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From the Bankruptcy Courts: The Earmarking Defense to Preference Actions: The Requirements of the Bohlen Decision

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THE EARMARKING DEFENSE TO PREFERENCE ACTIONS: THE REQUIREMENTS OF THE *BOHLEN* DECISION

A trustee in bankruptcy carries out one of the primary principles of the Bankruptcy Code—the equal distribution of the debtor's property among creditors—by recovering voidable preferences under Section 547 of the Code.[1] Among other requirements, a payment is a voidable preference only if it involves a transfer of the *debtor's* property. Occasionally, a trustee seeking to avoid a preferential payment is met by the evolving "earmarking"[2] defense; that is, the funds used to pay the old debt were recently advanced by a new lender for the sole purpose of paying the old debt and, therefore, such funds never became the *debtor's* property. As the Court of Appeals for the Fifth Circuit had stated: "[I]f all that occurs in a 'transfer' is the substitution of one creditor for another, no preference is created because the debtor has not transferred property of his estate; he still owes the same sum to a creditor, only the identity of the creditor has changed."[3]

Facts of the Case

In *In re Bohlen Enterprises, Ltd.*,[4] a case involving a bizarre set of facts, the earmarking defense confronted the trustee. The debtor was engaged in a retail office equipment business and, in April 1986, owed two separate obligations to the National Bank of Waterloo, both secured by a single security agreement. One obligation was a short-term inventory loan of $189,000 dating from November 1985, and the other was a longstanding arrangement for an open line of credit in the amount of $125,000.

In late April 1986, the bank insisted that the overdue $189,000 obli-

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[1] 11 U.S.C. § 547.

[2] See *Black's Law Dictionary* (5th ed. 1979), which defines "ear-mark" as "a mark put upon a thing to distinguish it from another. . . . Property is said to be *earmarked* when it can be identified or distinguished from other property of the same nature."

[3] Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351, 1356 (5th Cir. 1986).

[4] 859 F.2d 561 (8th Cir. 1988), *rehearing denied* (Feb. 17, 1989).

gation be repaid by the end of the month. In an effort to satisfy the bank, the president of the debtor, Bohlen, applied to John Deere Community Credit Union for a $200,000 loan. He disclosed to the credit union the debtor's $125,000 obligation owed to the bank but failed to disclose its $189,000 obligation. He told the credit union that if it provided the $200,000 loan, $125,000 of the proceeds would be used to repay the $125,000 obligation to the bank, and the rest would be used for miscellaneous purposes. The credit union agreed to those arrangements.

The credit union's formal approval of the loan did not occur until May 1, 1986, but the credit union determined on April 30, 1986, that the loan would be granted and opened a "share draft account"[5] in the debtor's name. Bohlen was given blank share drafts to use in drawing on the share draft account. The court of appeals observed that the opening of the share draft account on April 30, the day before the approval and funding of the loan, "was a critical fact in the rather bizarre series of transactions which followed."[6] The transcript did not disclose why the account was opened prior to the approval and funding of the loan or why the debtor was given the blank share drafts before there was any money in the account.

On April 30, 1986, Bohlen "purported to utilize and draw upon the share draft account despite the fact that on that date it had nothing in it."[7] On that day, he issued a share draft on that account in the sum of $192,000, payable to the bank, and deposited it in the debtor's checking account at the bank. Immediately thereafter, Bohlen wrote and delivered three checks drawn on the debtor's checking account at the bank, each payable to the bank, totaling $191,777.21. One check was for $189,000 to repay the principal of the larger debt, one was for $1,708.77 representing interest on that loan, and the third was for $1,068.50 to pay the interest on the $125,000 obligation. The principal of $125,000 remained unpaid. All three checks collectively constituted the transfer that was later alleged to be a voidable preference.

The court of appeals stated that "the conclusion is inescapable that Mr. Bohlen on his own had decided to pay off the $189,000 obligation to the bank, which he was being pressured to return at once, and to leave the $125,000 obligations unpaid. . . ."[8] Bohlen expected the $191,777.21 share draft to be made good by the credit union's depositing the entire $200,000 of loan proceeds in the share draft account so that he could draw freely on the

[5] "The record does not disclose the exact nature of a 'share draft account' or the exact nature of a 'share draft.' So far as we can determine they are indistinguishable from the usual bank checking account and the usual form of checks used in connection with such an account." *Id.* at 562 n.1.

[6] *Id.* at 562.

[7] *Id.*

[8] *Id.* at 563.

account as he saw fit. The credit union, however, apparently surprised Bohlen by depositing only $74,931.50 of the loan proceeds in the share draft account.

The remainder of the new loan was funded on May 1 by the credit union's issuance of a check for $125,068.50 jointly payable to the debtor and the bank. The credit union apparently intended the joint payee check to be endorsed by the debtor and delivered to the bank to pay off the $125,000 obligation as Bohlen had promised. If the check was indorsed and turned over to the bank, the bank would clearly use it as repayment of the $125,000 loan, and this action would leave Bohlen without funds to cover the outstanding check used for the unauthorized payment of the $189,000 obligation. "Mr. Bohlen was apparently unable to resolve that dilemma and the joint payee check was never negotiated."[9]

Playing for Time

Without further action on his part, Bohlen's plan to pay the $189,000 obligation without disclosing that debt to the credit union was doomed to failure; only $74,931.50 was available to cover the $191,777.27 share draft that he had written, and he could not use the remaining $125,000 of new loan proceeds because that was embodied in the joint payee check. His need was for another $125,000, which, when added to the $74,931.50, would cover the share draft. Thus, on May 2, 1986, at 8:05 A.M., utilizing a drive-through window at the credit union, Bohlen purported to deposit into the debtor's share draft account at the credit union a check for $125,000 that he wrote on the debtor's checking account at the bank, an account with no funds in it. The court of appeals characterized this scheme as "a desperate check-kiting scheme in which Mr. Bohlen was playing for time"[10]

Although the $125,000 check deposited in the share draft account eventually was dishonored, the $192,000 share draft deposited in the checking account cleared the credit union's normal electronic process during the night on May 1 and was paid. The court summarized the state of affairs at that time:

> As of Monday, May 5 then, the picture was as follows: The credit union and the debtor had made a deal for a new $200,000 loan to the debtor with the credit union stipulating that $125,000 of the proceeds be used to retire the debtor's $125,000 obligation to the bank, the only obligation of the debtor to the bank known to the credit union. Through the share draft account, the credit union had advanced $192,000. None of that money had been used to pay the $125,000 obligation. Instead, the bulk of the money was used to pay the $189,000 obligation which was still unknown to the credit union.[11]

[9] *Id.*

[10] *Id.*

[11] *Id.*

Bank's Defense

On July 21, 1986, the debtor filed a voluntary petition for relief under the Bankruptcy Code, and thereafter the trustee instituted an adversary proceeding against the bank, asserting that the three checks written by Bohlen on April 30 totalling $191,777.27 in favor of the bank constituted voidable preferences under Section 547(b) of the Bankruptcy Code.[12] The bank's defense was that the entire sum of $191,777.27 was protected from treatment as a voidable preference by the doctrine of "earmarking" or, in the alternative, that, under Section 547(b)(5), it did not receive a greater sum that it would have received in a chapter 7 liquidation. The alternative defense was premised on an assumption that the bank (1) was a secured creditor and (2) had a right of setoff under Section 553 of the Bankruptcy Code.

The court of appeals reviewed the findings of the bankruptcy judge,[13] who had held that $125,068.50 of the $191,777.27 was not a voidable preference because of earmarking and, rejecting all of the bank's other defenses, held that the trustee was entitled to recover $66,708.77 from the bank as a preferential transfer. Both sides had appealed to the district court, which had affirmed the bankruptcy court's decision.[14]

Before the court of appeals, the trustee again argued that the application of the earmarking doctrine to any of the funds was an error of law. The bank contended that the doctrine should be extended to protect the entire $191,777.27 and pressed its alternative defense that it had a right to retain the entire sum under Section 547(b)(5) because it would have received at least an equal sum in a chapter 7 distribution. As to the latter assertion, the bank no longer pressed its claim as a secured creditor. The assertion was solely premised on the right of setoff.

Court of Appeals' Decision

Addressing the merits of the case, the court of appeals indicated that

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[12] Section 547(b) provides:

(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition; or

(B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under Chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

[13] See 78 Bankr. 556 (Bankr. N.D. Iowa 1987).

[14] See 91 Bankr. 486 (Bankr. N.D. Iowa 1987).

Section 547(b) began with a threshold requirement that a voidable preference must involve a "transfer of an interest of the debtor in property,"[15] and if such a transfer was involved, the trustee had the right to set it aside as a voidable preference if it satisfied all the requirements set for in Sections 547(b)(1)–547(b)(5). A dispute existed only as to the requirement of Section 547(b)(5), but the court of appeals held its decision as to that requirement in abeyance until it had dealt with the major dispute. "[The] threshold requirement [is] that the transfer being attacked be a transfer of an interest of the debtor in property."[16]

Application of Doctrine

The court of appeals, focusing on the question of whether the earmarking doctrine was properly applied to any of the funds in the case, first considered the origins and rationale of the doctrine and its various applications. "The earmarking doctrine is entirely a court-made interpretation of the statutory requirement that a voidable preference must involve a 'transfer of an interest of the debtor in property'."[17] Examining the history of earmarking, the court found that neither the former Bankruptcy Act nor the present Bankruptcy Code defines "property of the debtor," leaving the definition of the term entirely to the courts. The court then began to explain the earmarking concept by listing the players involved:

> In every earmarking situation there are three necessary dramatis personae. They are the "old creditor", (the pre-existing creditor who is paid off within the 90-day period prior to bankruptcy), the "new creditor" or "new lender" who supplies the funds to pay off the old creditor, and the debtor.
>
> 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.[18]

Application to Guarantors

The court of appeals noted that the earliest enunciation of the earmarking doctrine occurred in cases where the new creditor who provided the new funds to pay off the old creditor was also obligated to pay that prior debt. In essence, the new creditor was a guarantor, such as a surety, a subsequent indorser, or a straight contractual guarantor.

In instances where the guarantor paid the debtor's obligation directly to the old creditor, courts did not view such payment as a voidable preference because the payment did

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[15] Bohlen Enterprises, Ltd., 859 F.2d at 564.

[16] *Id.*

[17] *Id.* at 565.

[18] *Id.* See *id.* at n.8 of the court's opinion: "In the beginning the term 'earmarking' was not used. That nomenclature was apparently used for the first time in this context in *Smyth v. Kaufman*, 114 F.2d 40 (2d Cir. 1940)."

not constitute a transfer of the debtor's property and there had been no diminution of the debtor's estate. "[T]he new funds and new debt were equal to the preexisting debt and the amount available for general creditors thus remained the same as it was before the payment was made."[19] The court also noted a possible additional rationale for the development of the earmarking doctrine in guarantor situations: the avoidance of unfairness and inequity to the guarantor. "If his direct payment to the old creditor was voided, and the money was ordered placed in the bankruptcy estate, the new creditor, as guarantor, would have to pay a second time."[20]

Where the guarantor entrusted the new funds to the debtor with instructions to use them to pay the debtor's obligation to the old creditor, the courts logically reached the same result. Continuing its historical discussion, the court of appeals observed:

> In this later type of case [i.e., payment to the debtor with instructions to pay the old creditor], the courts have been willing to overlook the fact that the method chosen by the guarantor to pay off the old creditor was one in which the debtor was given some control of the new funds. . . . In some instances the language used has been that the debtor was holding the new funds "in trust" or in a "fiduciary capacity." In other cases the courts have said they would not let form control over substance. . . . Finally, as in the direct payment situations, almost every opinion emphasizes that the result involves "no diminution" in the debtor's estate.[21]

Extension of Doctrine

The court then observed, with apparent disapproval, that the earmarking doctrine has been extended to situations in which the new creditor was not a guarantor but merely loaned funds to the debtor to enable the debtor to pay an older creditor.[22] "The equities in favor of a guarantor or surety, the risk of his having to pay twice if the first payment is held to be a voidable preference, are not present where the new lender is not a guarantor himself. Yet the courts, without much detailed analysis of the differences, have routinely made the extension to nonguarantors."[23]

The court further observed that where there was no guarantor the earmarking doctrine helped neither the debtor nor the new lender. The new creditor is actually harmed by the earmarking doctrine because, as a general creditor, recovery must

[19] Bohlen Enterprises, Ltd., 859 F.2d at 565.

[20] *Id.*

[21] *Id.* at 565-566. The court noted that the term "earmarking" was "probably devised as a synonym for these terms." *Id.* at 565 n.9.

[22] "As a matter of first impression, it would seem that the doctrine should not have been so extended." *Id.* at 566.

[23] *Id.* But see *In re* International Club Enterprises, Inc. 109 Bankr. 562 (Bankr. D.R.I. 1990) (limits earmarking doctrine to situations in which the funds transferred were based on a guarantee or similar obligation).

come from the debtor's estate, which had been diminished to the extent that the payment made to the old creditor could not be recovered as a preference. Observing that the only person to benefit from the doctrine is the old creditor who had nothing to do with earmarking the funds and who, in equity, deserves no such benefit, the court could see no basis for preferring the old creditor to another who was paid with nonearmarked funds.

Application of Doctrine

Despite the court's uneasiness with the development of the earmarking doctrine, it found that it was not necessary in this case to decide whether use of the doctrine in nonguarantor situations "should not be preserved, limited, or even rejected entirely."[24] The court observed that, regardless of whether a nonguarantor advanced the funds, the instant case involved an improper extension of the earmarking doctrine beyond situations in which it had previously been employed. The court of appeals enunciated three requirements that have to be met before a transaction will qualify for the earmarking doctrine:

1. The existence of an agreement between the new lender and the debtor that the new funds will be used to pay a specified antecedent debt;
2. Performance of that agreement according to its terms; and
3. The transaction viewed as a whole (including the transfer in of the new funds and the transfer out to the old creditor) does not result in any diminution of the estate.[25]

In the instant case, the court found that the second requirement had not been met since the proceeds of the credit union's new loan was not used to pay the $125,000 obligation. Although there were two debts to be paid, payment of the larger debt was not within the agreement of the parties. The court then went beyond its own requirements and stated: "Even if we apply the frequently invoked test of whether the debtor had 'control' over the funds provided by the new lender, the instant facts nevertheless require a holding that a voidable preference has occurred. One cannot conceive of greater or more telling 'control' of the new funds by the debtor than to have the debtor use them for its own purposes and in violation of its agreement with the new lender."[26]

The bankrupcty court apparently recognized that its decision involved a new extension of the earmarking doctrine based on general equitable principles. The bankrupt-

[24] Bohlen Enterprises, Ltd., 859 F.2d at 566.

[25] *Id.* "Where a guarantor pays the old creditor directly, the requirement of an agreement between the new lender-guarantor and the debtor is inapplicable. For the reasons discussed *supra*, no voidable preference can exist even in the absence of a specific agreement." *Id.* at 566 n.11.

[26] *Id.* at 567.

cy judge noted that a court of equity should "look through form to substance" and should "act to achieve the intended result [of the parties]."[27] The bankruptcy judge commented that failure to follow these equitable principles in extending the earmarking doctrine in this case would "result in unjust enrichment to the estate and the general creditors."[28]

The court of appeals did not agree that extending the earmarking doctrine to these facts was required by equitable principles. The recovery of any preference adds to the funds of the estate and to the general creditors' dividends, but this activity has never been viewed as "unjust enrichment" of anyone. Additionally, application of the earmarking doctrine would not achieve the parties' "intended result" where none of the parties contemplated the debtor's bankruptcy, the unwinding of transactions, and the division of the estate. "Moreover, the bank's only intention was that its $189,000 loan would somehow be repaid, regardless of the source of the funds."[29] Finally, the new pay off of the $189,000 debt and not the $125,000 obligation was not the result intended by the new lender. "Equity does not require a court to construct a hypothetical transaction which did not occur in order to allow what is really a preference to remain in the old creditor's hands."[30]

Bank's Alternative Argument

The bank's alternative argument was that, even if the earmarking doctrine did not apply, the entire sum of $191,777.27 was not a voidable preference because, under Section 547(b)(5), the bank did not receive more than it would have obtained in a chapter 7 liquidation. This contention was based on an alleged right of the bank to set off the entire payment against the debtor's total debt to the bank. The court below had rejected this defense on three separate grounds, but the court of appeals found it necessary to turn only to Section 553(a)(3), which allows a setoff "except to the extent that . . . (3) the debt owed to the debtor by such creditor was incurred by such creditor . . . . (c) for the purpose of obtaining a right of setoff against the debtor." The court held that the right of setoff was inapplicable and that, therefore, the payment to the bank was a voidable preference. The court of appeals reversed the judgment below and remanded it for further proceedings in conformity with its opinion (i.e., the complete turnover of the total amount of $191,777.27).

Dissenting Opinion

In dissenting, Circuit Judge Theodore McMillian commented that the transfer had no effect on the assets to be distributed to the creditors because the credit union's check of $125,068.50 was written for the purpose of paying off the debtor's debt to the bank. The fact

[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] *Id.*

that this specific check was not used to pay the debtor's obligation to the bank did not alter the fact that at least $125,068.50 of the credit unions' funds that were intended to be used to pay the debtor's debt to the bank were, in reality, used for that purpose.

The dissent apparently placed no weight on the facts that there were two debts owed to the bank, that the new funds advanced were earmarked for the payment of the smaller debt, but that the funds were used in fact to pay the larger debt. The dissent relied on the earmarking standards enunciated in the treatise, *Collier on Bankruptcy*, which apparently does not expressly require strict performance of the precise terms of the new lender's agreement:

> The [earmarked funds] rule is the same regardless of whether the proceeds of the loan are transferred directly by the [new creditor] to the [old] creditor, or are paid to the debtor with the understanding that they will be paid to the [old] creditor in satisfaction of his claim, so long as such proceeds are clearly "earmarked."[31]

Interpretation of Majority Opinion

Comparing the majority's three-prong requirements for application of the earmarking doctrine and the standards set forth in *Collier on Bankruptcy*, it appears that the court of appeals was going beyond the current state of the law in restricting earmarking to those situations involving strict compliance with the new lender's agreement. Under the *Collier on Bankruptcy* test, it appears to be sufficient that the earmarked funds eventually are transferred to the old creditor, whether or not they are used to pay the specific debt contemplated by the new lender or are used in accordance with the terms of the agreement.

As is often the case, the court of appeal's decision has raised as many questions as it has answered by requiring performance of the new lender's agreement according to its terms in order to apply the earmarking doctrine. It is difficult to foresee that the *Bohlen Enterprises, Ltd.* requirements will be met unless one of the concepts of "control," "in trust," or in a "fiduciary capacity" is present. Conceivably, these concepts could be employed in determining whether there is a diminution of the estate. These concepts, however, may have been eroded as evidenced by the recent case of *In re Oliver's Stores, Inc.*[32]

Erosion of Concepts

In *Oliver's Stores, Inc.*, the debtor needed a new financing bank and arranged to substitute the old with the new upon the new bank's lending Oliver's Stores $3 million to pay the old. It was the "express understanding between the parties that the [new] loan proceeds would be used to repay the [old loan]"[33]

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[31] *Id.* at 569 (quoting 4 *Collier on Bankruptcy* ¶ 547.03 at 547-525 (15th ed. 1987)).

[32] 112 Bankr. 671 (Bankr. D.N.J. 1989).

[33] *Id.* at 678.

although the new lender "did not take any action to restrict Oliver's use of the proceeds of the [new lender's] loan."[34]

On December 29, 1986, Oliver's Stores issued a check in the amount of $2,949,000 from its checking account at the new bank payable to Oliver's Stores and deposited the proceeds of that check into Oliver's investor savings account also maintained at the new bank. On January 5, 1987, the new lender wired $3,000,010 from Oliver's investor account to Oliver's checking account with the old lender which then charged Oliver's account in full repayment of its loan.

Notwithstanding that no agreement was reached among the parties as to a direct payment to be made from the new lender to the old lender, that there were no restrictions on the use of the monies by the debtor, and that there was a transfer of the monies from a checking account to the debtor's interest bearing savings account, the court held that the funds had been earmarked because of the parties' understanding that the funds would be used to pay the old debt.

It is interesting to note that, in support of the holding that there was proper earmarking, the court cited the *Collier on Bankruptcy* as well as the *Bohlen Enterprises, Ltd.* requirements. "[T]he court finds, through the stipulation of facts, that [the old lender] satisfied all tiers of the [*Bohlen*] test. Therefore, the court finds that the January 5, 1987 payment to [the old lender] by Oliver's did not diminish or deplete the estate because the [new lender] loan funds were directly 'earmarked' for payment to [the older lender]."[35]

Conclusion

The *Bohlen Enterprises, Ltd.*, decision may be used by courts to both broaden and narrow the application of the earmarking doctrine. As evidenced by the decision in *Oliver's Stores, Inc.*, which used the *Bohlen Enterprises, Ltd.*, test to arrive at the wrong conclusion, so long as the new lender and the debtor agree that the funds will be used to pay the old debt and the funds are then used for that purpose, courts may hold that earmarking is available as a preference defense despite the fact that the debtor has control of the funds, does not hold the funds "in trust" and is not in a fiduciary role.[36] On the other hand, performance of terms of the agreement between the new lender and the debtor is required. If the "earmarked" funds are used to pay the old lender, but with regard to a debt not contemplated by the new lender, then earmarking is unavailable.

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[34] *Id.* at 675.

[35] *Id.* at 677.

[36] But see *In re* Sierra Steel, Inc., 96 Bankr. 271 (Bankr. 9th Cir. 1989) (earmarking doctrine did not apply where earmarked funds were deposited in debtor's general account and preferred creditor failed to trace the funds); New York City Shoes, Inc. v. Best Shoe Corp., 106 Bankr. 58, 61 (Bankr. E.D. Pa. 1989) ("for funds to be 'earmarked' the third party lender must exercise strict control over the distribution of the funds which it advances to the debtor").