Continued viability of "earmarking doctrine" defense to preference actions affirmed by Fifth Circuit

Cadwalader Wickersham & Taft LLP
Michele Maman Cohen

CADWALADER

USA
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In *In re Entringer Bakeries, Inc.*,1 the United States Court of Appeals for the Fifth Circuit affirmed the viability of the "earmarking doctrine" as a judicially-created defense to a preference action under section 547(b) of the Bankruptcy Code. Specifically, the doctrine provides that when a debtor pays a creditor with money from a new lender that is advanced to the debtor for the specific purpose of paying off the pre-existing debt of the first creditor, the funds never become property of the debtor and thus the payment is not a "transfer of an interest of the debtor in property" and cannot be attacked as a preference. It is immaterial whether the proceeds of the loan are transferred directly by the lender to the creditor or whether they are advanced to the debtor with the requirement that the debtor transmit the proceeds to the creditor.2 In either case, the payment to the pre-existing creditor would be afforded the equitable protection of the earmarking doctrine and would not be subject to avoidance as a preference under section 547 of the Bankruptcy Code. Although the Fifth Circuit held that the doctrine was not applicable on the facts presented, it rejected the trustee's argument that the doctrine was no longer recognized and clarified the circumstances under which this important defense may be invoked.

Factual Background

On September 29, 2000, Entringer Bakeries ("Entringer") received a loan from First Bank and Trust ("FBT") in the amount of $180,000. Interest was due monthly and principal was due at maturity on December 29, 2000. The loan was secured by a guaranty and pledge of the personal brokerage account of one of Entringer's principal owners. The purpose of the loan was to provide Entringer with short term financing until it was able to arrange for longterm financing, which would, in part, be used to repay FBT. Entringer sought long-term financing from Whitney National Bank ("Whitney"), which was to be secured by certain fixtures, machinery, equipment and a leasehold interest, and guaranteed by the Small Business Administration ("SBA"). The SBA's agreement to guarantee the loan, however, was conditioned upon Entringer receiving certain additional financing from other institutions. This condition delayed the closing on the Whitney loan until after the maturity date of the FBT Loan.3

FBT, aware of the prospective SBA-backed Whitney loan, did not issue a notice of default to Entringer following the maturity of the loan. Rather, on January 30, 2001, Entringer executed a second promissory note in favor of FBT. Once again, however, the Whitney loan did not timely close and Entringer was unable to satisfy its debt to FBT. However, FBT again refrained from issuing a notice of default upon the maturity of the loan based on its understanding that the Whitney loan was near fruition. On April 6, 2001, the Whitney loan closed, and one week later Entringer delivered to FBT a check for the outstanding principal and accrued interest.4

On May 29, 2001, Entringer filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code. The proceeding was converted to a case under chapter 7, and a trustee was appointed. The trustee liquidated the collateral securing the Whitney loan, and Whitney received $74,381.04. Moreover, acting on behalf of Entringer's creditors, the chapter 7 trustee filed an adversary proceeding against FBT, seeking to avoid the payment FBT received from Entringer as a preference under section 547(b) of the Bankruptcy Code. The central issue facing the bankruptcy court was whether the funds used by Entringer to pay FBT were a transfer "of an interest of the debtor in property." 5 The bankruptcy court held that the funds were designated by Whitney for Entringer's use to pay FBT. As a result, under the earmarking doctrine the payment was not a transfer of Entringer's interest in property except to the extent that the transfer actually diminished the estate. The bankruptcy court determined that the transfers diminished the estate by $74,381.04, the amount of the collateral pledged to secure the Whitney loan, and entered judgment for the trustee in that amount.6

The trustee appealed the bankruptcy court's decision, arguing that the payment was a transfer of Entringer's interest in property. The trustee also appealed the bankruptcy court's valuation of the collateral securing the Whitney loan. FBT cross-appealed, arguing that only a fraction of the total amount of the Whitney loan was paid to it, and thus it should be liable for only a pro rata share of the amount by which the estate was diminished, i.e. the value of the liquidated collateral. The district court affirmed the bankruptcy court's decision, and both parties appealed to the Fifth Circuit.7

Fifth Circuit's Analysis

The Fifth Circuit rejected the trustee's argument that the earmarking doctrine was no longer a recognized exception to a preferential transfer under Bankruptcy Code section 547. The trustee argued that the Supreme Court's 1990 decision in *Begier v. IRS* 8 overruled the viability of the earmarking doctrine. However, the Fifth Circuit held that the Supreme Court in *Begier* did not address the viability of the earmarking doctrine but rather only clarified what property is subject to the preferential transfer provision of section 547(b).9 The Fifth Circuit also noted the continued application of the earmarking doctrine by other circuits since the Supreme Court rendered its decision in *Begier*. Accordingly, the Fifth Circuit rejected the trustee's argument that the earmarking doctrine was no longer viable, and instead, clarified its continued application in cases where the debtor has no control over the disposition of the subject funds and the funds are not available for payment to creditors in general because they have been clearly designated for payment to one creditor in particular.

The Fifth Circuit nevertheless concluded that the earmarking doctrine could not be invoked to protect the specific transfer by Entringer to FBT.10 Because Entringer had control over the disposition of the Whitney loan proceeds and the funds had not been restricted to the specific purpose of paying off the

FBT debt, the Fifth Circuit disagreed with the bankruptcy court and district court and refused to apply the earmarking doctrine. In pertinent part, the court reasoned that because Entringer never agreed with Whitney that it would use the funds to pay off FBT, when Whitney deposited the funds into Entringer's general account Entringer obtained full control over their use and disposition. At that time, the funds became part of Entringer's estate and Entringer could have elected to use the money for any purpose.11 Thus, the later payment of the funds by Entringer to FBT diminished the estate's value. In reaching this conclusion, the Fifth Circuit relied upon a previous Fifth Circuit case, *Coral Petroleum, Inc. v. Banque Paribas-London*,12 which validated the use of the earmarking doctrine where all that occurred was the substitution of one creditor for another. Where, as here, however, the debtor had general control over the funds and could independently determine how to apply them, the earmarking exception is not triggered. Accordingly, the Fifth Circuit held that the trustee could avoid the entire payment to FBT as a preferential transfer. Having concluded that the earmarking doctrine was not applicable, the Fifth Circuit declined to reach the issue of whether the collateral securing the Whitney loan had been properly valued by the bankruptcy court. The judgment in favor of the trustee was affirmed but the original award was vacated. Instead, the Fifth Circuit rendered an award in the entire amount of the preferential transfer.13

Conclusion

Though the earmarking doctrine was found inapplicable to the facts of this case, the Fifth Circuit's decision affirms the continued viability of the doctrine as a valid defense to a preference claim. Notably, this decision highlights the importance of a contractual restriction on the debtor's use of the new funds – an informal understanding about how the debtor will use the funds is not enough to protect a transfer of funds. Rather, the funds must be unambiguously earmarked for a particular creditor and the debtor must have no general control over their disposition. Creditors who are aware that their claims will be paid off with the proceeds of a "take out" financing or other new loan should insist that this payoff be included as a condition on the debtor's use of the proceeds of the new loan, and may even want to take the extra precaution and request that the funds be paid to them directly by the new lender rather than flowing through the debtor's accounts. Although the lender in *Entringer* was unsuccessful in its earmarking doctrine defense, the Fifth Circuit's decision provides important guidance for future creditors on how to use this important defense.

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Edward J. Willey III
Corporate Counsel
Huawei Technologies (USA)