Don't Forget the Earmarking Doctrine if Your Creditor Client is Sued in a Preference Action

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Scenario: A debtor makes a payment to your client, one of its creditors, less than one year before filing for bankruptcy. This payment is known as a preference payment, under the Bankruptcy Code. After the debtor files for bankruptcy, your client is sued by the trustee of the bankruptcy estate in a preference action. Does your creditor client have a possible defense?

According to the Bankruptcy Code, when a debtor makes a payment to a creditor during the preference period, within ninety days before filing for bankruptcy, or in some cases within one year before filing, the trustee of the bankruptcy estate can bring a preference action against the creditor to avoid the debtor's payment. *See*, 11 U.S.C. § 547(b). The trustee would want to bring such an action on behalf of the bankruptcy estate because this money could be used to pay the debtor's other creditors.

If you are trying to come up with a defense for your creditor client who has been sued in a preference action, don't forget about the earmarking doctrine! Sometimes forgotten, the earmarking doctrine is a valid defense to a preference action, even though it is not specifically mentioned in the Bankruptcy Code. The earmarking doctrine was judicially-created as a defense to a preference action and is supported by case law.

So, what is the earmarking doctrine? The Bankruptcy Code states that a preference payment must involve a transfer of the debtor's property in order to be avoided by the trustee of the bankruptcy estate. *See*, 11 U.S.C. § 547(b). In an earmarking situation, the debtor makes a payment to a creditor during the preference period, prior to filing for bankruptcy, with funds provided to the debtor by another creditor. *See,* In re Bohlen Enterprises, Ltd., 859 F.2d 561, 565 (8^{th} Cir. 1988). These funds are "earmarked" for the purpose of paying a particular creditor and do not become part of the debtor's property. Bohlen, 859 F.2d at 565. Every earmarking situation contains these three players: the old creditor who is paid by the debtor within the preference period; the new creditor who provides the funds to pay the old creditor; and the debtor. Id.

There are three requirements for a transfer to fall within the earmarking doctrine: 1) there must be an agreement between the new creditor and the debtor that the funds provided to the debtor by the new creditor will be used to pay a specified debt to the old creditor; 2) the agreement must be performed according to its terms; and 3) the transaction viewed as a whole must not result in diminution of the estate. Bohlen, 859 F.2d at 566.

In addition, in order for the earmarking doctrine to apply as a defense to a preference action, the debtor must not have had control over the funds at issue. 3 Norton Bankr. L. & Prac. 2d § 57:30. In determining control over the funds, courts consider whether the debtor had physical control over the funds, whether the debtor had the ability to direct payment of the funds, and whether the new creditor restricted the debtor's use of the funds. *See,* In re Moses, 256 B.R.

641, 650 (10th Cir. 2000). It does not matter that the funds entered the debtor's account, but whether the debtor could freely disburse the funds, or whether the debtor's disbursement was limited to the old creditor pursuant to the debtor's agreement with the new creditor to pay the old creditor. *See,* In re Superior Stamp & Coin Co., Inc., 223 F.3d 1004, 1009 (9th Cir. 2000).

In conclusion, the earmarking doctrine was judicially-created and should not be forgotten if you are trying to establish a defense for your creditor client that has been sued in a preference action. However, in order for the defense to be applicable, there must have been an agreement between the new creditor and the debtor stating that the funds provided to the debtor will be used to pay the old creditor and the debtor must not have had control over the funds.

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