Earmarking Defense

1

Scaffidi v. Smith (In re Fox Bay Entm't, Inc.), 2001 Bankr. LEXIS 2362 (Bankr. E.D. Wis. Feb. 15, 2001)

2

Facts:
- May 7, 1998 -- Fox Bay Entertainment, Inc.'s ("Debtor") President (James Young) entered into an agreement with Bonnie Smith ("Defendant").
  - Defendant agreed to loan Fox Bay $50,000 for a short time.
  - Provided that "the full amount must be repaid in 90 days from the date of check or upon the closing of the sale of J.Y. Coffee Corp. (DBA - Gloria Jeans) or which ever is sooner."
  - Young signed the agreement as the President of Fox Bay Entertainment.
- July 7, 1998 – Young closed on the sale of Gloria Jeans and, from the proceeds of the sale, deposited $68,000 of his personal funds into the account of Fox Bay Entertainment.
  - Young wrote a check to the Defendant for $50,000 from Fox Bay's account, in full payment of the note.
- July 10, 1998 – The Defendant endorsed and negotiated the check three days later - July 10, 1998.

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Arguments:
- The Defendant argued that the transaction did not constitute a preferential transfer under of the earmarking doctrine.
  - The trustee failed to allege a transfer of an interest of the debtor in property.
- The Trustee argued that that earmarking doctrine did not apply because Young, did not control the funds once they were placed in Debtor's general account.
  - Payment to Defendant diminished the estate.

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Court's Decision:
- The Court looked at whether the Debtor's interest in property had been transferred.
  - Introductory element of §547(b).
  - Trustee must prove the absence of earmarking as part of his burden of proof.
- The court identified three tests used, sometimes used together, by other courts to determine if funds are earmarked:
  - 1) Looked if the Debtor lacked 'control' over the funds supplied by the new creditor.
    - Whether Debtor had physical control over the funds, and
    - Whether the Debtor had the ability to direct to whom the funds should be paid.
  - 2) Looked at the "intent" of the new creditor and the Debtor:
    - Existence of an agreement between new creditor and Debtor,
    - Performance of that agreement according to its terms, and
    - The transaction does not result in any diminution of the estate
  - 3) Applied a "diminution of the estate" test.
    - If creditors would have been able to recover from the funds but for the transfer, the estate was diminished.

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- The focus of the doctrine should not be solely on fairness to the creditor who is also personally obligated with the debtor.
- The transfer met all the standards the courts have established for earmarking:
  - Control:
    - The note showed that the funds coming from the sale of Gloria Jeans was used to pay the Defendant.
    - Control can take the form of an "understanding" between the source of the funds and the debtor as to the use of the funds.
      - Not necessary for the presence of a legal obligation for the use of the funds be in place.
  - Intent:
    - The intent of both the contributor and the corporation as to the use of the funds was clear, undisputed and identical.
    - The funds were used for the purpose of paying Ms. Smith's loan.
  - Diminution of the estate:
    - The debtor's estate was not diminished because the money would never have went into the estate had it not been targeted for this particular debt.

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Debtor Control

Vieira v. Anna Nat'l Bank (In re Messamore), 250 B.R. 913 (Bankr. S.D. Ill. 2000)

7

Facts:
- April 1996 – Green Point Credit ("GP") financed the purchase of Donald and Dena Messamore's ("Debtors") mobile home.
  - GP held a lien on its title.
- June 24, 1999 – Debtors entered into a loan transaction with Anna National Bank ("Bank") to refinance the debt to GP secured by their mobile home.
- June 29, 1999 – Bank mailed the payoff amount to GP and requested GP to forward the mobile home title directly to Bank.
- July 6, 1999 – GP released the lien on the mobile home title.
  - However, GP forwarded the title to the Debtors.
- August 25, 1999 – Bank obtained the title from Debtors and mailed it to the Illinois Secretary of State with an application that requested a corrected title showing Bank as lienholder.
  - August 30, 1999 – Secretary of State received the application.
- September 13, 1999 – Debtors filed for Chapter 7 Relief.
- Trustee brought a preference action against the Bank seeking to avoid the lien on the Debtor's mobile home.

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Arguments:
- Trustee argued the transfer was voidable because the lien was not perfected within the time period specified for precluding avoidance as preference, the Debtor's obligation to the Bank should be rendered an antecedent debt.
  - The perfection of the lien within the preference period constituted a transfer of the debtors' interest in property "on account of" the antecedent debt.
- The Bank denied that the transfer was on account of an antecedent debt.
- The Bank argued that under the "earmarking doctrine," no avoidable preference occurred in this case because the Bank's interest in the mobile home was merely substituted for that of GP (by virtue of the Debtors' refinance obligation to GP).
  - The Bank contended that there was neither a transfer of the Debtors' interest in the property nor any diminution of the Debtors' estate.

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Court's Decision:
- When a debtor borrows money from a third party to pay a specific creditor, the transfer of the borrowed funds does not constitute a preference.
  - The funds are "earmarked" for the creditor in question and are not considered property of the debtor.
  - The debtor never exercised control over the new funds and debtor's property is not diminished.
- The earmarking Doctrine had no logical relevance to the transfer at issue.
  - Debtor's transfer to the Bank did not involve the payment of funds by a third party, the payment of borrowed funds.
  - The transfer to the Bank was separate and distinct from the transfer that occurred when GP was paid with borrowed funds.
    - The transfer to GP was clearly a transfer of the Debtors' interest in property since it depended on the Debtors' grant of a security interest to the Bank.

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Adams v. Anderson (*In re Superior Stamp & Coin Co.*), 223 F.3d 1004 (9th Cir. Cal. 2000)

11

Facts:
- Superior Stamp & Coin ("Debtor") operated a full service auction house specializing in the auction of coins, sports and Hollywood memorabilia until it filed for bankruptcy in 1994.
- 1992 – Carolyn Adams ("Creditor") and Debtor entered into an auction consignment agreement.
  - Debtor agreed to auction Creditor's coin collection and pay Creditor the net proceeds within 30 days after receiving the funds.
    - Proceeds amounted to $347,125.57.
  - Debtor failed to pay Creditor.
- April 1994 – Creditor inquired about whether Debtor had remitted the auction funds.
  - Parties negotiated a repayment schedule, which called for Debtor to remit the proceeds to the Creditor in six equal payments ($62,355.00 each).
- The Bank of California ("Bank"), Debtor's largest creditor, was actively involved in Debtor's day-to-day management.
  - Debtor submitted the letter confirming the repayment schedule to the Bank.

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- May 13, 1994 – Bank and Debtor entered into a written agreement regarding consequences of Debtor's default on credit agreement with the Bank.
  - Agreement required Debtor submit monthly budgets to the bank for approval.
  - The "borrower [would] not, under any circumstances, without written approval from the bank, pay any obligations of borrower other than to bank, which [was] due prior to January 1, 1994."
- May 25, 1994 – Debtor and the Bank met to discuss procedures established by the bank for advancing funds to Creditor.
- May 27, 1994 – Debtor issued a $62,355 check to Creditor.
  - Check was subjected to a "special review" process and then approved by the bank.
  - Bank advanced the funds necessary to clear the check (full amount) and simultaneously electronically transferred the funds to Creditor.

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- July 7, 1994 – Debtor issued a second check ($62,335) to Creditor in accordance with a budget approved by the bank.
  - Bank approved the payment and advanced the funds necessary to cover the check ($19,915.90) – [Debtor already had $42,439.10]
- After the two payments, the Bank decided to no longer pay the Creditor further or authorize Superior to make any more payments to Creditor.
- August 26, 1994 – Debtor filed an involuntary petition for Chapter 11.
- Trustee sought to recover payments on the grounds they were preference payments.
- Posture:
  - The Bankruptcy court ruled that the payments to Creditor were voidable transfers because the earmarking doctrine was inapplicable.
    - Debtor (not the bank) "controlled" the borrowed funds.
      - Bank did not pay Creditor directly and Debtor requested the loan in order to pay Creditor.
  - District court affirmed.

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<u>Arguments</u>:
- Creditor conceded that the $42,439.10 paid out of the Debtor's existing funds were not subject to the earmarking exception and was voidable as a preference transfer.
- Creditor argued that the two payments (totaling $82,270.90) advanced by the bank were covered.

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<u>Court's Decision</u>:
- Court's have held that a key inquiry into the earmarking doctrine analysis was the source of control over the new funds.
  - Bankruptcy court's finding does not serve to render the earmarking doctrine inapplicable.
- The Bankruptcy Court's conclusion contravened with the Circuit court's rule applying the earmarking doctrine to cases in which "a third party lends money to a debtor for the specific purpose of paying a selected creditor."
  - Just because the Debtor may have had the power to divert the loan after it was deposited into the Debtor's account does not amount to "control" of the funds by the Debtor.
    - This application would be limited to situations where the guarantor or new creditor paid the old creditor directly.

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- The Court found that the proper inquiry was whether the Debtor had the right to disburse the funds to whomever it wished, or whether their disbursement was limited to a particular old creditor under the agreement with the new creditor.
  - Bank advanced funds for the specific purpose of paying a specific creditor.
  - Bank agreed to fund the payments to the extent necessary but only on the condition that the amounts involved be paid to Creditor.
  - Debtor was required to obtain written approval before making each payment to Creditor.
  - Debtor's actions were not "independent of" the bank.
- The two payments totaling $82,270.90 made by the bank to fund the checks to Creditor fell within the earmarking doctrine.

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<u>Intent</u>

In re Bohlen Enterprises, Ltd., 859 F.2d 561(8th Cir. Iowa 1988)

18

Facts:
- Bohlen Enterprises Ltd. ("Debtor") was a retail office equipment business.
  - Mr. William Bohlen ("Mr. B") was the president.
- April 1986 – Debtor owed two separate obligation to the National Bank of Waterloo, Iowa ("Bank").
  - Obligation 1 – short-term inventory loan in the principal amount of $189,000.
  - Obligation 2 – long-standing arrangement for an open line of credit in the principle amount of $125,000.
  - Both obligations were secured by a single security agreement.
- Late April 1986 – Bank insisted that the $189,000 obligation be repaid by the end of the month.
- Mr. B went to John Deere Community Credit Union ("Credit Union") and applied for a $200,000 loan.
  - Mr. B disclosed the debtor's $125,000 obligation to the bank but did not disclose the $189,000 obligation.
  - Mr. B stated that $125,000 would be used for the $125,000 obligation and the remaining would be used for miscellaneous purposes.
  - Credit Union agreed.

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- April 30, 1986 – Credit Union opened a share draft account in Debtor's name and gave Mr. B some blank share drafts in use in drawing on the share draft account.
  - Mr. B drew upon the share draft account (nothing was in the account at the time).
  - Mr. B. issued a share draft on the account for $192,000 payable to the bank.
    - Deposited into Debtor's checking account at the bank.
  - Mr. B wrote three checks on the Debtor's checking account at the bank for $191,777.27 (all checks payable to the bank).
    - Check 1 – For $189,000 to repay the entire principal of the Debtor's larger loan obligation
    - Check 2 – For $1,708.77 for the interest on the larger obligation.
    - Check 3 – For $1,068.50 for the interest on the Debtor's smaller obligation.
- May 1, 1986 – Credit Union approved and funded the loan.
  - Share draft of the $192,000 was cleared electronically.

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- May 2, 1986 – Mr. B realized the attempt to pay off the $189,000 was going to fail because the full $200,000 was not put at his disposal.
  - Only $75,000 was available to him to pay
  - Mr. B deposited into the Debtor's share draft account at the Credit Union, a check for $125,000 which was written on the Debtor's checking account at the bank.
    - Check was dishonored.
- May 5, 1986 – Credit Union and the Debtor made a deal for a new $200,000 loan to the debtor with the Credit Union stating that $125,000 of the proceeds be used to retire the debtor's $125,000 obligation to the bank.
  - Credit union advanced $192,000 through the share draft account.
    - Most of the money was used to pay the $189,000 obligation, which the Credit Union was unaware of.
- July 21, 1986 – Debtor filed for Chapter 11 bankruptcy petition.
- August 19, 1986 – Trustee commenced an adversary proceeding against the bank.
- Posture:
  - Bankruptcy Judge held that $125,068.50 of the $191,777.27 was not a voidable preference because of earmarking.
    - Ordered the bank to disgorge the remainder ($66,708.77).
  - District court affirmed on all accounts.

21

Arguments:
- The trustee asserted that the three checks written by Mr. B on April 30, 1986 for $191,777.27 in favor of the bank, was a voidable preference and that the sum should be disgorged by the bank and made a part of the debtor's estate.
  - Contended that the application of the earmarking doctrine to any of the funds is an error of law.
- Bank contended that the entire sum was protected by the doctrine of earmarking.
  - Bankruptcy court failed to extend the doctrine to all the funds.

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Court's Decision:
- In every earmarking situation there are three necessary personae:
  - 1) Old Creditor – the pre-existing creditor who is paid off within the preference period;
  - 2) New Creditor/New Lender – the supplier of funds to pay off the old creditor;
  - 3) 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 a voidable preference.
- Courts had extended the doctrine and applied it to situations where a new creditor is not a guarantor but merely loaned funds to the debtor for the purpose of paying the old creditor.
  - Debtor held the money in a trust
  - Did not have control of the new money

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- Court applied the "intent test" stating that the earmarking doctrine required:
  - 1) The existence of an agreement between the new lender and debtor regarding new funds being used to pay a specified antecedent debt,
  - 2) The performance of that agreement according to its terms, and
  - 3) The transaction viewed as a whole did not result in diminution of the estate.
- The instant facts demonstrate prong 2 was not met.
  - The agreement was not performed according to its terms.
- Court found that the parties failed to carry out the parties' intent.
  - The parties failed to contemplate the Debtor's bankruptcy, the unwinding of transactions, and the division of the estate.
  - The Bank's only intention was that its $189,000 loan would be repaid regardless of the source.

24

Kaler v. Community First Nat'l Bank (In re Heitkamp), 137 F.3d 1087 (8th Cir. N.D. 1998)

25

Facts:

- Scott and Darcy Heitkamp ("Debtors") built and sold homes in North Dakota.
  - Over the course of business, they borrowed money from Community First National Bank ("Bank") and maintained credit with several subcontractors.
- The Bank loaned (mortgage secured loan) the Debtors $50,000 to build a home.
- Debtors ran out of cash before completing the project.
  - November 1995 -- Debtors obtained another loan for $40,000 from the Bank.
- Bank issued cashier's checks payable to specific subcontractors who supplied goods or services to construct the house.
  - Debtor's obtained mechanic's lien waivers from the subcontractors in exchange for the checks (at the Bank's direction).

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- Debtors gave the Bank a second mortgage on the home.
  - However, due to an oversight, the Bank did not record the mortgage until March 1, 1996.
- March 4, 1996 – Debtor's filed a Chapter 7 petition.
- Trustee brought an adversary proceeding to set aside the Debtor's transfer of the second mortgage interest to the Bank.
- Posture:
  - Bankruptcy court set the transfer aside.
    - Rejected the earmarking doctrine
  - District court affirmed.

27

Arguments:

- The Bank argued that the earmarking doctrine prevented avoidance of the mortgage's transfers.

28

Court's Decision:

- The court stated that the earmarking doctrine extends to situations where "any third party paid a debt of the debtor because the payments would have no effect on the estate of the debtor."
  - The doctrine applies when a security interest is given for funds used to pay secured debts, but not when a security interest is given for funds used to pay an unsecured debt.
- The Court applied the earmarking doctrine based on the facts.
  - The Bank and Debtors agreed the secured funds would be used to pay specific pre-existing debts:
    - Before Loan – Debtors owed subcontractors $40,000 secured by the house for goods and services rendered.
    - After Loan – Debtors owed the bank $40,000 secured by the house for the cash loan used to pay the subcontractors.

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- The transfer did not diminish the amount available for distribution to the Debtors' creditors.
  - Before Loan – Debtors owed subcontractors $40,000 secured by the house for goods and services rendered.
  - After Loan – Debtors owed the bank $40,000 secured by the house for a cash loan used to pay the subcontractors.
    - Essentially, the bank took subcontractors' security interest in the home.

30

Reigle v. Mahajan (In re Kumar Bavishi & Assocs.), 906 F.2d 942 (3d Cir. Pa. 1990)

31

Facts:

- Brothers, R.K Mahajan and S.S. Mahajan ("Appellees"), were limited partners in the partnership Kumar Bayishi & Associates ("Debtor").
  - Brothers were creditors of the Debtor.
- April 1984 – Debtor applied to a Salween Financial (lending institution) for a $200,000 loan.
  - Salween insisted on receiving personal guarantees of other parties for the full amount of the loan.
- General partner of the Debtor induced the Appellee's to guarantee payment of the Salween loan.
  - General partner agreed to pay off a portion of the partnership's pre-existing debt to appellees, in the amount equal to appellee's estimated share of the exposure of personal guarantee of the loan ($33,333).

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- Six limited partners (including the appellees) were to become guarantors of the $200,000 loan.
  - Upon consummation of the loan transaction, $33,333 of appellee's pre-existing debt was repaid in exchange for appellee's personal guarantee.
    - Other limited partners received nothing for their guarantees.
- June 14, 1984 – Debtor petitioned for reorganization under Chapter 11.
  - Salween sued the guarantors and the guarantors were forced to satisfy the $200,000 loan.
    - Appellees paid approximately $41,000 each.
- Debtor's trustee commenced an adversary proceeding against the Appellees, to set aside the alleged $33,000 preferential transfer.
- Posture:
  - Bankruptcy judge dismissed the §548 claim on the grounds that the trustee failed to prove that the transaction had been accomplished with intent to hinder, delay or defraud creditors.

33

Arguments:

- Appellees argued that the funds borrowed by Salween were earmarked for payment to the appellees (guarantors).

34

Court Decision:

- The Court applied the Intent test of the earmarking doctrine.
- The Court found that the record failed to show an existence of an agreement between Salween and the Debtor that the funds be used to pay a specified antecedent debt.

35

Diminution of the Estate

Yoppolo v. MBNA Am. Bank, N.A. (In re Dilworth), 560 F.3d 562 (6th Cir. Ohio 2009)

36

Facts:
- August 22, 2005 – Jeannette Dilworth ("Debtor") used a balance transfer check drawn on her CitiPlatinum Select Card, to pay the credit card balance of $10,500 on her MBNA credit card.
  - Citi paid the entirety of Debtor's debt to MBNA.
- October 16, 2005 – Debtor filed for Bankruptcy.
- June 23, 2006 – Trustee filed a complaint to avoid the balance transfer as preferential and to recover $10,5000 from MBNA.
- Posture:
  - Bankruptcy court granted summary judgment to the Trustee.
    - Found the Debtor, not the lender, decided which creditor would receive the proceeds.
  - Bankruptcy Appellate Panel affirmed.

37

Arguments:
- MBNA contended that the Citi to MBNA transfer was not a "transfer of an interest of the debtor in property" because the funds were not property of the debtor because of the earmarking doctrine.
- Trustee argued that because CitiBank did not direct or require that the funds be paid to MBNA, the earmarking doctrine was inapplicable.

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Court's Decision:
- The Bankruptcy Court correctly held that the earmarking doctrine did not apply.
  - The funds transferred by Citi to MBNA became part of the Debtor's estate, and the transferred diminished the estate.
- The determinative factor in a diminution-of-estate analysis was the degree of control exercised by the debtor over the distribution of the funds.
  - The Debtor demonstrated significant, if not total control over the distribution of the funds when she decided to pay MBNA and not her other creditors.
    - Key fact was that the Debtor could have chose to direct the funds to other creditors.
- The Debtor's ability to direct the funds constituted a sufficient degree of control for the funds to become part of the Debtor's estate.

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Manchester v. First Bank & Trust Co. (In re Moses), 256 B.R. 641(B.A.P. 10th Cir. Okla. 2000)

40

Facts:
- 1997 – Debtor borrowed money ("First Loan") from Charles Machine Works, Inc., Employee Stock Ownership Plan and Trust ("Trust").
- August 1998 – Debtor applied for a loan from a bank stating he needed $9,700 to repay a portion of the First Loan.
  - Stated he would obtain a new loan from the Trust to repay the Bank.
- August 18, 1998 -- The Bank loaned the Debtor $9,700, on an unsecured loan basis ("Bank Loan"), with the transaction being memorialized by a promissory note ("Bank Note").
- Debtor used the Bank Loan to pay the First Loan.
- Debtor then borrowed $15,000 from the Trust ("Trust Loan") secured by his retirement trust account (valued at $66,000).
  - Debtor represented that the proceeds would be used to consolidate his debts, including the Bank Loan.
  - Requested the Trust make a check payable to Pioneer Loans (creditor), and that the balance be made payable to himself.
    - Debtor did not request that the trust issue a check payable to the Bank.

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- Three days after obtaining the Trust Loan, the Debtor paid the Bank loan in full plus interest ("Transfer").
  - Remaining trust loan proceeds were used to repay money that he had borrowed from his family and living expenses and bankruptcy fees.
- Same day as the Transfer – Debtor filed for a Chapter 7 petition.
- Trustee filed a complaint against the Bank seeking to avoid the Transfer.
- Posture:
  - Bankruptcy court granted the Trustee's motion for summary judgment.
    - Rejected the application of the earmarking doctrine stating that the doctrine did not apply if an unsecured debt ("Bank Loan") was replaced with a secured debt ("Trust Loan").
    - Earmarking doctrine was inapplicable because the Debtor had complete and unrestricted control of the funds that were transferred to the Bank.
    - Bankruptcy court refused to address the Bank's argument that the Debtor's estate was not diminished because the Trust loan was secured by the Debtor's exempt retirement account.

42

Arguments:
- The Bank argued that the Bankruptcy Court erred in refusing to apply the earmarking doctrine as to find the absence of a "transfer of an interest of the debtor in property" as required.

43

Court's Decision:
- The court found that the Transfer was a "transfer of an interest of the debtor in property" within §547(b).
  - Debtor had a legal and equitable interest in the Trust Loan proceeds, and the Transfer to the Bank diminished the debtor's estate.
  - Trust loan proceeds were no longer available to pay unsecured creditors because they had been used by the Debtor for his personal needs or to pay antecedent debts of his choosing.
- The Earmarking Doctrine was not extended beyond co-debtor cases.
  - The transfer diminished the debtor's estate because the Trust Loan proceeds that would be available to creditors were paid to one creditor (Bank).
  - Debtor's liabilities may not have changed, but the assets changed.

44

Official Comm. of Unsecured Creditors of Crystal Med. Prods, Inc. v. Pedersen & Houpt (In re Crystal Med. Prods., Inc.), 240 B.R. 290 (Bankr. N.D. Ill. 1999)

45

Facts:
- Crystal Medical Products ("CMP") was engaged in the business of developing immunoassay technology and selling medical devices.
  - CMP's largest shareholder, Oryin Nordness Jr. ("Nordness") engaged in harmful conduct to the business.
    - Grossly mismanaged CMP's assets,
    - Failed to pay payroll
    - Withheld taxes for three years and federal corporate income tax for two years,
    - Attempted to use company funds to purchase an automobile dealership, and
    - Fraudulently converted over $100,000 in company cash to personal account.
- In 1995 – CMP was evicted from its offices and operation was at a standstill.
  - Shareholders filed a derivative suit, attempted to remove the current directors and officers.

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- February 1996 – Derivative suit was settled.
  - Nordness was forced to resign from CMP's board of directors.
- New board retained P&H for a variety of matters including litigation, corporate and financing matters.
  - P&H invoiced CMP for work performed.
- To pursue financing, some shareholders of CMP formed KingCo, L.L.C. ("KingCo").
  - KingCo agreed to provide CMP with $1.2M line of credit.
  - CMP borrowed $585,000 from KingCo pursuant to a note and related security and credit agreements.
    - Loan was secured by all of CMP's assets.
  - Proceeds were distributed to vendors and service providers.
- P&H was one of the creditors paid with the loan proceeds.
  - Received two cashier's checks (totaling $100,000) and deposited them into its bank account on May 23, 1996.
    - $54,8622.75 ("Claim portion") was applied to an outstanding invoice for services performed on behalf of CMP itself, and
    - $45,137.25 ("Shareholder portion") was applied to an outstanding invoice for services performed on behalf of CMP shareholders.
- May 24, 1996 – CMP filed Chapter 11 petition.

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Arguments:
- The Committee sought Summary Judgment in the amount of $100,000.
  - Contended that Summary Judgment was warranted to the claim portion ($54,862.75) because the facts indicate that this payment was an avoidable preference.
- Committee argued that the transfers were constructively fraudulent under both the Bankruptcy code and State code.
- P&H argued that Summary Judgment was not warranted for the Claim portion transfer because the funds were earmarked.
  - Contended that the preference transfer was not an interest of the debtor's property because the funds paid to it came from a third party creditor (KingCo) who directed how the money was to be used.
  - CMP never had dispositive control over the money and therefor the money was not property of the debtor.
- P&H argued that there were issues of material fact in regards to the Committee's claim that the Shareholder portion was a fraudulent transfer.

48

Court's Decision:

- The Court used a four part test when applying the earmarking doctrine to the Claim portion:
  - 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;
  - 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; and
  - 4) The debtor lacked dispositive control over the transferred property.
- The Court found that the earmarking requirements were not all meet for the claim portion because the transaction, viewed as a whole, did result in the diminution of the estate.
  - CMP traded unsecured debt owed to P&H for secured debt owed to KingCo debt, which was secured by all of CMP's assets.
  - By obtaining a security interest in all of CMP's assets, KingCo made them unavailable to other creditors.

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- The Court looked at whether the transfer was for reasonably equivalent value.
  - General rule is that a debtor does not receive reasonably equivalent value if it made a transfer in exchange for a benefit to a third party.
    - However, the 7th Circuit affirmed a Court decision stating that it was not the case.
    - The court stated that although a guarantor may receive no direct economic benefit from a transfer, courts are willing to consider whether it received an indirect benefit.
- An indirect benefit must be "fairly concrete" to be recognized by the courts.
  - The facts indicated that CMP was on the verge of collapse when the shareholder brought suit against Nordness.
  - However, there was no evidence that showed CMP received a benefit (or value) in exchange for the transfer it made to P&H to pay for the shareholders' legal bills stemming from the lawsuit.
    - P&H had not shown that CMP received any services or property or even any indirect benefit in exchange for the transfer.

50

Indirect Benefit and Fraudulent Conveyance

51

Leibowitz v. Parkway Bank & Trust Co. (In re Image Worldwide), 139 F.3d 574 (7th Cir. Ill. 1998)

52

Facts:

- Richard Steinberg was the sole shareholder, officer and director of Image Marketing, Ltd. ("IM").
  - IM was in the commercial printing business.
- IM leased space from FCL Graphics ("FCL"), a printing company that did all of the printing for IM.
- 1992 – IM obtained a line of credit from Parkway Bank ("Bank") secured by a first lien against substantially all of IM's assets ("IM loan").
  - By June 1993 – IM had borrowed $300,000 on its line of credit.
- End of 1993 – IM was several hundred thousand dollars in debt to trade creditors.
- December 1993 – Steinberg incorporated Image Worldwide, Ltd. ("IW").
  - Steinberg was again sole shareholder, officer and director.
  - IW leased same space from FCL as IM, used same supplies, and had many of the same customers.
- Early 1994 – Steinberg liquidated IM.
  - Bank knew of the liquidation, and instead of demanding payment for loan, Bank allowed Steinberg to use the money obtained from the liquidation of IM to pay down IM's trade debts.
  - Bank never required IM to pay off its loan.

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- IM owed FCL $200,000 at the time it was wound down.
  - Bank lent $200,000 to Steinberg to pay the debt ("Steinberg loan").
    - Bank paid proceeds from this loan directly to FCL.
  - Loan secured by all of IW's accounts receive.
- Bank demanded that IW guarantee IM's $300,000 debt.
  - May 27, 1994 – IW executed the guarantee
    - Secured by a first lien on substantially all of IW's assets.
- IM debt effectively transferred to IW and IW assets pledged to Bank to cover IM debts. IW assets shipped out but what does IW get in return?
- IW fails to pay FCL and runs up debts.
- August 1995 – FCL filed an involuntary chapter 7 petition for Bankruptcy against IW.
  - Bank collected IW's accounts to pay down the debts guaranteed by IW ($444,507.55).
- July 1996 – Trustee filed an adversarial proceeding to recover the amounts transferred to Bank stating the transfers were constructively fraudulent.
- Posture:
  - Bankruptcy court found in favor of the trustee and ordered the Bank to disgorge the amounts it received from IW.
    - Determined that "a conveyance by a corporation for the benefit of an affiliate is not regarded as give fair consideration to the creditors of the conveying corporations.
  - District court affirmed.

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Arguments:
- The Bank appealed the district courts decision arguing that IW received reasonably equivalent value for its guarantees to the Bank.
  - The Bank argued that allowing IW to stay in business constituted reasonably equivalent value for IW's guarantee of IM's debt.
- The Trustee argued that the transfer made or obligations incurred for the benefit of third parties did not furnish reasonably equivalent value to the debtor.

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Court's Decision:
- The transaction that was in question was a "cross-stream intercorporate guarantee."
  - Cross-stream guarantee is when a corporation guarantees the debt of an affiliate.
    - Legitimate business transactions
  - Courts have generally loosened the old rule that transfers primarily for the benefit of a third-party give no consideration to the transferor.
    - Courts willing to look at whether a guarantor received indirect benefits from the guarantee.
- A court will not recognize an indirect benefit unless it is "fairly concrete."
- In order for the bank to prevail, they must show that the bankruptcy court clearly erred in finding that no consideration or reasonable equivalent value were given in exchange for the guarantee.

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- The court agreed with the Bankruptcy court in finding that there was no consideration for the guarantee of the IM loan.
  - Before IW signed the guarantee to repay the IM loan, the Bank had no claim against IW.
  - Under Illinois law, forbearance is sufficient consideration for a guarantee only when it is pursuant to an agreement to forbear.
  - The bank failed to allege that there was an agreement to forbear.
- Regarding the Steinberg loan, the court found that IW received an indirect benefit from the transfer but that it was not reasonably equivalent value.
  - Steinberg's testimony showed that if the loan had not been made to pay off IM's debt to FCL, FCL would have posed a substantial threat to IW.
    - Eviction, discontinue of providing services.
  - IM and IW were not two functioning corporations that benefited mutually from the same loan.
    - IM was wound down and inactive by the time IW guaranteed the Steinberg loan.
  - IW kept IM out of bankruptcy by bankrupting itself.
    - The court found that the shift of risk from the creditors of the debtor to the creditors of the guarantor was the type of situation that fraudulent transfer law sought to avoid.

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Duplication Mgmt. v. Countrywide Home Loans, Inc.,

501 B.R. 462 (Bankr. D. Mass. 2013)

58

Facts:

- The debtor was a printing manufacturer. Michael E. Jenoski was the president and sole shareholder of the debtor as well as debtor's affiliate DMI.
- Jenoski and his wife borrowed a certain amount of money from a bank. To secure the repayment of the loan, the Jenoskis granted the bank mortgage on their lake front home.
- On refinancing of the loan, the defendant bank held the note secured by the mortgage.
- The debtor was neither a co-maker nor guarantor of the note with respect to the loan. The debtor had no obligation to pay the loan obtained by Jenoskis.
- Even though the debtor was not liable to repay the loan, the debtor made monthly payments with respect to the loan. Even after the commencement of the bankruptcy case, debtor's affiliate, DMI, continued to make the loan payments until it ceased operations.

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- From December 2004 through early June 2006, the Debtor made monthly payments to the defendants with respect to the Loan in the total amount of $110,320.61. During the period commencing four years before the petition date and ending when the Note was acquired by the defendant in 2008, the Debtor made the payments each month for more than 30 months to the defendant, totaling $287,040.50. During the period from two years before the petition date through May, 2009, the Debtor made eleven payments to the defendant totaling $85,205.73.
- The defendant, Countrywide, credited each monthly payment to reduce the outstanding principal balance due on the Loan. For invoices due for the months of June 2009 through March 2010, the Debtor made ten separate payments to the defendant in the total amount of $105,221.18. The defendant credited the payments to reduce the outstanding principal balance due on the Loan.
- As per Debtor's balance sheets on the court record, at all relevant times, debtors assets never exceeded debtor's liabilities.
- The Plaintiff sought to avoid and recover the payments made to the debtors as alleged constructively fraudulent transfers under federal and state law.

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Plaintiff's Arguments:

- The Plaintiff pointed out that determination of reasonably equivalent value was a two-step process that involved consideration of direct and indirect benefits.
- Plaintiff maintained that the Debtor received no direct benefit each month in exchange for making the Mortgage payment to the Defendants because the Debtor was not a co-maker or guarantor on the Note with respect to the Loan, and had no obligation to repay it and the Defendants had admitted that they did not provide anything of value to the Debtor, directly or indirectly, in exchange for the monthly Mortgage payments.
- The plaintiff further contended that even if the defendants could show that the Debtor made each monthly mortgage payment in lieu of other compensation for Mr. Jenoski's services, and even if they could show that Mr. Jenoski's services were "concrete", the Defendants could not satisfy their burden of quantifying the value the Debtor received from those services.
- The Plaintiff also argued that at all relevant times, the Debtor was insolvent which was reflected in the Debtor's balance sheets. The liabilities exceeded the assets at all relevant times.

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Defendant's Arguments:

- The Defendants argued that the Debtor received indirect benefit in the form of Jenoski's services as Debtor's sole shareholder and president. The Defendants contented that the mortgage payments were a part of Jenoski's compensation. This indirect benefit was the value provided to the Debtor.
- Defendants argued that it was not their burden to prove that the Debtor received indirect benefit in exchange for paying the Jenoskis' Mortgage. They maintained that the Plaintiff had the burden to prove that the Debtor received no reasonably equivalent value, whether direct or indirect and also that the Debtor was insolvent.
- Defendants contended that there were factual issues for trial as to whether the Mortgage payments were in lieu of salary and whether the payments were reasonably equivalent in value to the service of Mr. Jenoski as the Debtor's president. bank.

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- Relying on their witness' testimony, the Defendants argued that the sum of the Mortgage payments represented value because the mortgage payments were in lieu of Mr. Jenoski's salary and were his employment compensation upon which he paid taxes.
- The Defendants also filed a third-party complaint against Mr. Jenoski for contribution and indemnification alleging that he received the benefit of the payments made to the Defendant bank and was therefore allegedly equally liable in this case.

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Issue:

- Whether the debtor received an indirect benefit from the transfers in the form of Jenoski's services to the Debtor which could be quantified to determine whether the Debtor received reasonably equivalent value for the transfers.

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Court's ruling:

- The Defendants could not show that the Debtor paid the mortgage for the Jenoski as part of his compensation as a shareholder. They did not submit enough evidence in support of their arguments. The court observed that the Defendants proffered no written agreement between the debtor and the shareholder as to his compensation, let alone an agreement to make the mortgage payments as part of his compensation package.
- The court dismissed the third-party complaint against Jenoski stating that the court did not have a subject matter jurisdiction to determine the allegations made in the third-party complaint. The order stated that the third-party plaintiff i.e. the Defendants in the case, could seek remedy in any competent court or go for a jury trial.
- The Plaintiff showed that debtor was insolvent at the time of the transfers to defendants for sole shareholder's mortgage payments on the lake home and the third-party defendant i.e. the debtor failed to show that it received reasonably equivalent value for the transfers.

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- While the Defendants argued that the mortgage payments made by the debtor were for services provided by the sole shareholder, they did not sustain their burden to show indirect value because the evidence provided was unconvincing and insufficient to create a genuine issue of material fact.
- Plaintiff made out prima facie case and did not have burden of disproving the defendants theories. Burden shifted to Defendant once Plaintiff made prima facie case. They failed to prove value.
- In light of the above , the court opined in favor of the Plaintiff and held that the transfers were constructively fraudulent under both federal and state law.

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Conclusion:

- If a defendant can prove an indirect benefit being provided to the Debtor in the form of services by the Debtor's principal, the courts may hold that the indirect value may be received in exchange for the alleged transfers.
- If the debtor's principal is not a party to the adversary case, the defendants may file a third-party complaint against the debtor's principal for contribution and indemnification.

67

Conduit Defense

Peachtree Special Risk Brokers, LLC v. Kartzman (In re John A. Rocco Co.), 2014 U.S. Dist. LEXIS 178043 (D.N.J. Dec. 29, 2014)

68

Facts:

- John Rocco ("Debtor") brokered and produced lines of insurance for clients and was licensed by the NJ Department of Banking and Insurance.
- Peachtree operated as a wholesale insurance broker licensed and organized in the State of Georgia.
- July 30, 2009 – Debtor and Peachtree entered into an agreement where Debtor worked for and on behalf of the insured while Peachtree worked for and on behalf of the insured.
  - First policy – Placed with Navigators Insurance Company ("Navigators") for the W5 Group and required a $100,000 premium.
  - Second Policy – Placed with Axis Insurance for the W5 Group and required a $94,500 premium.
    - Both policies ran from July 29, 2009 to July 29, 2010.

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- August 3, 2009 – Debtor wired to Peachtree a partial payment for the policies in the amount of $47,500.
  - Peachtree apportioned the transfer as $22,500 to Axis and $25,000 to Navigators.
- September 21, 2009 -- The two policies were cancelled due to non-payment of the balance owed.
- October 2, 2009 -- Peachtree mistakenly transferred $85,133.80 to Navigators (full payment of the policy)
  - Navigators refunded the portion of the premium, which was unearned as of the effective date of cancellation.
- October 5, 2009 – Peachtree transferred $18,562.50 to Axis in partial payment of the policy.
- Net effect of the two transfers:
  - Peachtree received $25,000 from Debtor and paid $21,952.45 to Navigators, and
  - Peachtree received $22,500 from Debtor and paid $18,562.50 to Axis.

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- January 22, 2010 -- Debtor wired Peachtree funds for both policies (even though policies were cancelled).
  - $70,614.50 for payment to Navigators, and
  - $67,500.00 for payment to Axis.
  - Both payments were made from Debtor's trust account and were deposited in Peachtree's own trust account.
- January 26, 2010 – Peachtree paid Navigators and Axis the balance due on both policies.
  - Both policies were reinstated.
- March 26, 2010 – Debtor filed a voluntary petition for relief under Chapter 11.
  - Trustee instituted an adversary proceeding against Peachtree to recover the payment it received from Debtor on January 22, 2010.
- Posture:
  - Bankruptcy Court rejected Peachtree's conduit defense because a creditor-debtor relationship between the transferee and debtor defeated a conduit defense.
    - Peachtree advanced payment to Axis and Navigators on the debtor's behalf and was an initial transferee.

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Arguments:

- Trustee argued that even though Peachtree forwarded the funds to Navigators and Axis, the funds were received within preference period.
- Peachtree argued that it was not an initial transferee, instead it was a mere "conduit" because it was not permitted to exercise legal control over the transferred property.
  - Peachtree stated they were unable to use the transfers for its "own purpose."

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Court's Decision:
- Courts had adopted a "dominion and control" or a "conduit" test to determine what an "initial transferee" is.
  - The test seeks to determine whether the recipient was a "mere conduit" with regard to the property or "something more."
    - The test asks whether that recipient, at a minimum, had dominion over the money or other assets, the right to put the money to one's own purpose.
- The remaining question was whether Peachtree was permitted to exercise legal control over the transfers before forwarding payments to the insurers.
  - The Bankruptcy's finding that Peachtree was permitted to exercise legal control was under incorrect factual assumptions.
- The court remanded the case so the bankruptcy court could consider Peachtree's conduit defense on the corrected record.

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Official Comm. of Unsecured Creditors v. Guardian Ins. 401 (In re Parcel Consultants, Inc.), 287 B.R. 41 (Bankr. D.N.J. 2002)

74

Facts:
- Parcel Consultants, Inc. ("Debtors") engaged in the sale of telecommunication products.
- GIAC ("Defendant") was licensed by New Jersey to authorize and sell investment products.
- May 5, 1994 – Debtor and Defendant entered into a Group Allocated Variable and Fixed Annuity Contract.
  - Defendant provided the investment vehicle for Debtor's employee 401(k) plan.
    - Defendant provided several funds in which employees could choose to invest.
  - Contributions to the 401(k) plan came from payroll deductions for each employee enrolled, and through matching contributions made by Debtor on an annual basis.

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- Defendant opened an account for each participating employee.
  - Employee contributions were allocated to specific accounted for each enrolled employee.
  - Employer contributions were allocated to each individual account based on eligibility.
- February 26, 1999 – Debtors filed a voluntary chapter 11 petition.
  - Committee sought to avoid and recover 3 pre-petition payments totaling $18,581.42.
  - Committee sought to avoid 2 post-petition payments totaling 10,279.79.
    - 4 of 5 payments represent employee payroll deductions.
- Issue -- Whether the Committee could avoid the payments made by the Debtor to the Defendant

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Arguments:
- Defendant asserted that it is not an initial transferee within the meaning of §550.

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Court's Decision:
- The Court stated that property subject to an avoidance proceeding may be recovered from an initial transferee.
  - However, where a party is a "mere conduit" of funds, recovery from that party cannot be maintained.
- Courts expanded the doctrine and defined a "mere conduit" as one who does not have control over the subject funds.
- Defendant was not an initial transferee pursuant to §550.
  - Defendant provided 8 different investment options for employees to choose from.
  - Participating employees decided how much they would invest and which investment funds their contributions would be deposited into.
  - Debtor would withhold funds from the employee's payroll and statement of withholding to Defendant.
    - Once statement received, Defendant would than distribute the funds in accordance with the contract.
  - Defendant could not exert dominion and control over the funds because it was bound by the contract terms, which granted control to the individual employees participating in the plan.
  - Defendant was not capable of using the funds for its own purpose.
    - Obligated to deposit the funds at the direction of the participants.

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Dembsky v. Frommer, Lawrence & Haug, LLP (In re Lambertson Truex, LLC), 458 B.R. 155 (Bankr. D. Del. 2011)

79

Facts:

- Lambertson Truex, LLC ("Debtor") was a designer of luxury consumer goods.
- Debtor engaged with a law firm ("Defendant") to register its "LT" trademark in various countries.
  - Defendant contacted Gilbey Delorey ("Gilbey"), a Paris-based law firm to handle the European community.
- Gilbey secured the registration in 2000 and the renewal of the registration in 2008, with Defendant acting as liaison between Debtor and Gilbey.
- November 2008 -- Gilbey sent an invoice to Defendant for $2,371.94.
- December 10, 2008 – Defendant submitted an invoice to Debtor for fees incurred in securing the European Community trademark renewal.
  - Invoice listed Defendant's fee of $77.50 for services performed, and a disbursement of $2,371.94 for "foreign associate's fee for application renewal of registration."

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- January 6, 2009 -- Defendant paid Gilbey $2,371.94 by check
- March 5, 2009 -- Debtor filed a voluntary petition under Chapter 11.
  - First Amended Plan of Liquidation provided for the creation of the LT Liquidation Trust.
  - Under the terms of the plan, Defendant held a claim against Debtor's estate for the unpaid invoice amount.
    - Court authorized Debtor or Trust to pay Defendant $367.42.
  - However, Debtor paid Defendant $2,449.44.
- November 24, 2011 – Trustee brought action to avoid and recover the transfer of $2,082.02 (excess of the amortized $367.42) as an unauthorized post-petition transfer.
- Issue – Whether the Defendant was a "transferee" for §550 purposes.

81

Arguments:

- Trustee filed a motion for summary judgment alleging that the payment was a transfer of estate property made after the commencement of the bankruptcy case and was unauthorized by the Court.
- Defendant asserted that it was not a "transferee" and thus the Plaintiff could not recover the payment.
  - Argued that it "acted as a mere conduit and was not a "transferee" for "more than 95%" of the overpayment, since all but $77.50 was for Gilbey's fee.
  - Claimed that since it had an obligation to "pass the funds along to Gilbey" and that Gilbey sent Defendant an invoice for its services shows that the Defendant acted as a mere conduit.

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Court's Decision:

- The Court adopted the "dominion and control" test for whether a party was a transferee.
- The Court found that that the mere conduit defense was not available to the Defendant under the circumstances.
  - Defendant fulfilled its obligation to pay a third party before the Debtor reimbursed them.
  - Defendant submitted an invoice to Debtor on December 10, 2008 and paid Gilbey on January 6, 2009.
  - Defendant received payment from Debtor on September 24, 2009.
    - The obligation to pay Gilbey was already extinguished since January 2009.

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- A true conduit's obligation to the transferee would not arise until the transferor paid the conduit and the amount of the obligation would depend on the amount the transferor paid to the conduit.
  - Here, Defendant's obligation to pay Gibley had already arisen, and had already been satisfied by the time the Defendant received the transfer from the Debtor.
    - This resulted in the Defendant being able to use the funds for whatever purpose it chose.
- Court granted summary judgment in favor of the Trustee.
  - Court found the Defendant to be a transferee.

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Assumed and Assigned

Kimmelman v. Port Auth. of N.Y. & N.J. (In re Kiwi Int'l Air Lines, Inc.), 344 F.3d 311 (3d Cir. N.J. 2003)

85

Facts:
- September 30, 1996 – Kiwi International Air Lines Inc. ("Debtor") filed petition for reorganization under chapter 11.
- Within the 90 days before the Chapter 11 filing, the Debtor made a number of payments to different creditors pursuant to existing arrangements that it had with those creditors:
  - 1) $1,551,000 to Port Authority of NY and NJ ("Port Authority");
  - 2) $192,555 to Sabre Group, Inc. ("Sabre"); and
  - 3) $2,148,554 to CIT Group/Capital Transportation, Inc. ("CIT")
- Debtor eventually suspended operation due to a lack of cash for daily operations.
  - Debtor resumed flight operations only after obtaining outside capital from Dr. Charles Edward who owned an entity named Kiwi International Holdings, Inc. ("KIH")
- June 1997 – Kiwi filed a motion for an order approving the sale of tis assets to KIH

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- July 18, 1997 – Bankruptcy Court approved a compromise among the parties and creditors.
  - Court entered an Order approving the settlement and the Sale Order authorizing Kiwi to sell assets to KIH.
  - Transaction resulted in the debtor's assumption and then assignment to KIH of several contracts, which it had entered into pre-petition.
    - Debtor assumed and assigned to KIH its operating agreement with the Port Authority in order to continue aircraft operations.
    - Debtor assumed and assigned to KIH the operating agreement it had with Sabre
    - Debtor assumed and assigned to KIH leases with CIT
  - Court ordered KIH to cure Debtor's existing monetary defaults under the agreements and provide adequate assurance of future performance.
- September 21, 1998 – Creditors' Committee seeking conversion under Chapter 11.
  - Court appointed a Trustee.
- April 30, 1999 – Trustee filed separate adversary proceedings against the Port Authority, Sabre, and CIT seeking to recover under §547.

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- Posture:
  - Bankruptcy Court dismissed each of the three actions following the Defendants' dismissal motions.
    - Held that the trustee could not recover the payments pursuant to agreement which the debtor later assumed and assigned to they buyer of its assets.
  - District Court affirmed the dismissal of each of the actions brought by the Trustee.
    - Since the Debtor was required to pay the Defendants all amounts in arrears in order to compel their continued performance of its agreements with the buyer, the pre-petition payments did not improve their position in the bankruptcy, and therefore were not preferential transfers.

88

Arguments:
- Defendants asserted the Trustee could not establish a prima facie case because he could not meet the requirements of §547(b)(5).
- Trustee argued that the Defendant's claims were unsecured on the filing date.

89

Court's Decision:
- §365 authorized a trustee or debtors in possession (Kiwi) to assume or reject any executor contract or unexpired lease of the debtor, subject to court approval.
  - To assume an agreement, the debtor in possession must cure defaults and provide assurance of future performance.
  - Once an assumption order is entered, creditor must perform in accordance with the terms of the assumed agreements.
    - However, courts require the debtor to cure all defaults, assure future performance, and make the other contracting party whole before it may be permitted to assume the agreement.
- The agreements were not rejected here and would not necessarily have been rejected in a hypothetical Chapter 7 liquidation.
  - Once the Debtor assumed the agreements, the Defendants were no longer unsecured creditors because the Defendants had more than a simple unsecured claim for a sum of money.
  - Instead, all the Defendants were entitled to full payment of the amounts owed under the agreement, pursuant to §365.

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Weinman v. Allison Payment Sys., LLC (In re Centrix Fin., LLC), 434 B.R. 880 (Bankr. D. Colo. 2010)

91

Facts:
- Centrix Financial, LLC ("Debtor") and the Defendant were parties to two contracts:
  – Postage Accounts Contract -- Defendant was to provide postage metering and mailing services to the Debtor.
    - Signed mid August 2003.
  – Professional Services Contract – Defendant was to provide other professional services, such as the generation of the Debtor's monthly statements.
    - Signed April 28, 2004
- The parties disputed over whether the two contracts became one integrated contract, or remained two distinct contracts.
- February 6, 2007 – Bankruptcy court issued an order authorizing the sale of the Debtor's assets.
  – Court also granted Debtor's motion to assume and assign certain executor contracts, including the "contract for generation of monthly payment statements" between the Debtor and Defendant.
- Trustee sought to avoid 9 transfers from Debtor to Defendant (totaling $518,853.41).
  – However, neither Defendant nor the Trustee matched the 9 payments to either of the contracts.
    - Only one payment (for $25,000) represented a post-petition transfer.

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Arguments:
- The Defendant raised affirmative defenses alleging that the payments cannot be recovered because they were made on executor contract that the Debtor later assumed and assigned.
  – Asserted that while there were two accounts, the Professional Services Contract incorporated the Postal Accounts Contract
- The Trustee argued that:
  – The Professional Services Contract did not integrate with the Postal Accounts Contract;
  – There was always two distinct contracts governing the two accounts;
  – The Debtors only assumed and assigned one of the contracts; and
  – There was a material ambiguity that existed as to which contract was assumed and assigned, making summary judgment inappropriate.
  – If the Court were inclined to recognize the contract assumption defense, the court should not do so in the present case because the Defendant waived the defense by failing to plead it in its Answer.

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Court's Decision:
- The court found the issue of whether there was one contract or two to be a pivotal issue.
  – If only one contract existed, then the Defenses' Contract Assumption Defense would be successful.
  – If two contracts existed, then the Court must decide which contract was assumed and therefore making all payments under the unassumed contract subject to avoidance claims.
- Based on State law, it was the court's job to examine if the two contracts were intended to be integrated based on the plain and ordinary meaning of the words in the contract.
- The court looked at the language of the Professional Services Contract because it was the later of the two.
  – The court found two operative clauses pertaining to the integration.
  – The court found that one of the clauses unambiguously provided that the Professional Services Contract subsumes the Postage Accounts Contract.

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- The Court stated that the fundamental purpose of §365 is to make the non-debtor contracting party whole upon assumption of the executor contract.
  – The court joined the majority in recognizing that Contract Assumption Defense was a complete bar to the exercise of a trustee's avoidance powers.
    - Assumption under §365 is inconsistent with recovery of payments under the avoidance power.
  – Trustee was unable to establish the necessary element of §547(b)(5)
- The Court found that the Trustee was put on clear notice of the Contract Assumption Defense and thus had a full and fair opportunity to address the purely legal defense.

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Compton v. InOcean AS (In re MPF Holding US LLC), 2013 Bankr. LEXIS 2534 (Bankr. S.D. Tex. June 21, 2013)

96

Facts:

- June 13, 2006 – InOcean entered into an agreement with Wilhelm Blystad ("First Vendor Contract").
  - InOcean agreed to provide engineering and design work related to the construction of the vessel designated by MPF Corp. Ltd ("MPF")
- Same Day – InOcean, Blystad and MPF entered into an Assignment Agreement where Blystad assigned all of his rights and obligations under the First Vendor Contract to MPF.
- December 8, 2006 – InOcean entered into another contract with MPF ("Second Vendor Contract") where InOcean agreed to provide additional engineering and design work related to the same vessel as the First Vendor Contract.

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- September 24, 2008 – MPF filed voluntary petitions for relief under Chapter 11.
  - Both contracts were listed on MPF's Schedule G under executor contracts.
- June 3, 2010 – MPF entered into an Assignment and Purchase Agreement with COSCO.
  - COSCO agreed to purchase and assume their "rights, title and interest in and to certain assets and contracts
- Trustee of MPF brought an adversary proceeding to recover alleged preferential payments made to the InOcean.
  - InOcean moved for Motion to Dismiss.
- Issue – Whether the Trustee had standing to pursue the instant preference avoidance action against InOcean.

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Arguments:

- InOcean moved for Motion to Dismiss alleging:
  - 1) MPF assumed and assigned its contract with InOcean to COSCO pursuant to §365 which barred the Trustee from pursuing a preference action against InOcean, and
  - 2) Even if the MPF did not assume and assign its contract, the preference action was nevertheless, released pursuant to MPF's confirmed plan of reorganization.
- The Trustee alleged that the assumption defense does not apply because the contract was not assumed and assigned pursuant to §365.
  - Trustee claimed that the Novation Agreement was a novation and thus precluded InOcean from asserting the contract assumption defense.

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Court's Decision:

- The Court emphasized two points:
  - 1) Parties to an executor contract may not circumvent the requirements of §365; and
  - 2) Once an executor contract is assumed pursuant to §365, the contract assumption defense bars future preference actions that seek to recover payments made pursuant to that contract.
- The Court looked at the plain language of Plan and Confirmation Order and found that the contract was assumed and assigned by the Debtor.
  - The Plan itself demonstrated that executor contracts were assumed and assigned pursuant to the "applicable novation agreements."
    - Plan: "The Debtors will assume and assign to the Purchaser all executory contracts identified on Schedule 1 to the Plan pursuant to each applicable Novation agreement."

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- The Court rejected the Trustee's argument that a party can assume and assign a party by novation and avoid §365.
  - Regardless of what the transaction was labeled, the result is the same: the original party transferred its rights and obligations under an executor contract to a third party.
- The Court concluded that the Trustee lacked standing to bring the preference avoidance action and that the Defendant's Motion to Dismiss was warranted.

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