultimate disposition, is not liable in a fraudulent transfer suit. In a decision issued on August 27, 2010, the United States Court of Appeals for the Seventh Circuit considered this rule and, vacating the decisions of the bankruptcy and district courts, held that a bank acting as trustee for holders of asset securitization corporation commercial mortgage pass-through certificates was an “initial transferee” of certain repayments on the certificates and therefore the appropriate subject of an avoidance action to recover those sums. Paloian v. LaSalle Bank, N.A., No. 09-2011, 2010 WL 3363596 (7th Cir. Aug. 27, 2010). Although this was an issue of first impression for the federal appellate courts, the Seventh Circuit’s decision in Paloian suggests that trustees with legal title to funds can be held liable in avoidance actions, regardless of whether the trustee has any discretion over disposition of the funds under the terms of the relevant trust agreement.

### Background

In Paloian, Doctors Hospital of Hyde Park (the “Hospital”), took out two loans in the three years prior to its bankruptcy filing in August 2000, certain payments on which the Hospital’s trustee in bankruptcy eventually attempted to recover as fraudulent conveyances. The first loan was a \$25 million line of credit extended in March 1997 by Daiwa Healthco to MMA Funding, L.L.C., a non-debtor affiliate of the Hospital that was intended to be bankruptcy-remote. As part of the transaction, the Hospital purportedly transferred all of its current and future accounts receivable to MMA, and Daiwa took a security interest in the accounts.

Several months later, in August 1997, Nomura Asset Capital Corporation loaned \$50 million to the Hospital through HPCH LLC, a non-debtor affiliate of the Hospital that owned its building and land. HPCH made the funds available to the Hospital in exchange, in part, for additional rent, and Nomura was granted a security interest in the rent. The Nomura loan was securitized shortly after it was issued, and packaged by a third party with several billion dollars of commercial credit for resale to investors. The notes and accompanying security interests were transferred to a trust, of which LaSalle National Bank was trustee.

The bankruptcy and district courts agreed that the increased rent payments to HPCCH were more properly characterized as debt service by the Hospital on the Nomura loan, and recoverable from LaSalle as fraudulent conveyances because the Hospital had been insolvent when the Nomura loan was extended. The lower courts limited the Hospital's recovery, however, by concluding that any payments on the Nomura loan made by MMA rather than the Hospital itself were outside the bankruptcy. On appeal, the Seventh Circuit considered three questions: (1) whether the Hospital was insolvent when the Nomura loan was made; (2) whether LaSalle bank was an "initial transferee" subject to liability in a fraudulent transfer action; and (3) whether the Hospital's accounts receivable had been sold to MMA or if they remained assets of the Hospital that could be pursued in a fraudulent transfer suit.

### **Solvency Analysis**

A threshold question for any fraudulent transfer analysis is whether the transferor was either insolvent at the time of the challenged transfer or was rendered insolvent as a result of the transfer. Payments made while an entity is solvent may not be unwound in later avoidance actions. The bankruptcy court, utilizing a discounted cash flow analysis, concluded that the Hospital was insolvent in August 1997 despite the fact that it had positive financial statements and was current in paying its creditors, and therefore certain payments by the Hospital on the Nomura Loan were preferential. Although the Seventh Circuit rejected the bankruptcy court's calculations and reversed its determination, it remanded the question of whether the Hospital became insolvent at some point between August 1997 and its bankruptcy filing in April 2000. If the bankruptcy court were to find the Hospital was solvent at the time of the challenged transfers, the claims against the defendants would fail regardless of the below rulings.

### **Liability of Securities Pool Trustee**

The key legal issue considered by the Seventh Circuit in Paloian was whether the bankruptcy trustee could seek to recover payments by the Hospital to LaSalle on the Nomura Loan, based on the assertion that LaSalle was an "initial transferee" of the funds for purposes of section 550(a)(1) of the Bankruptcy Code, which provides that preferential transfers may be recovered only from initial transferees, recipients from initial transferees, and any entity for whose benefit the transfers were made. Although the Bankruptcy Code does not define the term "initial transferee," courts considering the issue regularly hold that a transferee must have some control over the funds to be held liable in an avoidance action. In defense, LaSalle compared itself to a bank holding money in a checking account for a customer, claiming that it was simply a conduit for the funds, which were placed into trust for the benefit of the investors and distributed by the trustee pursuant to the trust agreement.

The Seventh Circuit rejected LaSalle's argument, concluding that LaSalle's role as trustee of a securities pool is better compared to an entity that receives funds for

paying down a loan or passing money to investors in a pool, which other courts have held to be “initial transferees” despite the recipients’ contractual obligation to pay the funds according to a formula. According to the Seventh Circuit, the purpose of a trustee’s avoiding powers is to “recoup money from the real recipient of preferential transfers.” In this situation, the Seventh Circuit held that the “real recipient” was LaSalle because under “American law,” a trustee is the legal owner of a trust’s assets, notwithstanding the trustee’s duties to the trust’s beneficiaries. More pragmatically, the Seventh Circuit claimed that it would be more “appropriate” for a bankruptcy trustee to seek recourse from a trustee, who could draw funds from the corpus of the trust, than to sue thousands of individual investors. In reaching its decision, the Court did not further analyze the scope of the trustee’s discretion under the securitization trust agreement.

### **Sale to Bankruptcy-Remote Vehicle**

Finally, the Court evaluated whether MMA was a legitimate bankruptcy-remote vehicle that had purchased the Hospital’s accounts receivable in a true sale. If it was not, then payments made through that entity to LaSalle while the Hospital was insolvent would be subject to recapture by the bankruptcy trustee. Although the Court ultimately remanded this issue to the bankruptcy court for further factfinding, it observed that MMA’s complete disregard for corporate formalities and the fact that the Hospital continued to carry the accounts receivable on its own books as a corporate asset was “the sort of structure that makes the payments amenable to a preference-recovery action whether or not the receivables are remitted to a lockbox at a bank.”

### **Broader Implications**

Although, as noted, this is an issue of first impression, the Seventh Circuit’s conclusion that a securities pool trustee may be an “initial transferee” for fraudulent transfer purposes has potential implications for entities serving in such trustee roles. While the Court concluded that the trustee could make any necessary payments to a bankruptcy estate from the corpus of the trust, presumably without damage to the trustee, it did not address what would happen if there was no such corpus and the trustee was obligated to make payments from its own funds and seek reimbursement from what could be thousands of investors. It remains to be seen whether courts in other circuits will similarly adopt this reasoning or whether courts will consider the scope of a trustee’s authority and discretion in more detail in determining initial transferee status.

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Bankruptcy and Restructuring in the “Practices” section of our website (<http://www.clearygottlieb.com>) if you have any questions.

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