AN UPDATED PRIMER ON DEFENSES TO PREFERENCE ACTIONS

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I. **Basic Elements of a Preference**

a. The provisions of § 547 are intended to promote the fair treatment of similarly situated creditors. Section 547 is also designed to discourage creditors from racing to the courthouse to sue and obtain judgments against a financially distressed company, or take any other action to collect their claims, that would precipitate the company's filing for bankruptcy. Because of the Code's goal of treating similarly situated creditors equally, § 547 empowers a Debtor or trustee to avoid a "preferential" pre-petition transfer of the Debtor's property. After avoidance of the transfer, the property or interest transferred is recovered for the benefit of the estate.

b. Section 547(b) of the Code sets forth the essential elements of a preference:

i. any transfer;

ii. of an interest of the debtor in property;

iii. to or for the benefit of the creditor;

iv. for or on account of an antecedent debt;

v. made while the debtor was insolvent;

1. made on or within 90 days of the bankruptcy filing date, or,

2. if the transferee was an "insider" (as defined at Code §101(31)), the transfer was made within one year prior to the filing of the petition; and

vi. that enables the creditor to receive a greater percentage of its claim than the creditor would have received had the transfer not taken place and the debtor's assets were liquidated in a Chapter 7 case. 11 U.S.C. § 547(b).

II. **Elements**

a. **Transfer: Section 547(b)**

<u>Definition of Transfer</u>: Transfer means:
(A) the creation of a lien;
(B) the retention of title as a security interest;
(C) the foreclosure of a debtor's equity of redemption; or
(D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of

disposing of or parting with--
(i) property; or
(ii) an interest in property.
See 11 U.S.C. § 101(54).

b. **Debtor's Property: Section 547(b)**

i. **The transfer must be from the Debtor's assets**. The Code does not define "an interest of the debtor in property." Property of the estate is defined in Section 541(a) as "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a). The Supreme Court has interpreted the term "an interest of the debtor in property" to mean "property that would have been part of the estate had it not been transferred before the commencement of [the] bankruptcy [case]". Begier v. I.R.S., 496 U.S. 53, 58 (1990).

ii. **The earmarking doctrine**: The "earmarking doctrine" is a defense which is not provided for explicitly in the Code itself, but rather is a product of case law. This defense is based upon the idea that, when a third party loans money to a debtor for the express purpose of paying another creditor, the funds loaned never become property of the estate, and instead simply pass through the debtor as if the transfer had been made directly from the new creditor to the old creditor. The earmarking doctrine is discussed in more detail below in Article VII.

c. **Creditor's Benefit: Section 547(b)(1)**

i. **Transfer to or for the benefit of a creditor**: Creditor is defined as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." See 11 U.S.C. § 101(10)(A). A creditor also may include an entity that is subject to the sections specified in 11 U.S.C. §101(10)(B) and, under 11 U.S.C. § 101(10)(C), an entity that has a "community claim" as defined in 11 U.S.C. § 101(7).

d. **Antecedent Debt: Section 547(b)(2)**

i. **Definition of debt**: A "debt" is defined by the Code as a "liability on a claim." 11 U.S.C. § 101(12). An "antecedent debt" is one that was incurred prior to the transfer.

ii. **When a debt is incurred**: The Third, Fourth, Fifth, Seventh, Ninth and Tenth Circuits have found that the terms "debt" and "claim" are "coextensive", and because claims can arise before a debtor is legally bound to pay, debts may be incurred before the debtor is legally bound to pay. United States Trustee v. First Jersey Securities, Inc. (In re First Jersey

Securities, Inc), 180 F.3d 504, 510 (3rd Cir. 1999); Sigmon v. Royal Cake Co., Inc. (In re Cybermech, Inc.), 13 F.3d 818, 822 (4th Cir. 1994); Southmark Corp. v. Schulte Roth & Zabel (In re Southmark Corp.), 88 F.3d 311, 318 (5th Cir. 1996), cert. denied, 519 U.S. 1057 (1997); Warsco v. Preferred Technical Group, 258 F.3d 557, 569 (7th Cir. 2001); Danning v. Bozek (In re Bullion Reserve of N. Am.), 836 F.2d, 1214, 1218-19 (9th Cir.), cert. denied, 486 U.S. 1056 (1988); Gill v. Winn (In re Perma Pac. Props.), 983 F.2d. 964, 967 (10th Cir. 1992)(unpublished); but see Harrah's Tunica Corp. v. Meeks (In re Armstrong), 291 F.3d 517, 522 (8th Cir. 2002) (In the Eighth Circuit, a debt is not deemed to have been incurred until the date upon which the debtor first becomes legally bound to pay the debt.)

e. **Insolvent Debtor: Section 547(b)(3)**

i. **Definition of insolvent**: "Insolvent" is defined at 11 U.S.C. § 101(32). For entities other than a partnership or municipality, a debtor is insolvent when the sum of its debts exceeds all of its property, at a fair valuation, exclusive of property fraudulently transferred and property that may be exempted under § 522. 11 U.S.C. § 101(32)(A). The term "insolvent" is defined for a partnership in 11 U.S.C. §101(32)(B) and for a municipality in 11 U.S.C. §101(32)(C).

ii. The "insolvency" requirement is simplified by the application of a statutory presumption: Code § 547(f) contains a rebuttable presumption that the debtor was insolvent for the 90 days immediately preceding the filing of the bankruptcy petition. The presumption only operates for transfers during that 90-day pre-petition period. In order to invalidate a transfer that occurred between 90 days and one year before the filing of the petition, the debtor must definitively establish:

1. that the transferee was an "insider;" and

2. that the debtor was insolvent at the time of the transfer.

iii. **Preference Avoidance Period: Section 547(b)(4)**

1. 90 day window: Transfers made on or within the 90-day period immediately preceding the filing of the petition are subject to attack as avoidable preferences.

2. Insiders: When the creditor to or for whose benefit the transfer is made is an "insider" at the time of the transfer, transfers made between "90 days and one year before the date of the filing of the petition" are also subject to attack as avoidable preferences.

a. Definition of Insider: The term "insider" is defined under Section 101(31) of the Code. Different definitions apply for individual, corporate and partnership debtors. The definition set out in the Code is illustrative only; it is not all-inclusive. Legislative history and case law further expand upon who might qualify as an insider.

f. **Creditor receives more than would be received in a Chapter 7 liquidation: Section 547(b)(5)**

i. This element tests whether the transfer improved the creditor's position relative to the debtor's other similarly situated creditors, as measured by what such creditors would have received in a Chapter 7 liquidation of the debtor's estate. See Comm. of Creditors Holding Unsecured Claims v. Koch Oil Co. (In re Powerine Oil Co.), 59 F.3d 969, 972 (9th Cir. 1995), cert. denied, 516 U.S. 1140 (1996); Palmer Clay Prods. Co. v. Brown, 297 U.S. 227, 229 (1936); Neuger v. United States (In re Tenna Corp.), 801 F.2d 819, 821 (6th Cir. 1986).

ii. Secured creditors: Fully secured creditors are generally not in danger of being subject to avoidance actions under Section 547 since it is usually difficult in such cases to show the creditor received more than it would in a Chapter 7 liquidation. Comm. of Creditors Holding Unsecured Claims v. Koch Oil Co. (In re Powerine Oil Co.), 59 F.3d 969, 972 (9th Cir. 1995), cert. denied, 516 U.S. 1140 (1996).

III. Defenses to Alleged Preferences

Section 547(c) of the Code lists a number of exceptions to the power to avoid preferential transfers. If a transfer comes within the scope of one of those exceptions, the debtor-in-possession or trustee cannot invalidate it, even though it would otherwise qualify as a preference. These defenses are intended to encourage creditors to continue doing business with, and extend credit to, financially troubled companies.

The defenses of contemporaneous exchange, ordinary course of business, enabling loan and subsequent new value are affirmative defenses that must be pled by the defendant. Federal Rule of Bankruptcy Procedure 7008.

a. **Contemporary exchange for new value: Code § 547(c)(1)**

i. A trustee or debtor-in-possession may not avoid a transfer that (1) was intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor, and (2) which was in fact a substantially contemporaneous exchange. 11 U.S.C. § 547 (c)(1).

ii. The policy behind this defense is that it encourages creditors to continue to conduct business with a debtor. In addition, other creditors are not adversely affected by such a transfer because the debtor receives new value in exchange for the transfer. See Hall-Mark Elecs. Corp. v. Sims (In re Lee), 108 F.3d 239 (9th Cir. 1997); Harrah's Tunica Corp. v. Meeks (In re Armstrong), 291 F.3d 517 (8th Cir. 2002).

1. "New value": 11 U.S.C. § 547(a)(2) defines "new value" as "money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable . . . but does not include an obligation substituted for an existing obligation."

    a. The new value may be transferred to the Debtor from a third party.

    b. The defense is limited to the extent of the new value received by the debtor.

    c. It is not necessary that the new value go directly to the debtor. The only requirement is that the "new value" benefits the debtor. In re Jones Truck Lines, Inc., 130 F.3d 323, 327-28 (8th Cir. 1997); In re Fuel Oil Supply & Terminaling, Inc., 837 F.2d 224, 229-31 (5th Cir. 1988).

2. Intent: Whether the transaction was intended by both parties to be a contemporaneous exchange may be inferred from the nature of the transaction or from the surrounding circumstances. See Tyler v. Swiss American Securities, Inc. (In re Lewellyn & Co., Inc.), 929 F.2d 424, 428 (8th Cir. 1991); Creditors' Comm. v. Spada (In re Spada), 903 F.2d 971, 975 (3d. Cir. 1990).

3. Substantially contemporaneous: Whether a transfer is "substantially contemporaneous" is a question of fact, for which most courts look to the circumstances surrounding the transfer. Pine Top Ins. Co. v. Bank of America Nat'l Trust and Sav. Ass'n., 969 F.2d 321, 328 (7th Cir. 1992).

    a. Bounced checks: Some courts have held that this defense is inapplicable if the check in question is dishonored, regardless of the intent of the parties. See Morrison v. Champion Credit Corp. (In re Barefoot), 952 F.2d 795, 800 (4th Cir. 1991).

b. Time between receipt and clearing of check: The Fifth Circuit held in In re Locklin, 101 F.3d 435, 443 n.10 (5th Cir. 1996), that the time difference between the date the creditor receives a check and the date the check clears the debtor's bank does not defeat the defense of contemporaneous exchange – assuming the check is promptly deposited and cleared.

b. **Payments in the ordinary course of business of debtor and creditor: Code § 547(c)(2)**

i. The following is a comparison of § 547(c)(2) showing the amendments made by BAPCPA – italics are additions and strikethroughs are deleted portions (Note the amendment to the word "or" –in bold below):

(c) The trustee may not avoid under this section a transfer –
….

(2) to the extent that *such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and* such transfer was—

(A) ~~in payment of a debt incurred by the debtor~~ *made* in the ordinary course of business or financial affairs of the debtor and the transferee; ***or***

(B) made ~~in the ordinary course of business or financial affairs of the debtor and the transferee; and (C) made~~ according to ordinary business terms;

ii. Thus, the new statute reads that a trustee may not avoid a transfer to the extent that the transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of both the debtor and transferee, and such transfer was (1) made in the ordinary course of business or financial affairs of the debtor and transferee; or (2) made according to ordinary business terms. 11 U.S.C. § 547(c)(2).

1. The purpose of this exception is to protect and preserve credit transactions that are made, paid and received in the normal and ordinary custom of the debtor and the creditor.

2. The Code does not define "ordinary course of business" or "ordinary business terms."

3. Subsection (c)(2)(A) requires that the obligation that was paid with the subject transfer was incurred in the ordinary course of both the debtor's and the creditor's business.

4. Proving the ordinary course defense under pre-BAPCPA law: Prior to the enactment of BAPCPA, old Subsections (c)(2)(B) and (C) imposed two separate tests that had to both be satisfied if the transferee was to invoke the defense successfully. "Under the BAPCPA, the second and third prongs of the ordinary course defense have become disjunctive rather than, as here, conjunctive." G.H. Leidenheimer Baking Co. v. Sharp (In re SGSM Acquisition Co., LLC), 439 F.3d 233, 240 n.4 (5th Cir. 2006). Thus, defendants were required to establish not only that the payment was typical or in the ordinary course of business between the parties but was ordinary or typical in the related industry at large.

    a. While BAPCPA changed old Subsections (B) and (C) from conjunctive to disjunctive, presumably courts will continue to look to pre-BAPCPA case law to determine if a transfer meets one or the other of these subsections. But see In re National Gas Distribs., LLC, 346 B.R. 394 (Bankr. E.D.N.C. 2006) (discussed in greater detail in subsection 5, below).
    b. Subsection (c)(2)(B): This subsection is a subjective test, focusing on the relationship between the debtor and the creditor. The analysis focuses on the terms under which the payments in question were made in the preference period, including the timing and method of payment. That information is then compared to the same type of historical data predating the preference period – typically one to two years. If the transferee can show that the payment pattern in the preference period generally paralleled that in the pre-preference period, the test will be met. See Solow v. Ogletree, Deakins, Nash, Smoak & Stewart (In re Midway Airlines, Inc.), 180 B.R. 1009 (Bankr. N.D. Ill. 1995). A late payment or payment outside stated credit terms is not automatically outside the ordinary course, if the creditor had historically accepted tardy payments within the same range of "lateness." See Huffman v. New Jersey Steel Corp. (In re Valley Steel Corp.), 182 B.R. 728 (Bankr. W.D. Va. 1995). Also, many courts have found that a first-time transaction is not automatically ineligible for (c)(2) protection. See Kleven v. Household Bank F.S.B., 334 F.3d 638 (7th Cir. 2003).

i. With respect to the subjective prong of § 547(c)(2)(B), the Sixth Circuit has explained:

> With respect to subsection (B), the subjective component, the courts generally eschew precise legal tests and instead engage in a fact-specific analysis. In doing so, they examine several factors, "including timing, the amount and manner a transaction was paid and the circumstances under which the transfer was made." Late payment of a debt has been considered particularly important in determining whether the payment is ordinary. A late payment will be considered "ordinary" only upon a showing that late payments were the normal course of business between the parties.

Roberds, Inc. v. Broyhill Furniture (In re Roberds, Inc.), 315 B.R. 443, 456 (Bankr. D. Ohio 2004) (citing Logan v. Basic Distr. Corp. (In re Fred Hawes Org., Inc.), 957 F.2d 239, 244 (6th Cir. 1992)) (internal citations omitted); see also In re Sunset Sales Inc., 220 B.R. 1005, 1020-21 (B.A.P. 10th Cir. 1998) (applying a four-factor test examining (1) the length of time the parties were engaged in the transaction at issue; (2) whether the amount or form of payment differed from past practices; (3) whether the debtor or creditor engaged in any unusual collection or payment activities; and (4) the circumstances under which the payment was made).

ii. Courts have been fairly lenient in applying § 547(c)(2)(B). In two recent decisions, Bohm v. Golden Knitting Mills, Inc. (In re Forman Enters., Inc.), 293 B.R. 848 (Bankr. W.D. Pa. 2003), and Kleven v. Household Bank F.S.B., 334 F.3d 638 (7th Cir. 2003), the courts held that a payment, as part of the first transaction between the debtor and creditor, can be in the ordinary course of their business, and thereby satisfy § 547(c)(2)(B). Thus, a creditor who starts doing business with a financially distressed company shortly before the latter's bankruptcy might still be able to rely on the

§ 547(c)(2) ordinary course of business defense to shield itself from preference exposure.

c. Subsection (c)(2)(C): This section provides an objective test, looking at the typical and ordinary credit terms, and payment patterns, in the subject industry. Miller v. Fla. Mining & Materials (In re A.W. & Assoc., Inc.), 136 F.3d 1439, 1443 (11th Cir. 1998). Some courts have recognized that proof of some rigid standard in a given industry may be unrealistic, but evidence of general prevailing practices will be considered. In re Tolona Pizza Prods. Corp., 3 F.3d 1029, 1033 (7th Cir. 1993) (only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope of Subsection (c)(2)(C)).

   i. Some courts had employed a sort of sliding scale when considering both the subjective and objective prongs of Subsection (c)(2). Where the course of dealing between the parties had been longer and more well established, the objective industry standard prong would be less important, while in a relatively short pre-petition business relationship, the industry standard prong would carry greater weight. See Fiber Lite Corp. v. Molded Acoustical Prods., Inc. (In re Molded Acoustical Prods., Inc.), 18 F.3d 217, 220 (3rd Cir. 1994); Advo-System, Inc. v. Maxway Corp., 37 F.3d 1044 (4th Cir. 1994). (but see Hutson v. Branch Banking & Trust Co. (In re National Gas Distributors, LLC), 346 B.R. 394 (Bankr. E.D.N.C. 2006)).

   ii. In recent years, the objective test, requiring proof that payment was made "according to ordinary business terms," has assumed greater importance, with many courts emphasizing the need for proof that the timing of payments were within an established industry standard. This entails identification of the relevant "industry," followed by proof of the "industry standard" as to timing of payments. The type of testimony and evidence sufficient to prove that a particular transfer was within the relevant industry standard varies widely. See e.g., Gulfcoast Workstation Corp. v. Peltz (In re Bridge Info. Sys.), 460 F.3d 1041, 1045-46 (8th Cir. 2006) (while debtor's employees may be "experts" for purpose of proving industry standard, employees did not testify that it is common in the industry to use remittance invoice notations to direct application of payments to specific invoices); In re U.S. Interactive Inc., 321 B.R. 388 (Bankr. D. Del. 2005) (rejecting expert testimony that "industry standard" was 60 days past invoice where conclusion was not supported by statistics or other objective basis); Moglia v. ISP Techs, Inc. (In re DeMert & Dougherty, Inc.), 232 B.R. 103, 111 (N.D. Ill. 1999) (preference defendant must introduce evidence of its competitors' accounts receivable and collections practices and also of the actual payment practices of its competitors' customers); Arrow Elecs., Inc. v. Justus (In re Kaypro), 218 F.3d 1070, 1075 (9th Cir. 2000) ("self-serving" testimony of defendant's employee should not necessarily be discounted in determining industry standard where there is evidence that, based upon the employee's experience, he has personal knowledge of the industry standard).

5. As previously noted, under post-BAPCPA § 547(c)(2), the ordinary course defense may now be established by proving either the payment history between the debtor and the creditor or the standards in the relevant industry.

    a. It has been suggested that the practical effect of the 2005 BAPCPA amendment to § 547(c)(2) will be the virtual elimination of the "ordinary business terms" prong of the defense. Whenever possible, defendants will be more likely to rely on the subjective test because this will not require presentation of expert testimony (i.e., the defendant can simply present its own business records showing the parties' billing and payment history).

    b. The big distinction between the current and the prior statutory provision is the substitution of the word "or" for the word "and." Presumably this will allow preference defendants to use this defense more successfully.

        i. For example, many jurisdictions require expert testimony to establish the ordinary or typical business terms between such parties in the business or industry at large. The related expense of retaining an expert was often a deterrent to asserting this defense. As modified, the statute will allow the defendant to establish that the manner of payment between the parties was typical for the parties, which should not require the use of expert witnesses. Or in the alternative, if there is little or no history between the debtor and transferee, the defendant may still be able to establish that the payments were typical for the industry at large.

ii. What has not yet been played out in the post-BAPCPA case law in many jurisdictions is what practical effect the "and" to "or" change will have on asserting the ordinary course defense. For example, it is not known whether courts will continue to apply the same standards to determine what is "ordinary" as between the parties and what is "ordinary" in a particular industry (or industries) as they did under pre-BAPCPA cases.

c. In a recent decision, Judge Small of the United States Bankruptcy Court for the Eastern District of North Carolina emphasized the change from "and" to "or" in this Subsection. See Hutson v. Branch Banking & Trust Co. (In re National Gas Distribs., LLC), 346 B.R. 394 (Bankr. E.D.N.C. 2006). Prior to the BAPCPA amendments to Section 547(c)(2), law in the Fourth Circuit was that creditor's industry was the standard for review of the ordinary business terms prong of the Section 547(c)(2) defense. Advo-System, Inc. v. Maxway Corp., 37 F.3d 1044 (4th Cir. 1994).

i. The facts of National Gas are helpful in understanding that decision. National Gas Distributors, LLC ("National Gas") had a line of credit note and a term note with Branch Banking and Trust Company ("BB&T) that both matured on December 23, 2005. On December 15, 2005, Natural Gas paid off the line of credit note of approximately $750,000. Then on December 19, 2005, it paid off its term note of approximately $2,500,000. Both notes had been guaranteed by the husband and wife who owned National Gas. Assets of the wife had been pledged as collateral for both notes.

ii. On January 20, 2006, National Gas filed a voluntary petition under Chapter 11. A Trustee was appointed in the case and he filed an adversary proceeding to recover the amounts paid to satisfy in full both notes. Since BB&T conceded that it was a customary practice for similar loans to be rolled over or extended by new loans, BB&T chose not to rely on payment in the ordinary course of business between the debtor and itself but instead, focused its defense on the "ordinary business terms" portion of amended Section 547(c)(2). BB&T submitted an affidavit of an experienced bank officer that the payments were made within ordinary business terms of the creditor's industry.

iii. Judge Small found that the changes in the law mandated a change in the analysis of ordinary business terms. The Court reasoned that what used to be a unified defense with three elements was now an "either or" defense. Since the ordinary business terms defense is separate and distinct from the ordinary course of business defense, the Court reasoned that the ordinary business terms defense now required analysis of more than just the creditor's industry to determine the effect of "ordinary business terms."

iv. In analyzing the industries of the debtor and the creditor and sound business practices in general, the <u>National Gas</u> court reasoned that it was not sound business practice and not within ordinary business terms for a debtor to pay off the notes as in this case (even if at or near maturity) with no provision made for continued funding of the operations of its business. In this case, the Court observed that the payments effected a full satisfaction of corporate debt that had been both guaranteed and collateralized by assets of its individual principals. The Court held that the payments were not made according to ordinary business terms and were not the type of transfers that the ordinary business term defense is designed to protect.

v. The court determined that both the creditor and debtor industries and "general business standards that are common to all business transactions in all industries" must be taken into account under the ordinary business terms defense. National Gas at 404. The Court noted that "[m]any courts have observed many times that the purpose of the ordinary course of business defense is to 'leave undisturbed normal financial relations, because it does not detract from the general policy of the section to discourage unusual action by either the debtor or its creditors during the debtor's slide into bankruptcy." National Gas at 404 (quoting Union Bank v. Wolas, 502 U.S. 151, 160 (1991)). Further, if the "'ordinary business terms' defense only requires examination of the industry standards of the creditor, there would be no review or check on the debtor's conduct." National Gas at 404.

vi. In response to the supposed reduced burden on creditors to establish a defense to a preference attack after the BAPCPA amendments, the Court in National Gas presents a sobering analysis. In courts that follow the National Gas decision, a creditor attempting to establish an ordinary business terms defense will have to establish satisfactory evidence of the creditors' and debtors' industries and standards applicable to sound business practices in general to win.

c. **Enabling Loans: Code § 547(c)(3)**

i. Section 547(c)(3) of the Code protects from avoidance a transfer of a security interest in property acquired by the debtor to the extent that the security interest secures new value given by a secured party to enable the debtor to acquire the property. The security interest must be perfected on or before 30 days after the debtor received possession of the property. Note that BAPCPA changed the grace period to perfect in § 547(c)(3)(B) from 20 days to 30 days.

ii. Section 547(c)(3) protects a transfer creating a security interest in property of the debtor (A) to the extent the security interest secures new value that was: (i) given at or after the signing of a security agreement that contains a description of such property as collateral; (ii) given by or on behalf of the secured party under such agreement; (iii) given to enable the debtor to acquire such property; and (iv) in fact used by the debtor to acquire such property; and (B) that is perfected on or before 30 days after the debtor receives possession of such property. 11 U.S.C. § 547(c)(3).

iii. Most courts that have considered the issue have agreed that a purchase-money security interest that is not sheltered under the enabling loan defense of § 547(c)(3) cannot have alternative shelter under the contemporaneous exchange defense of subsection (c)(1). See Pongetti v. GMAC (In re Locklin), 101 F.3d 435, 443 (5th Cir. 1996); Wachovia Bank and Trust Co. v. Bringle (In re Holder), 892 F.2d 29, 31 (4th Cir. 1989); Union Bank & Trust Co., Erie v. Baker (In re Tressler), 771 F.2d 791, 794 (3d Cir. 1985); Gower v. Ford Motor Credit Co. (In re Davis), 734 F.2d 604, 607 (11th Cir. 1984).

iv. However, the courts are divided in the application of § 547(c)(3) to non-purchase money security interests. See Ray v. Sec. Mut. Fin. Corp. (In re Arnett), 731 F.2d 358, 363 (6th Cir. 1984) (limiting secured creditor's ability to argue transfer of security interest was a contemporaneous exchange under Section 547(c)(1) to the grace period for perfection under Section 547(e)(2)); Collins v. Greater Atlantic Mortgage Corp. (In re Lazarus), ___ F.3d ___, 2007 U.S. App. LEXIS 388 (1st Cir. Jan. 9, 2007) (following the reasoning of Arnett); but see Pine Top Ins. Co. v. Bank of America Nat'l Trust & Sav. Ass'n, 969 F.2d 321, 328-29 (7th Cir. 1992); Dye v. Rivera (In re Marino), 193 B.R. 907, 915 (B.A.P. 9th 1996), aff'd, 117 F.3d 1425 (9th Cir. 1997) (each declining to follow Arnett and adopting a more "flexible" approach when determining whether the transfer of a non-purchase money security interest is substantially contemporaneous).

d. **Subsequent extensions of new value: Code § 547(c)(4)**

i. The Bankruptcy Code, through Section 547(c)(4), provides a defense to an otherwise avoidable transfer where the creditor, "after such transfer," provides new value to the debtor (A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor. 11 U.S.C. § 547(c)(4).

ii. "[The subsequent advance] defense aims to protect creditors who have furnished and been paid for ongoing supplies or revolving credit to a debtor in distress, because such transactions fortify the debtor's business and may avert bankruptcy. At worst, the extensions of new value do not harm existing creditors." G.H. Leidenheimer Baking Co., v. Sharp (In re SGSM Acquisition Co., LLC), 439 F.3d 233, 241 (5th Cir. 2006). Section 547(c)(4) only applies to transfers where, after receiving subsequent new value from the creditor, "the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor." Id. at 242 n.7. A transfer subject to another § 547(c) defense is an "otherwise unavoidable" transfer for the purposes of the subsequent advance defense. As a result, "new value on account of which [otherwise unavoidable] payments were made cannot be used by the [creditor] under § 547(c)(4)". Id. (quoting Tenn. Valley Steel Corp. v. Rockwood Water, Wastewater, & Natural Gas Sys. (In re Tenn. Valley Steel Corp.), 201 B.R. 927, 941 (Bankr. E.D. Tenn. 1996). "Stated another way, if a payment is otherwise unavoidable under § 547(c), then the new value immediately preceding that payment cannot be used anywhere for the purposes of the subsequent advance defense; taking the subsequent new value deduction prior to a transfer defended under § 547(c) is double dipping." Id. at 242 n.7.

iii. In discussing the limitation on "double-dipping" with respect to assertion of the subsequent new value defense, the Fifth Circuit stated "[a] creditor is allowed to assert alternative defenses in attempting to ward off the bankruptcy trustee. However, with respect to an individual payment made by the debtor during the preference period, a creditor can only benefit from one § 547(c) defense; if the subsequent advance defense is utilized, a creditor cannot attempt to support part of the same payment as being in the ordinary course of business." G.H. Leidenheimer Baking Co., v. Sharp (In re SGSM Acquisition Co., LLC), 439 F.3d 233, 242 n.7 (5th Cir. 2006). See also Tenn. Valley Steel Corp. v. Rockwood Water, Wastewater, & Natural Gas Sys. (In re Tenn. Valley Steel Corp.), 201 B.R. 927 (Bankr. E.D. Tenn. 1996) for a thorough and careful analysis of attempted "double-dipping" by a creditor with a valid ordinary course defense to payments which the debtor had made on account of the subsequent new value extended. [For a more detailed discussion of the impermissibility of "double dipping" see Article V, infra.]

iv. The exception requires that after receipt of the preferential transfer, the preferred creditor must advance additional credit to the debtor on an unsecured basis. 11 U.S.C. § 547(c)(4)(A). Thus it appears that the reservation of a security interest does not preclude netting of new value against a preference unless the new value is subject to a security interest that is valid and enforceable at the time of the bankruptcy.

v. New value can only be applied retroactively, i.e., it can only be applied backwards to shield a prior payment, not forward to protect a subsequent transfer. Tenn. Valley Steel Corp. v. Rockwood Water, Wastewater, & Natural Gas Sys. (In re Tenn. Valley Steel Corp.), 201 B.R. 927, 940 (Bankr. E.D. Tenn. 1996).

vi. Payments need not be made directly to the debtor to constitute new value; also qualifying are payments made for the benefit of the debtor. In determining whether a creditor has extended "new value" to a debtor, a court should focus on whether the debtor's estate has been materially benefited – not on detriment or harm to the creditor.

vii. Several years ago, a number of courts held or indicated that new value must remain unpaid, regardless of whether the payment on account of the new value was "otherwise unavoidable". See e.g., New York City Shoes, Inc. v. Bentley Int'l, Inc. (In re New York City Shoes, Inc.), 880 F.2d 679 (3rd Cir. 1989); In re Prescott, 805 F.2d 719, 731 (7th Cir. 1986); In re Bishop, 17 B.R. 180 (Bankr. N.D. Ga. 1982). Recently, however, most courts addressing the issue have employed the plain meaning of the statute, and no longer rely on a general rule that new value must unconditionally remain unpaid, instead determining whether the transfer of payment on account of the new value extension of credit is "otherwise unavoidable." See e.g., Hall v. Chrysler Credit Corp. (In re JKJ Chevrolet, Inc.), 412 F.3d 545 (4th Cir. 2005); Mosier v. Ever-Fresh Food Co. (In re IRFM, Inc.), 52 F.3d 228 (9th Cir. 1995); In the Matter of Toyota of Jefferson, Inc., 14 F.3d 1088, 1092-93 (5th Cir. 1994); Jones Truck Lines v. Central States (In re Jones Truck Lines, Inc.), 130 F.3d 323 (8th Cir. 1997); Hechinger Inv. Co. of Del., Inc. v. Universal Forest Prods., Inc. (In re Hechinger Inv. Co. of Del., Inc.), 326 B.R. 282 (Bankr. D. Del. 2005), aff'd, 339 B.R. 332 (D. Del. 2006); In re Kroh Bros. Dev. Co., 930 F.2d 648, 653 (8th Cir. 1991).

e. **Floating Liens: perfected security interest in inventory and receivables: Code § 547(c)(5)**

i. No preference will be avoidable if the transfer created a perfected security interest in the debtor's inventory or receivables, except and to the extent that the creditor "improves his position" (i) during the preference period or (ii) from the date during the preference period on which new value was given under the security agreement. Basically, a preference exists to the extent there is any reduction during the 90-day period of the amount by which the initial existing debt exceeded the security.

1. Floating Lien: A "floating lien" is a lien or security interest in a mass of collateral, the individual components of which change over the life of the security interest.

2. The defense applies only to secured creditors with security interests in inventory and accounts receivable.

3. Valuation of the secured creditor's collateral is the key to a successful defense under Section 547(c)(5). The method of valuation should generally be determined on a case-by-case basis, depending upon the facts and circumstances in the case. Wilson v. First Nat'l Bank, Lubbock, Texas (In re Missionary Baptist Found. Of Am., Inc.), 796 F.2d 752, 761-62 (5^{th} Cir. 1986).

4. Two-point net improvement test: The test to determine the extent the creditor's position was improved requires the establishment of two computation dates: (1) (i) 90 days before the filing of the petition, (ii) one year before the filing of the petition for an insider creditor, or (iii) the date during the preference period on which the creditor gives new value under the security agreement creating the security interest, and (2) the date of the filing of the petition. For each date, the difference between the amount owed and the value of the collateral, i.e., the "deficiency," must be computed. "A comparison is made, and, if there is a reduction during the 90 day period of the amount by which the initially existing debt exceeded the security, then a preference for section 547(c)(5) purposes exists." Samson v. Alton Banking & Trust Co. (In re Ebbler Furniture & Appliances, Inc.), 804 F.2d 87, 90 (7th Cir. 1986).

f. **Statutory liens: Code § 547(c)(6)**

i. The fixing of a statutory lien that is not avoidable under § 545 cannot be avoided as a preference. 11 U.S.C. § 547(c)(6).

g. **Alimony, Maintenance or Support: Code § 547(c)(7)**

i. Section 547(c)(7), as amended by BAPCPA, provides that a transfer may not be avoided "to the extent such transfer was a *bona fide* payment of a debt for the domestic support obligation."

h. **"De minimis" Transfers in Consumer Cases: Code § 547(c)(8)**

i. The trustee may not avoid a transfer "if, in a case filed by an individual debtor whose debts are primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than $600." 11 U.S.C. § 547(c)(8).

i. **Small preferential transfers in business cases: Code § 547(c)(9)**

i. The trustee may not avoid a transfer "if, in a case filed by a debtor whose debts are not primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than $5,000". 11 U.S.C. § 547(c)(9).

IV. **Section 547(e) Governs When a Transfer is Made**

a. Section 547(e) sets out when various types of transfers are made for the purpose of applying the avoidance powers of Section 547. While Section 547(e) dictates when a transfer occurs for preference purposes, state law generally determines

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when the transfer is perfected. 5 Collier on Bankruptcy ¶ 547.05[2] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2006).

b. **Transfer not made until debtor acquires rights: Section 547(e)(3)**

i. "For purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred." 11 U.S.C. § 547(e)(3).

c. **Made when perfected: Section 547(e)(2)**

i. Section 547(e)(2) sets out rules regarding the timing of the perfection of a transfer and such timing's effect on the time the transfer is deemed to have occurred under Section 547. 11 U.S.C. § 547(e)(2). A transfer of real property is perfected when a bona fide purchaser of the property from the debtor cannot acquire an interest superior to the transferee. 11 U.S.C. § 547(e)(1)(A). A transfer of property, other than real property, is perfected when a creditor on a simple contract cannot acquire a judicial lien superior to the transferee. 11 U.S.C. § 547(e)(1)(B).

1. Increase in grace period under BAPCPA: Pursuant to BAPCPA, the perfection grace periods have been increased from 10 to 30 days. As amended, a transfer is now deemed made at the time such transfer takes effect between the transferor and the transferee if perfected at or within 30 days after such time, except as provided in subsection (c)(3)(B) (regarding perfection of purchase money security interests). 11 U.S.C. § 547(e)(2)(A).

2. Transfers not perfected within the grace period: Under Section 547(e) as amended by BAPCPA, if a transfer is not perfected at or within 30 days after the transfer takes effect between the transferor and the transferee, the transfer will be deemed to have been made at the time the transfer is perfected. 11 U.S.C. §547(e)(2)(B).

3. No perfection: A transfer is deemed to have been made immediately before the petition date if such transfer is not perfected by the later of (1) commencement of the case or (2) 30 days after transfer takes effect between the transferor and the transferee. 11 U.S.C. § 547(e)(2)(C).

V. Double-dipping

a. "Double-dipping" is the practice whereby a creditor attempts to apply a second § 547(c) defense to a particular payment after having successfully invoked the subsequent advance defense as to the same payment. The practice is prohibited in bankruptcy. See Mosier v. Ever-Fresh Food Co. (In re IRFM, Inc.), 52 F.3d 228, 233 (9th Cir. 1995); In re Toyota of Jefferson, Inc., 14 F.3d 1088, 1092-93 (5th

Cir. 1994); G.H. Leidenheimer Baking Co., v. Sharp (In re SGSM Acquisition Co., LLC), 439 F.3d 233, 242 n.7 (5th Cir. 2006).

b. "[A] creditor cannot receive a windfall or double benefit. If subsequent new value given by a creditor is paid with a subsequent advance from the debtor and this payment is subject to another affirmative defense (such as ordinary course of business, for example) which would make the payment 'otherwise unavoidable,' then the paid new value given cannot be used as an affirmative defense to any prior preferential transfer." Roberds, Inc. v. Broyhill Furniture (In re Roberds, Inc.), 315 B.R. 443, 472-73 (Bankr. S.D. Ohio 2004); see also In re Toyota of Jefferson, Inc., 14 F.3d 1088, 1092-93 (5th Cir. 1994).

c. Right of set-off as double dipping?: At least two cases have touched on whether a new value defense can be defeated by a creditor's pre-petition set-off rights. Specifically, the question raised by this situation is whether set-off rights arising upon a creditor's shipment of goods and accrual of a receivable when the creditor owes a debt to the debtor constitutes an "otherwise unavoidable security interest". See In re Comptronix Corp., 239 B.R. 357, 360 (Bankr. M.D. Tenn. 1999); Gulfcoast Workstation Corp. v. Peltz (In re Bridge Info. Sys.), 460 F.3d 1041, 1046 (8th Cir. 2006). The Comptronix court determined that the existence of such a set-off right did not preclude use of the subsequent new value defense because (a) the debtor "did not make" the unavoidable transfer, because the setoff itself was not a transfer, and (b) the limitation applies when the creditor has a security interest, not when the creditor has some other type of lien (such as a right of set-off). [Note that the Code's definition of "security interest" is a lien created *by agreement*. 11 U.S.C. § 101(50) (emphasis added).] The Bridge decision, while not deciding the issue, does seem to raise the possibility that a court could decide the issue differently. In re Bridge Info. Sys., 460 F.3d at 1046, n.6. ("Double dipping occurs in this context when a creditor uses the debtor's unpaid, prepetition invoices both to offset the creditor's prepetition liability to the debtor under Bankruptcy Code § 553 and to establish new value to a preference action under Bankruptcy Code § 547.").

VI. "Mere Conduit" and "Initial Transferee"

a. Under § 550, preferential transfers can be recovered from an "initial transferee" or an immediate or mediate transferee of an "initial transferee." Subsections 550(a)(1) and (2) permit the trustee to recover from the initial transferee or the entity for whose benefit the transfer was made or subsequent transferees. Note that "or" as used here is not exclusive, so it would appear that the trustee or debtor-in-possession can recover from any combination of the entities mentioned above subject to the limitation of a single satisfaction. 11 U.S.C. § 550(d).

b. Thus, a plaintiff in an avoidance action may recover from the initial transferee. If there is not an affirmative good faith defense, then § 550(a) allows recovery from the subsequent transferees as well. 11 U.S.C. § 550(b)

c. The trustee can theoretically recover from both the initial transferee of the debtor and any subsequent transferee, as well as from any entity for whose benefit the transfer was made – but the trustee's right to do so is limited by §§ 550(b), (c), (d) and (e).

d. The Code does not define the terms "initial transferee," "immediate transferee," and "mediate transferee." Several circuit courts have adopted a "control" or "conduit" test to determine whether the recipient of an avoidable transfer of assets is an "initial transferee." Generally, the party who receives a transfer of property directly from the debtor is the initial transferee. However, many courts have found that a party acting merely as a conduit who facilitates the transfer from the debtor to a third party is not a "transferee" and, therefore, not the initial transferee. Rather, these courts have held that the minimum requirement of status as a "transferee" is dominion and/or control over money or other assets. 5 Collier on Bankruptcy ¶550.02[4][a] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2006).

e. <u>"Dominion," "Control" or "Dominion and Control"?</u>

   i. The various Circuits which have found a mere conduit exception to the definition of "initial transferee" have adopted either the "dominion" test, the "control" test or the "dominion and control" test to aid in determining whether a transferee is an initial transferee.

   ii. The Seventh Circuit has adopted the "dominion" test, in which the court looks to the ability of the transferee to use the funds transferred as he or she sees fit, without being compelled to use the funds in a particular manner. <u>Bonded Fin. Servs., Inc. v. European Am. Bank</u>, 838 F.2d 890 (7th Cir. 1988). The most common example of this is a bank that takes a deposit on instruction to apply the funds to a third party's account. <u>See also</u> <u>Universal Serv.Admin. Co. v. Post-Confirmation Comm. of Unsecured Creditors of Incomnet Communications Corp. (In re Incomnet, Inc.)</u>, 463 F.3d 1064 (9th Cir. 2006) (applying the "more restrictive" dominion test and holding that, where a non-profit agency charged with carrying out the FCC's statutory mandate to collect certain telecommunications fees that are to be pooled and distributed to support rural and high-cost telecommunications needs collects those fees, takes legal title to such fees, and distributes those fees in accordance with certain requirements established by the FCC, that agency is an initial transferee).

iii. The Eleventh Circuit has adopted the "control" test, whereby the court looks at the transaction as a whole to determine if the transferee actually controls the funds, or if they are instead controlled by the transferor or the ultimate transferee. Nordberg v. Societe Generale (In re Chase & Sanborn Corp.), 848 F.2d 1196 (11th Cir. 1988). The Eleventh Circuit has since stated that under this test, a recipient of an avoidable transfer is an "initial transferee" if such recipient exercises legal control over the assets received, such that the recipient possesses the right to use the assets for its own purposes and is not a mere conduit for the assets that are under the actual control of the debtor-transferor or the real "initial transferee". Andreini & Co. v. Pony Express Delivery Servs. Inc.), 440 F.3d 1296, 1300 (11th Cir. 2006). The Eleventh Circuit further noted that this test takes on special significance where the recipients of avoidable transfers are agents or fiduciaries of the debtor-transferor, such as banks or insurance brokers, who are duty-bound to take limited actions with respect to received funds.

iv. Other Circuits have combined the two tests, denominating them the "dominion and control test" and generally citing to both the above cases. See e.g., In re Southeast Hotel Props. Ltd. P'ship, 99 F.3d 151 (4th Cir. 1996); Bailey v. Big Sky Motors, Ltd. (In re Ogden), 314 F.3d 1190, 1202 (10th Cir. 2002); Christy v. Alexander & Alexander of N.Y., Inc. (In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey), 130 F.3d 52 (2nd Cir. 1997); Sec. First Nat'l Bank v. Brunson (In re Coutee), 984 F.2d 138 (5th Cir. 1993); First Nat'l Bank of Barnesville v. Rafoth (In re Baker & Getty Fin. Servs., Inc.), 974 F.2d 712 (6th Cir. 1992).

f. Fiduciaries or agents are often not considered "initial transferees" because their legal control over the transferred assets is circumscribed by their legal duties to their clients. However, the Eleventh Circuit noted that even if entities have special legal relationships with the debtor-transferor, such entities can still be considered "initial transferees" when they do, in fact, take legal control of an avoidable transfer (i.e., when these entities receive assets directly from the debtor-transferor as compensation for services or in payment of a genuine debt). Thus, in these situations, the fiduciary or agent exercises legal control over the transferred assets, which immediately become its assets and are not simply held for its client's purposes. As a result, the Eleventh Circuit concluded that the pivotal analysis under the "control test" concerns the recipient's legal rights and obligations with respect to the transferred assets, and not just the recipient's legal relationship with the transferor or the ultimate use of the assets. Andreini & Co. v. Pony Express Delivery Servs. Inc., 440 F.3d 1296 (11th Cir. 2006).

g. Courts are not constrained to use of the "mere conduit" rule in order to recover a preference from a subsequent transferee. The Eleventh Circuit Court of Appeals, in IBT International Services., Inc. v. Northern (In re International Administrative

Services Inc.), joined other courts in holding that a trustee or debtor-in-possession need not first avoid a transfer as against the initial transferee in order to avoid and recover transfers to subsequent transferees. 408 F.3d 689 (11th Cir. 2005). By its language, § 544(b) indicates that a transaction must first be avoided before a plaintiff can recover under § 550. The International Administrative Services court found it necessary to read this language to mean only that the transfer must be avoidable in order to recover under Section 550, particularly in situations where the "mere conduit" rule could not be used to determine that a subsequent transferee should be deemed the "initial" transferee (for example, when the true initial transferee is not an innocent party, but rather is complicit in a scheme to transfer funds multiple times in an attempt to shield them from the transferor's creditors, as was the case in International Administrative Services.)

h. Pursuant to § 550 of the Code, a trustee may recover transfers avoided under §§ 547, 548, and 549 from the initial transferee or the entity for whose benefit the transfer is made. In order to qualify as a mere conduit, courts have found that a defendant must lack control over the transfers such that the payment "simply passed through its hands and it had no power to redirect the funds to its own use." Golden v. Guardian Life Ins. Co. of Am. (In re Lenox Healthcare, Inc.), 343 B.R. 96, 103 (Bankr. D. Del. 2006). In other words, if the transferee is not under any contractual or other obligation to use transfers for the benefit of others but may use the funds freely, it does not qualify as a mere conduit so as to not be liable for avoidance and recovery of transfers.

i. Those serving administrative or "conduit" roles with respect to third parties should be certain that their contractual relationship with customers sets forth specifically the terms of this role and, to the extent that any portion of their compensation originates with the customer, that the customer's obligation is either secured or held to a consistent ordinary course payment schedule. Second, in prosecuting preference actions on behalf of the estate, trustees should take pains to investigate and plead not just the transfers originating from the debtor, but also the nature and extent of the relationship of the debtor with the transferee.

VII. Earmarking

a. **The earmarking doctrine**: The "earmarking doctrine" is a defense which is not provided for explicitly in the Code itself, but rather is a product of case law. The earmarking doctrine applies when a third party lends money to a debtor for the specific purpose of paying a selected creditor. Under the earmarking doctrine, the payment from loan proceeds is not a preferential transfer because the third party lender is simply substituted for the original creditor. See In re Heitkamp, 137 F.3d 1087, 1089 (8th Cir. 1998).

   i. This doctrine provides that the debtor's use of borrowed funds to satisfy a pre-existing debt is not deemed a transfer of property of the debtor, and therefore, it is not avoidable as a preference. This is based on the premise that the property "transferred" in such a situation was never property of the debtor and so the transfer did not disadvantage other creditors. Thus, if a third party provides funds for the specific purpose of paying a creditor of the debtor, the funds may not be recoverable as a preferential transfer because the funds never become part of the debtor's estate. "When new funds are provided by the new creditor to or for the benefit of the debtor for the purpose of paying the obligation owed to the old creditor, the funds are said to be 'earmarked' and the payment is held not to be a voidable preference." McCuskey v. Nat'l Bank of Waterloo (In re Bohlen Enters., Ltd.), 859 F.2d 561, 565 (8th Cir. 1988) (footnote omitted).

b. **Requirements that must be met in order to apply the earmarking doctrine as a defense to a preference action**:

   i. agreement between debtor and new creditor that the new funds will be used for repayment of antecedent debt,

   ii. performance of the agreement according to its terms, passing the consideration to the old creditor,

   iii. debtor's lack of dispositive control of transferred property, and

   iv. the transaction viewed as a whole must not result in any depletion of the debtor's estate. Steinberg v. NCNB Nat'l Bank of North Carolina (In re Grabill Corp.), 135 B.R. 101 (Bankr. N.D. Ill. 1991).

c. The courts are divided on the applicability of earmarking as a defense to a voidable preference action in a "refinance" situation where the new lender is tardy in perfecting its security interest in accordance with § 547(e). Compare Vieira v. Anna Nat'l Bank (In re Messamore), 250 B.R. 913 (Bankr. S.D. Ill. 2000) (denying the use of earmarking doctrine to protect perfection of a security interest outside the grace period provided under Section 547(e)); Collins v. Greater Atlantic Mortgage Corp. (In re Lazarus), ___ F.3d ___, 2007 U.S. App. LEXIS 388 (1st Cir. Jan. 9, 2007) (same) with In re Heitkamp, 137 F.3d 1087, 1089 (8th Cir. 1998).

d. There are limits to what will qualify as an appropriate "earmarking" to prevail over the trustee or debtor-in-possession.

   i. First, the new creditor's claim may have at most the same priority as the debt it replaced. "Where a debtor transfers a security interest to the new creditor in return for the loan, the payment is voidable to the extent of the value of the collateral transferred by the debtor." Adams v. Anderson (In re Superior Stamp & Coin Co., Inc.), 223 F.3d 1004, 1008, n.3 (citing In re Kelton Motors, Inc., 97 F.3d 22, 28 (2nd Cir. 1996)). If a new secured creditor loans money to be used to satisfy the lien of an existing secured creditor, the resulting payment is probably not avoidable: (a) under the "earmarking doctrine;" or (b) due to the trustee's inability to prove the "fifth element," i.e., that the payment was more than the old secured creditor would have received on its secured claim. See In re Heitkamp, 137 F.3d 1087, 1089 (8th Cir. 1998).

ii. At least one case has evaluated the scenario where a "new creditor" was repaid with the very money it loaned to repay another creditor when the old creditor had its debt paid from another source. In re McDowell, 258 B.R. 296 (Bankr. M.D. Ga. 2001). When the new creditor was sued, it was unable to use the earmarking doctrine since its loan proceeds never went to pay the old creditor's debt and instead only repaid the new creditor's debt. Note however, that the McDowell court turned to the doctrine of constructive trusts to determine that the proceeds were not property of the debtor because the debtor only had limited rights to the funds.

iii. Some courts will only apply earmarking to situations in which a guarantor or co-debtor provides funds to pay a debt, arguing that a major policy argument for earmarking (i.e. that the payor may be required to pay twice on the same debt, once when it provides the funds to pay the debt, and then again if it remains liable as a guarantor) only exists in such a context. See Peters v. Wray State Bank (In re Kerst), 347 B.R. 418 (Bankr. D. Colo. 2006); Manchester v. First Bank & Trust Co. (In re Moses), 256 B.R. 641 (B.A.P. 10th Cir. 2000) (arguing that the doctrine undermines the policy goals of Section 547 because it actually prefers the old creditor and harms the new).

VIII. Allowance of a Claim as a Defense to Preference Actions

a. Several decisions have held that the allowance of a claim precludes the trustee or debtor-in-possession's from later asserting a preference action against the claim-holder.

i. LaRoche Indus., Inc. v. Gen. Am. Transp. Corp. (In re LaRoche Indus., Inc.), 284 B.R. 406 (Bankr. D. Del. 2002).

1. The Laroche court held that Section 502(d) of the Bankruptcy Code "stands for the proposition that if a claim is allowed there is no longer a voidable transfer due from that claimant." Id. at 409.

2. The court based its holding upon the Court's reading of Katchen v. Landy, 382 U.S. 323 (1966), interpreting Section 57(g) of the

Bankruptcy Act, reading that case to mean that an objection to a proof of claim and a preference claim must be decided at the same time. The Court further reasoned that it is "inequitable to allow a debtor to object to a claim while concealing a cause of action for a preference." Id. at 410.

ii. Caliolo v. Azdel, Inc. (In re Cambridge Indus. Holdings, Inc., 2003 Bankr. LEXIS 794; 50 Colliers Bankr. Cases 2d 731 (Bankr. D. Del. July 18, 2003).

1. In Azdel, Judge Lloyd King, relying on LaRoche, ruled that a "preference dispute must be resolved in tandem with the claim objection." Id. at *4. In this case, the preference action was actually filed prior to the claim objection; however, the objection was resolved first.

b. Other courts, including the United States District Court for the District of Delaware, have disagreed with the reasoning of Laroche, instead finding that allowance of a claim does not preclude a later preference suit against the claimant.

ii. TWA, Inc. Post Confirmation Estate v. City and County of San Francisco Airports Comm. (In re TWA Post Confirmation Estate), 305 B.R. 221 (Bankr. D. Del. 2004)

1. In a case before Judge Peter J. Walsh, the defendants moved to dismiss a preference adversary proceeding brought against it by arguing that 11 U.S.C. §502(d) precluded the avoidance action because the defendants' claims had been previously approved by a stipulated order and the preference action had not been raised at that time. The defendants relied on LaRoche, which had allowed the relief sought by them on similar facts.

2. Judge Walsh noted that a split of authority existed in that other courts had rejected the LaRoche holding and determined that a preference action was not barred by §502(d) after a claim was allowed to the defendant. Judge Walsh followed the courts that had rejected LaRoche, reasoning that in large chapter 11 cases, there is often a need to complete the claims review and objection process before undertaking a preference analysis. If section 502(d) was given a preclusive effect it could be detrimental to the chapter 11 process. See Peltz v. Gulfcoast Workstation Group (In re Bridge Info. Sys., Inc.), 293 B.R. 479 (Bankr. E.D. Mo. 2003) and Rhythms Netconnections, Inc. v. Cisco Sys., Inc. (In re Rhythms Netconnections, Inc.), 300 B.R. 404 (Bankr. S.D.N.Y. 2003); See also Homeplace of Am., Inc. v. Salton, Inc. (In re Waccamaw's Homeplace), 325 B.R. 524, 535 (Bankr. D. Del. 2005)

ii. Caliolo v. Saginaw Bay Plastics, Inc. (In re Cambridge Indus. Holdings, Inc., 2006 U.S. Dist. LEXIS 7939 (D. Del. March 2, 2006).

1. In a preference action from the same case and court as Azdel, the District Court reversed the bankruptcy court decision and rejected the reasoning of LaRoche and Azdel. The court held that the trustee's failure to raise a preference objection to the creditor's claim under Section 502(d) did not bar the trustee's right to prosecute a preference action under Section 547. The District Court found that Katchen, interpreting Section 57(g) of the Bankruptcy Act, did not support the finding by the Azdel court that a trustee waived the right to prosecute a preference action because he had failed to raise a preference objection to a proof of claim.

2. A trustee may fail "to raise the §502(d) shield, he does not thereby drop the sword sheathed in §547." Saginaw at *9-*10.

3. The District Court dismissed the reasoning in LaRoche and Azdel as flawed. The Court found that a failure to waive a §502(d) objection at the time a claim is allowed did not grant a windfall to the creditor by then prohibiting a later preference action to be prosecuted against it.

IX. Waiver of Avoidance Actions through Plan Confirmation

a. Browning v. Levy, 283 F.3d 761 (6th Cir. 2002).

i. The language of the debtor's confirmed plan contained a reservation of rights for the debtor to "*enforce any claims, rights, and causes of action that the Debtor or its bankruptcy estate may hold against any person or entity, including, without, limitation, claims and causes of action arising under section 542, 543, 544, 547, 548, 550, or 553 of the Bankruptcy Code*." (emphasis added) Id. 774-75. Following the general rule that confirmation of a plan constitute a final judgment, and based upon this reservation of rights language in a liquidating plan that the Court characterized as too broad, Browning held that such language was insufficient to preclude the effect of *res judicata* to bar post-confirmation cause of action. Most prior decisions had focused the preclusion of prosecuting causes of action post-confirmation to situations where the plan proponent had purposely failed to disclose the existence of a cause of action for the benefit of such party and the detriment of other parties, including, without limitation, creditors of the debtor. This decision extends the preclusive effect beyond the reasoning of most prior decisions. See D&K Props. Crystal Lake. v. Mut. Life Ins. Co. of New York, 112 F.3d 257 (7th Cir. 1997).

ii. The Sixth Circuit decision examined the elements required for *res judicata* and found they were all present. The Court reasoned that *res judicata* bars not only the parties to the bankruptcy case but also other parties in privity with them. However, the Court concluded that that *res judicata* would not apply if a claim was expressly reserved in the earlier proceeding. Browning at 771-75. The Court rejected the reservation language as insufficient to defeat the application of *res judicata* because it failed to state the factual basis for any purported cause of action to be reserved and failed to sufficiently identify the target parties.

iii. The Sixth Circuit rejected an argument that the claims were also barred by judicial estoppel because the Court reasoned "judicial estoppel is inappropriate in cases of conduct amounting to nothing more than mistake or inadvertence." Id. at 776.

iv. Browning has been cited by many courts and followed by some courts. See Official Comm. of Unsecured Creditors of Crowley, Milner & Co. v. Callahan (In re Crowley, Milner & Co.), 299 B.R. 830 (Bankr. E.D. Mich. 2003). It has been criticized or distinguished by other courts. See e.g., Katz v. I.A. Alliance Corp. (In re I. Appel Corp.), 300 B.R. 564 (Bankr. S.D.N.Y. 2003), aff'd 104 Fed Appx. 199 (2d Cir. 2004) (unpublished) (discussed below).

b. Katz v. I.A. Alliance Corp. (In re I. Appel Corp.), 300 B.R. 564 (Bankr. S.D.N.Y. 2003), aff'd Katz v. I.A. Alliance Corp. (In re I. Appel Corp.) 104 Fed. Appx. 199 (2d Cir. 2004) (unpublished).

i. The Katz Court rejected a limited specificity requirement and found more persuasive cases allowing a more general reservation of claims language for a plan. The court reasoned that it was impractical to require detail on every potential claim or objection of the debtor in a plan. The Court noted that requiring specificity could require lengthy pre-confirmation investigations that could delay confirmation of a plan to the detriment of creditors. See also Alary Corp. v. Sims (In re Associated Vintage Group, Inc.), 283 B.R. 549 (B.A.P. 9th Cir. 2002); In re Worldwide Direct, Inc., 280 B.R. 819 (Bankr. D. Del. 2002); and In re Ampace Corp., 279 B.R. 145 (Bankr. D. Del. 2002).

X. Preference Considerations in Connection With Sale of Claims

a. Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.), 340 B.R. 180 (Bankr. S.D.N.Y. 2006). Fleet National Bank held claims against Enron as of the commencement of its bankruptcy case. Fleet subsequently transferred such claims and they were ultimately transferred to the defendants.

The debtor, relying on a pending adversary against Fleet, objected to Fleet's transferred claims based upon §502(d). The defendants move to dismiss the debtor's action and argued, among other grounds, that (a) they had not received any avoidable transfers and (b) they were entitled to the good faith defense of §550. The bankruptcy court examined the relationship of §§502(d) and 550 and denied the motion to dismiss. The court determined that a transfer of a claim did not dispossess the debtor of the right to seek disallowance of that claim pursuant to §502(d) even if no determination had yet been made on whether an avoidable transfer existed. Further, the court found that the good faith defense in §550 did not protect a transferee of a claim that was otherwise subject to be disallowed pursuant to §502(d). The court reasoned that the defendants in purchasing claims against the debtor did not receive property that was subject to an avoidance action so they could not avail themselves of the protections of §550(b).

b. Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.), 333 B.R. 205 (Bankr. S.D.N.Y. 2005). In the same adversary proceeding but in a separate opinion, the debtor sought, among other relief, to equitably subordinate Fleet and other creditors' claims. Fleet had transferred its claims to other parties. Those parties moved to dismiss the equitable subordination claim on the grounds that such relief under §510(c) required inequitable conduct by the claim holder. The bankruptcy court denied the motions to dismiss and held that: (a) equitable subordination pursuant to §510(c) could be used to subordinate other claims held by a creditor and was not limited to claims involving the inequitable conduct and (b) that equitable subordination as a remedy followed the claim and could be used to subordinate such claim even if it had been transferred to another party. This decision held that subordination could be allowed even where the defendant paid value for the transferred claims and did not itself engage in any inequitable conduct.

c. On September 5, 2006, the United States District Court for the Southern District of New York (Southern District Court) granted the defendants' and intervenors' motions for leave to appeal both the disallowance opinion and the subordination opinion. See Enron Corp. v. Springfield Associates, LLC et. al. (In re Enron Corp.), 2006 U.S. Dist. LEXIS 63223 (S.D.N.Y., September 5, 2006). The claims involving Fleet and its related transferees were subsequently settled; however, it appears that the issues continue on appeal in the Southern District Court between Enron and other parties.

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