

**SEVENTH CIRCUIT ADDRESSES “TRUE SALES” TO BANKRUPTCY  
REMOTE VEHICLES**

***Paloian v. LaSalle Bank, N.A.*, Nos. 09-2011, 09-2012, 09-2013, and 09-2026 (7th Cir.  
Aug. 27, 2010)]**

By James Gadsden and Bryan J. Hall

The Seventh Circuit’s recent decision in *Paloian v. LaSalle Bank, N.A.*, 2010 WL 3363596 (7th Cir. Aug. 27, 2010), strikes a cautionary note for parties considering securitized financings involving a “true sale” of assets to a special purpose entity, and lawyers giving opinions in such transactions.

Doctors Hospital of Hyde Park, Inc. (“Doctors Hospital”) obtained a revolving credit facility (the “Daiwa Loan”) from Daiwa Healthco-2 LLC (“Daiwa”), pursuant to which (i) Doctors Hospital contributed all of its healthcare receivables on an ongoing basis to MMA Funding, L.L.C. (“MMA”), a special purpose entity organized by the owner of Doctors Hospital, (ii) MMA granted a security interest in those healthcare receivables to Daiwa, (iii) Daiwa loaned funds to MMA, and (iv) MMA disbursed those funds either to Doctors Hospital or directly to Doctors Hospital’s creditors as the purchase price of the receivables.<sup>1</sup>

Doctors Hospital conducted its operations in facilities that it leased from HPCH LLC (“HPCH”). Nomura Asset Capital Corporation (“Nomura”) loaned \$50 million to HPCH<sup>2</sup> (the “Nomura Loan”). In exchange, HPCH granted Nomura security interests in the facilities it leased to Doctors Hospital and the rent payments it received from Doctors Hospital. Doctors Hospital guaranteed HPCH’s obligations to Nomura and secured that guaranty by granting Nomura security interests in certain of its personal property. The flow of funds used to pay HPCH’s obligations under the Nomura loan was complex and changed over time. Initially, Doctors Hospital paid HPCH’s obligations under the Nomura Loan from cash that Doctors Hospital received from various third parties. Later, MMA paid HPCH’s obligations from the proceeds of the Daiwa Loan. Nomura sold the Nomura Loan (together with the related security and credit enhancements) to Asset Securitization Corporation, which in turn sold it as part of a mortgage securitization pool to LaSalle Bank, N.A. (“LaSalle”) as trustee.<sup>3</sup>

Doctors Hospital filed for chapter 11 and a chapter 11 trustee was appointed. In subsequent litigation, the trustee asserted that Doctors Hospital’s bankruptcy estate could recover the payments to LaSalle by MMA as fraudulent transfers of property of the debtor (Doctors Hospital), because the purported transfers of its healthcare receivables to

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<sup>1</sup> *Paloian*, 2010 WL 3363596, at \*1–2; *In re Doctors Hospital of Hyde Park, Inc.*, 360 B.R. 787, 798–804 (Bankr. N.D. Ill. 2007).

<sup>2</sup> While HPCH was the nominal borrower under the Nomura Loan, neither HPCH nor Doctors Hospital received or benefited from any of the proceeds, all of which went to James Desnick, the owner of Doctors Hospital. *In re Doctors Hospital of Hyde Park, Inc.*, 360 B.R. 787, 804 (Bankr. N.D. Ill. 2007).

<sup>3</sup> *Paloian*, 2010 WL 3363596, at \*1–2; *In re Doctors Hospital of Hyde Park, Inc.*, 360 B.R. at 804–819.

MMA pursuant to the Daiwa Loan were not “true sales” to a separate special purpose entity.<sup>4</sup>

LaSalle claimed that, as trustee of the securitization trust that included the Nomura Loan, it was not a proper defendant in an action to recover the payments. According to LaSalle, its role was a “mere conduit” and that the trust beneficiaries were the proper defendants as the “initial transferees” under Bankruptcy Code § 550(a)(1). LaSalle drew the analogy to cases holding that the initial transferee of money transferred by check is the holder of the account into which the check is deposited, not the bank that maintains that account. The Seventh Circuit affirmed the district court and bankruptcy court’s holdings that LaSalle was a proper defendant, reasoning that LaSalle as trustee was the legal owner of the trust’s assets (including monies received from Doctors Hospital), and therefore that it was appropriate to permit the Estate to sue LaSalle to recover any fraudulently transferred assets from the assets from the trust in one proceeding, instead of forcing the Estate to institute numerous suits to recover those assets from each of the trust beneficiaries.<sup>5</sup>

In considering the trustee’s claim that Doctors Hospital’s purported transfers of its healthcare receivables to MMA were not true sales, the bankruptcy court,<sup>6</sup> and the district court on appeal<sup>7</sup> each applied a multi-factor balancing test aimed at assessing the extent to which Doctors Hospital transferred the benefits and burdens of ownership of the healthcare receivables to MMA. Each court based its decision principally on the contribution agreement under which Doctors Hospital transferred the receivables to MMA, which provided that Doctors Hospital “relinquished ‘all right, title, and interest in and to [the receivables]’”<sup>8</sup> and expressly stated the parties’ intent that the transfer of receivables be a true sale. Relying on a law review article by Thomas Plank, a professor at the University of Tennessee College of Law and formerly of counsel to McKee Nelson (later Bingham McCutcheon), *The Security of Securitization and the Future of Security*, 25 *Cardozo L. Rev.* 1655-1741 (2004), the lower courts analyzed the question as whether the MMA was effectively organized as a special purpose entity and whether MMA should be considered an alter ego of Doctors Hospital. In affirming the bankruptcy court's decision, the district court also emphasized Daiwa’s reliance on MMA’s separateness, and the officer's certificate and legal opinion delivered in connection with the MMA financing.

On further appeal, the Seventh Circuit, in an opinion by Chief Judge Easterbrook, focused primarily on the parties’ actual conduct, as opposed to their intent as expressed in their agreement, and reversed.<sup>9</sup> Judge Easterbrook noted that in a typical true sale the purchaser makes an upfront payment to purchase assets from the seller, assumes

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<sup>4</sup> *Paloian*, 2010 WL 3363596, at \*1–2.

<sup>5</sup> *Paloian*, 2010 WL 3363596, at \*3; see *LaSalle National Bank Association v. Paloian*, 406 B.R. 299, 326–31 (N.D. Ill. 2009); *In re Doctors Hospital of Hyde Park, Inc.*, 360 B.R. at 841–45. The courts assumed that LaSalle could, as necessary, recover the payments from the trust beneficiaries.

<sup>6</sup> *In re Doctors Hospital of Hyde Park, Inc.*, 360 B.R. at 847–53.

<sup>7</sup> *LaSalle National Bank Association v. Paloian*, 406 B.R. at 336–44.

<sup>8</sup> *Id.* at 339 (quoting *In re Doctors Hospital of Hyde Park, Inc.*, 360 B.R. at 800).

<sup>9</sup> See *Paloian*, 290 WL 3363596, at \*7–\*9.

management of the assets, and makes a profit or loss, as the case may be, depending on how much value it can extract from the assets. According to the Court, MMA operated as if it were a department of Doctors Hospital. It did not have an office, a phone number, a checking account, or stationery; all of its letters were written on the Hospital's stationery. It did not prepare separate financial statements or file tax returns. The record did not indicate that MMA ever actually purchased Doctors Hospital's receivables for any particular price. Instead, MMA merely received a small portion of the proceeds of the receivables to cover its operating expenses. Moreover, Doctors Hospital continued to carry the receivables on its books and informed its other creditors that Daiwa had a security interest in the receivables, even though MMA was owned by the principal of Doctors Hospital and not by Doctors Hospital itself. The Court held that this record was insufficient to support a finding of a true sale of receivables from Doctors Hospital to MMA under its conduct-based analysis and vacated and remanded the district court's decision with instructions to remand the case to the bankruptcy court to determine whether there was a *bona fide* sale of accounts and whether "MMA Funding was more than a name without a business entity to go with it".<sup>10</sup>

This decision reinforces the importance of the parties to a structured financing transaction actually complying with the separateness covenants and other terms of the transaction documents.

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<sup>10</sup> *Id.* at \*8.