PREFERENCES AND PREFERENCE DEFENSES

By Elizabeth J. Futrell
Jones, Walker, Waechter, Poitevent, Carrere & Denegre, LLP

The basic policy behind the preference voidance power is that a debtor should not be able to "prefer" one creditor over another by selecting to pay one but not the other during the debtor's slide into bankruptcy. "The preference rule aims to ensure that creditors are treated equitably based on the theory that 'unless the favoring of particular creditors is outlawed, the mass of creditors of a shaky firm will be nervous, fearing that one or a few of their number are going to walk away with all the firm's assets; and this fear may precipitate debtors into bankruptcy earlier than is socially desirable.'" *Luper v. Columbia Gas of Ohio, Inc. (In re Carled),* 91 F.3d 811, 815 (6th Cir. 1996) (quoting *In re Tolona Pizza Prods. Corp.,* 3 F.3d 1029, 1032 (7th Cir. 1993)); *e.g.*, *Gulf City Seafoods, Inc. v. Ludwig Shrimp Co., Inc. (In re Gulf City Seafoods, Inc.),* 296 F.3d 363 (5th Cir. 2002) (reviewing the policy behind preference legislation). Therefore, debtors in possession and trustees are allowed to challenge certain transfers and recover the funds for proper distribution among all creditors.

A. For or on Account of An Antecedent Debt. To constitute a voidable preference, the transfer must have been made "for or on account of an antecedent debt owed by the debtor before such transfer was made." § 547(b)(2).

(1) Where a payment is made after a creditor provides goods or services, the payment is "for or on account of an antecedent debt."

(2) Unless one of the statutory defenses set forth in § 547(c)(3) and (c)(5) applies, where a debtor grants a lender a security interest in his assets to secure an existing debt, the security interest is a transfer of property "for or on account of an antecedent debt." In that case, the transfer in such a situation occurs when the security interest is perfected under applicable state law.

(3) If a payment is made before the creditor provides the services or supplies, the payment is not "for or on account of an antecedent debt." Where a creditor provides services or goods pursuant to a long-term contract, and the debtor is obligated to purchase a minimum amount of services or goods under that contract, an argument exists that the prepayment is "for or on account of an antecedent debt."

(4) The existence of a "debt" at the time of the transfer should be determined based on applicable non-bankruptcy law. *Ogden v. Big Sky Motors, Ltd. (In re Ogden),* 314 F.3d 1190, 1200 (10th Cir. 2002) (citing *Raleigh v. Illinois Dept. of Revenue,* 530 U.S. 15, 20 (2000) (the "basic federal rule" in bankruptcy is that state law governs the substance of debts)).

(5) The Bankruptcy Code does not define a "debt," although a "claim" is broadly defined in §101(10)(A) to include any right to payment, whether reduced to judgment, liquidated, fixed, contingent, matured, disputed, legal, equitable, secured or unsecured.

B. At a Time When the Transferor Was Insolvent. To constitute a voidable preference, the debtor must have been insolvent at the time of the transfer. § 547(b)(3).

(1) A debtor is presumed to be insolvent on and during the 90 days preceding its bankruptcy. § 547(i). Although a debtor has the ultimate burden of persuasion of all of the preference elements set forth in § 547(b), the creditor has the burden of producing evidence that the debtor was in fact solvent during the preference period to rebut the statutory presumption of insolvency. *Jones Truck Lines, Inc. v. Full Service Leasing Corp. (In re Jones Truck Lines, Inc.),* 883 F.3d 253, 258 (8th Cir. 1996); *Official Unsecured Creditors' Committee v. Airport Aviation Services, Inc. (In re Arrow Air),* 940 F.2d 1463, 1465 (11th Cir. 1991). In other words, the defendant in a preference action must produce evidence that the debtor was *not* insolvent to rebut the presumption of insolvency.

(2) An entity other than a partnership is insolvent when "the sum of such entity's debts is greater than all of such entity's property, *at a fair valuation*." § 101(32)(A) (emphasis added). A partnership is insolvent when the sum of the partnership's debts is greater than the aggregate of, at a fair valuation, (i) all of the partnership's property (with some exceptions) and (ii) the sum of the excess of the value of each general partner's nonpartnership property (with the same exceptions). § 101(32)(B).

(3) A person is insolvent under the Bankruptcy Code "if the sum of the debtor's debts is greater than all of the debtor's assets *at a fair valuation*." 5 Collier on Bankruptcy, ¶ 548.05, at 548-32 (15th ed.) ("Collier on Bankruptcy").

(4) For purposes of determining solvency, it is well established that contingent liabilities must be included to some extent. Rather than considering contingent liabilities at face value, the court should discount the liability "by the probability that the contingency will materialize." *E.g., WRT Creditors Liquidation Trust v. WRT Bankruptcy Litigation, Master File Defendants,* 282 B.R.343 (Bankr. W.D. La. 2001) (citing *Nordberg Arab Banking Corp. (In re Chase & Sanborn),* 904 F.2d 588, 594 (11th Cir. 1990)). Indeed, as one court has noted, "[t]o correctly value the contingent liability it is necessary to discount it by the probability that the contingency will occur and the liability become real." *F.D.I.C. v. Bell,* 106 F.3d 258, 264 (8th Cir. 1997).

C. Made within the 90-Day or One Year Preference Period. To constitute a voidable preference, the transfer must have been made within 90 days before the commencement of the bankruptcy. If the transferee was an "insider" at the time of the transfer, the preference period is one year, rather than 90 days. § 547(b)(4).

(1) "Insiders" is defined in § 101(32), and includes, by way of example, officers and directors of a corporation, or other person's in "control."

(2) For determining whether a payment is made within the applicable time, the preferential transfer is made when the check is paid, as opposed to when the check is delivered or mailed. *Barnhill v. Johnson,* 503 U.S. 393, 395, 113 S.Ct. 2141 (1992). Of course, if the check is a cashier's check, for calculation of the preference period, the transfer is complete when the check is delivered to the creditor.

(3) For purposes of the "subsequent new value" defense, the transfer may be treated as completed when the check is delivered. *E.g., Peltz v. Applicaiton Engineering Group, Inc. (In re Bridge Information Systems),* 287 B.R. 258, 264 (Bankr. E.D. Mo.2002). (See the below discussion of the subsequent new value defense.)

D. More than the Creditor Would Have Received in a Chapter 7 Case. To constitute a voidable preference, the transfer must have enabled the creditor to receive more than the creditor would have received in a Chapter 7 case and the transfer had not been made. § 547(b)(5). In other words, if the creditor would have received at least the same amount in a Chapter 7 had the payment not been made, the transfer is not a preference.

(1) In essence, a fully secured creditor who receives payments within the preference period did not receive preferential payments because the creditor would have received at least the same amount payments in a Chapter 7 case on account of its security interests

(2) Unlike the other elements of a preference, the pertinent determination is made at the time of the bankruptcy, rather than the time of the transfer. *E.g., Nueger v. United States (In re Tenna),* 801 F.2d 819, 821 (5th Cir. 1986) (determined using hypothetical liquidation on date bankruptcy was commenced); *Seidle v. GATX Leasing Corp.,* 778 F.2d 659, 665 (11th Cir. 1985).

E. A Transfer of An Interest of the Debtor in Property. To constitute a voidable preference, the transfer must have been a transfer of "an interest of the debtor in property." § 547(b).

(1) For purposes of most bankruptcy cases, "property interests are created and

defined by state law." *Butner v. United States,* 440 U.S. 48, 55 (1979). After the state law determination is made, the bankruptcy court "'must still look to federal bankruptcy law to resolve' the extent to which that interest is property of the bankruptcy estate." *Ogden,* 314 F.3d at 1197.

(2) As a general rule, a debtor's transfer of borrowed funds constitutes a preferential transfer of the debtor's property, assuming the other elements of a preference are satisfied. *Matter of Smith,* 966 F.2d 1527, 1537 (7th Cir. 1992) (the estate has been diminished when "nonearmarked funds" are borrowed and the debtor exercises control of those funds by paying them to a preferred creditor).

(3) The Bankruptcy Code does not define property of the debtor. "Because the purpose of the avoidance provision is to preserve the property includable within the bankruptcy estate--the property available for distribution to creditors–'property of the debtor' subject to the preferential transfer provision is best understood as that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings." *Sneakers Sports Grill, Inc. v. Crews,* 228 B.R. 795, 799 (Bankr. M. D. Fla. 1999).

(4) See the below discussions concerning the interplay between §§ 547(b) and 550(a), letters of credit, the remnants of the *Deprizio* issue, and other payments by third parties.

F. To or for the Benefit of a Creditor. To constitute a voidable preference, the transfer must have been a transfer "to or for the benefit of a creditor." § 547(b). A number of courts have held that "indirect transfers," or transfers made by someone other than the debtor or to someone other than the creditor, may constitute a voidable transfer under §§ 547(b) and 550. As the Supreme Court noted in a case decided under the Bankruptcy Act, to "constitute a preference, it is not necessary that the transfer be made directly to the creditor." *National Bank of Newport v. National Kerkimer County Bank of Little Falls,* 225 U.S. 178, 184, 32 S.Ct. 633 (1912).

(1) The Interplay with § 550(a). Under § 550(a), a trustee or debtor in possession that asserts a voiding power action may recover from "(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transferee." *Id.* While the focus of § 547 is on transfers, the focus of § 550 is on transferees.

(a) Section 547(b) requires a transfer "to or for the benefit of" a creditor. The transfer may be avoidable under §§ 547(b) and 550, even if it is not "to" a creditor, so long as it is "for the benefit of" a creditor. *E.g., Crafts Plus+, Inc. v. Foothill Capital Corp.,* 220 B.R. 331, 334 (Bankr. W.D. Tex. 1998).

(b) In *Crafts Plus,* Ben Franklin Stores, a debtor in possession ("Ben Franklin"), owed Foothill Capital Corporation ("Foothill") $30 million. Crafts Plus, on the other hand, owed Ben Franklin about $16 million. As part of the Ben Franklin bankruptcy case, Crafts Plus made two court-approved transfers totaling $5 million to Foothill in partial satisfaction of its debt to Ben Franklin. Shortly thereafter, Crafts Plus filed its own bankruptcy case. A preference action was asserted in the Crafts Plus bankruptcy against Foothill for the $5 million. Foothill defended the action by arguing, among other things, that the payment was not preferential because Foothill was not a creditor of Crafts Plus. The court rejected this argument because the payment was made "for the benefit of" a creditor. *Id*. at 331.

(c) The *Crafts Plus* court also concluded that a transfer can be voidable without naming as a party the creditor for whose benefit the transfer was made pursuant to § 550. 220 B.R. at 338. "Once it has been established that a qualified transfer has been made, § 550 provides for recovery against either the initial transferee (in this case Foothill) or "the entity for whose benefit such transfer was made." 220 B.R. at 338.

(2) Letters of Credit. Letters of credit present many interesting issues.

(a) A letter of credit is a "separate contract, independent of the underlying obligations or transactions that give rise to its issuance." *In re Prime Motor Inns, Inc.,* 130 B.R. 610, 613 (S.D. Fla. 1991). Strict adherence to this principle "is necessary to protect the integrity of letters of credit as a valuable commercial tool." *Id.* When the issuer of a letter of credit honors a creditor's draft on the letter, the payment is made from the issuer's funds, not the debtor's funds. Under this analysis, the issuer's payment would not constitute a voidable preference because the transfer is not a transfer of an "interest of the debtor in property." *E.g., Graham v. State of West Virginia (In re War Eagle Construction Co., Inc.),* 283 B.R. 193, 201 (S.D.W.Va. 2002); *In re Zenith Laboratories, Inc.,* 104 B.R. 667 (Bankr. D.N.J. 1980); *North Shore & Central Illinois Freight Co. v. American National Bank & Trust Co. of Chicago,* 30 B.R. 377, 379 (Bankr. N.D. Ill. 1983) ("[s]ince this court holds that the letter of credit is not property of the debtor's estate pursuant to section 541, the debtor's contentions regards preferences . . . are moot").

(b) When a letter of credit is issued during the preference period for the benefit of a creditor owed an existing debt, **and** the bank's contingent claim for issuing the letter of credit is secured by the debtor's property, some courts have held that a voidable transfer occurred. *E.g., Kellog v. Blue Quail Energy, Inc. (In re Compton Corp.),* 831 F.2d 586 (5th Cir. 1997); *American Bank of Martin County v. Leasing Service Corp. (In re Air Conditioning, Inc. of Stuart),* 845 F.2d 293 (11th Cir.), *cert. denied sub. nom. First Interstate Credit Alliance v. American Bank of Martin*

County, 488 U.S. 993 (1988). A transfer of an interest in the debtor's property (the collateral securing the issuer's contingent claim) occurs when the letter of credit is issued. The net result of the transaction is that a secured obligation (owed the issuer) is substituted for an unsecured obligation (owed on the pre-existing debt). The estate is thereby diminished proportionately. The beneficiary of the letter of credit profits, therefore, even though the profit is indirect. This was the holding in *Compton,* 831 F.2d at 591.

(c) In *Compton*, the debtor arranged for the issuance of a letter of credit from MBank for the benefit of a supplier that had already delivered an oil shipment to Compton. Payment for the shipment was delinquent. Because MBank already had a security interest in all of the debtor's assets to secure all existing loans, when MBank issued the letter of credit at the debtor's request, MBank's claim for payments on the letter of credit were secured by Compton's assets. Shortly after the letter of credit was issued, an involuntary case was commenced against Compton. The supplier presented a draft on the letter and MBank paid the draft, thereby adding to the amount of MBank's secured claim. Applying the so-called "two transfer" or "direct and indirect transfer rule," the Fifth Circuit found that the supplier had received the benefit of a preference because assets of the estate (MBank's collateral) were committed to repay the supplier's unsecured and antecedent debt. The debtor could not prevail in a preference action against MBank, on the other had, because MBank gave new value in the form of the letter of credit. *Id.* at 591-92. Under the "two transfer" or "direct and indirect transfer rule," the court breaks down certain transfers into two transfers, one direct and one indirect. For example, if MBank had paid the funds directly to the creditor, as opposed to issuing the letter of credit, the transfer from the debtor to the creditor would have been a preference. The court, therefore, reasoned that it has authority to breakdown the transaction into two transfers, even though only one transfer occurred.

(d) The Eleventh Circuit addressed the same issue shortly after *Compton* in the *Air Conditioning* case. 845 F.2d at 296. In *Air Conditioning*, the court permitted a trustee to avoid as a preference a payment made by the debtor to a bank to obtain the issuance of a letter of credit payable to a creditor in connection with an antecedent debt and to recover the preference from the creditor under § 550(a)(1) as the entity for whose benefit the transfer was made. In so ruling, the Eleventh Circuit summarized the *Compton* ruling as follows: "[w]hen a debtor pledges its assets to secure a letter of credit, a transfer of debtor's property has occurred under the provisions of 11 U.S.C. § 547." *Compton,* 845 F.2d at 296. The Eleventh Circuit also agreed "that an indirect transfer arising from a debtor's pledge of security to a third party bank 'may constitute a voidable preference as to the creditor who indirectly benefitted from the direct transfer to the third party.'" *Id.* at 296 (quoting *Compton*,

845 F.2d at 591-92).

(e) On the other hand, if the beneficiary of a letter of credit arranged by a debtor outside of the 90-day period presents a draft on the letter of credit within the 90-day period, no preference occurs when the issuer honors the draft. The issuer's payment is not property of the debtor, but property of the issuer. Delivery of the letter of credit to the beneficiary, as opposed to funding the letter of credit, completes the transfer of property under § 547(b).

(f) Further, if the bank issuing the letter of credit is unsecured, even if the letter of credit is issued within the 90-day preference period, the letter of credit should not constitute a voidable preference. *Compton,* 831 F.2d. at 595 ("[o]nly when a creditor receives a secured letter of credit to cover an unsecured antecedent debt" will the letter of credit beneficiary be at risk in a preference attack.)

(g) The "two-transfer" approach has been criticized for being results-oriented and for confusing the text of the statute. *See Lowrey v. First National Bank of Bethany (In re Robinson Brothers Drilling, Inc.*), 97 B.R. 77, 79-80 (W.D. Ok. 1988); *Haley v. Sorani (In re Richmond Produce Co., Inc.),* 188 B.R. 753 (Bankr. N.D. Cal. 1990). In fact, the Fifth Circuit arguably retreated from *Compton* in *Matter of T.B. Westex Foods, Inc.,* 950 F.2d 1187 (5th Cir. 1992). In *T.B. Westex*, the Fifth Circuit held that the "two-transfer" analysis was inapplicable where the debtor's payments to a non-insider represented only one obligation that was discharged by the transfer. That case involved the satisfaction of a garnishment. 950 F.2d at 1194.

(3) Remnants of the *Deprizio* Opinion After Enactment of § 550(c). With the Bankruptcy Reform Act of 1994, with the enactment of § 550(c), Congress sought to overrule of line of cases best down for the lead opinion in *In re V.N. Deprizio Construction Company,* 874 F.2d 1186 (7th Cir. 1989). The *Deprizio* opinion, and its progeny, transfers made more than 90 days before the bankruptcy but within one year of the bankruptcy to a non-insider, such as a bank, that benefitted an insider, such as an officer or director of the debtor company, could be recovered from the non-insider under § 550(a)(1).

(a) Section 550(c) only protects non-insiders for preferences under § 547, "and then only to the extent that the relief requested is the recovery of the transfer (as opposed to the avoidance of the lien). 5 Collier on Bankruptcy, at 550-27. For a review of the non-insiders problems after the enactment of § 550(c), *see* S. Nickles, *Deprizio Dead Yet? Birth, Wounding, and Another Attempt to Kill the Case,* 22 Cardozo L. Rev. 1251 (2001).

(b) If the non-insider could be attacked under applicable state law and § 544(b), nothing in § 550(c) would protect the non-insider. 5 Collier on Bankruptcy, at 550-27. This is a particular problem with states that have adopted Section 5(b) the Uniform Fraudulent Transfer Act "which, under certain circumstances, would allow the trustee to avoid certain insider transactions for up to a year after their occurrence." 5 Collier on Bankruptcy, at 550-27-28.

(4) More on Payments Made by a Third Party. As noted in *Sneakers Sports Grill, Inc. v. Crews,* 228 B.R. 795, 799 (Bankr. M.D. Fla. 1999), "[a]voiding preferential transfers received indirectly from the buyer of a debtor's assets is not a novel concept."

(a) In *Warsco v. Preferred Technical Group,* 258 F.3d 557, 564 (7th Cir. 2001), the Seventh Circuit summarized the third-party payment issue by concluding that a "transfer need not be made directly by the debtor; indirect transfers made by third parties to a creditor on behalf of the debtor may also be avoidable under the Code."

(b) In *Warsco,* the court found that payments made to a creditor were preferential even though the payments were made from an escrow account over which the debtor had no control. In that case, the debtor sold its assets to the third party and the third party agreed, as part of the purchase price, to assume the debtor's liabilities. The escrow was established to pay the third parties. *Accord Sommers v. Burton (In re Conard Corp.),* 806 F.2d 610 (5th Cir. 1986) (the purchaser's payment of the seller's debt as part of sales price constituted avoidable transfer, even where the purchaser executed an agreement with the creditor assuming the seller's obligations).

(c) Other opinions discussing the third-party payment issue include *Mordy v. Chemcarb, Inc. (In re Food Catering & Housing, Inc.),* 971 F.2d 396, 397 (9th Cir. 1992) (the debtor sold substantially all of its assets to a third party, and the payments were made by the purchaser to the seller's creditor on account of an antecedent debt of the seller); *Buckley v. Jeld-Wen (In re Interior Wood Prods. Co.),* 986 F.2d 228 (8th Cir.1993)*; Taunt v. Fidelity Bank (In re Royal Golf Products Corp.),* 908 F.2d 91, 94 (6th Cir. 1990) (third party payments are voidable to the extent that the debtor pledged its property as security for these payments and thus depleted its estate); *Feltman v. Board of County Comm'rs of Metro. Dade County (In re S.E L. Maduro (Florida), Inc.),* 205 B.R. 987, 990-91 (Bankr. S.D. Fla. 1997) (where the debtor entered into asset purchase agreement with a third party purchaser, the third party's payment to creditors were preferential transfers because the payments constituted part of the consideration paid for the debtor's assets).

(d) On the other hand, in *Sport Stations, Inc. v. Naples Partnership (In*

re Sport Stations, Inc.), 152 B.R. 335, 337 (Bankr. M.D. Fla. 1993*)*, the court found that rent payments made by the principals of a debtor to the debtor's landlord did not constitute an avoidable preferences. "When a payment is made by a nondebtor third party to a creditor it cannot be preferential because the funds used to pay the debt are not property of the estate and, thus, the amount of funds available for distribution to other creditors is not reduced." 152 B.R. at 337. In *Sports Stations,* the court determined that payments made to the debtor's landlord by the principals from the principals' own funds were not property of the estate and did not diminish funds available for distribution to creditors. *Id.*

G. Commonly Used Statutory Defenses. After the debtor in possession or trustee proves a prima face case under § 547(b), the creditor may raise one of the eight defenses set out in § 547(c). The defendant in a preference action has the burden of proving, by a preponderance of the evidence, each element of the defenses set forth in § 547(c). Below is a discussion of the most common statutory defenses: the contemporaneous exchange defense, the ordinary course of business defense, and the subsequent new value defense. In addition to these three statutory defenses, the Bankruptcy Code protects transfers that relate to the perfection of purchase money security interests, security interests in receivables and inventory, statutory liens, § 547(c)(3) and (c)(5), alimony and child support payments, § 547(c)(7), and transfers of less than $600 in consumer cases. § 547(c)(8). All of the defenses, whether statutory or otherwise, are designed to encourage (or at least not penalize) creditors who are willing to continue to do business with financially trouble companies--one of the many tradeoffs in bankruptcy.

(1) The Contemporaneous Exchange Defense under § 547(c)(1). Pursuant to § 547(c)(1), an otherwise preferential transfer is not avoidable to the extent such transfer was both intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor and was in fact a substantially contemporaneous exchange. *E.g., Official Unsecured Creditors' Committee v. Airport Aviation Services, Inc. (In re Arrow Air, Inc.),* 940 F.2d 1463, 1465 (11th Cir. 1991).

(a) For purposes of § 547, "new value" is defined as money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable under any applicable law, including proceeds of such property. A creditor seeking to except a preferential transfer from avoidance under § 547(c)(1) must supply proof of the specific dollar value of any "new value" provided in exchange for the transfer. *See Jet Florida, Inc. v. American Airlines, Inc. (In re Jet Florida Systems, Inc.)*, 861 F.2d 1555, 1559 (11th Cir. 1988) ("*Jet Florida II").* A creditor asserting a § 547(c)(1) defense must show that a preferential transfer conferred actual economic benefit upon a transferee/debtor, rather than merely showing that a transferee/debtor

and creditor **intended** some hypothetical or ephemeral value to be conferred. *Jet Florida II,* 861 F.2d at 1558-59.

(b) "New value" does not mean one obligation substituted for another obligation. § 547(a)(2). In *Babin v. Barry County Livestock Auction, Inc.,* 282 B.R. 871 (B.A.P. 8th Cir. 2002), the court found that cashier's checks delivered to the auction house two weeks after the debtor purchased cattle at an auction were not contemporaneous exchanges for new value. The auction house argued that the checks were not delivered to pay for the previously purchased cattle, but for the right to participate in auctions that were conducted on the dates that new auctions were conducted. The court first found that the debtor intended to satisfy its outstanding obligation to the auction house, and that the right to participate in future auctions was a mere consequence of the payment. *Id.* at 875. The court also found that the right to participate in new auctions did not constitute "new value" within the meaning of § 547(a)(2), because the right to participate did not constitute money, credit or "a good or service the value of which is qualified in the record." 282 B.R., at 875.

(c) Release of or credit on a debtor's preexisting obligation does not qualify as "new value" under § 547(a)(2). *Nordberg v. Arab Banking Corp. (In re Chase & Sanborn)*, 904 F.2d 588, 596 (11th Cir. 1990). In *Chase & Sanborn*, a creditor asserting a § 547(c)(1) defense proposed that the diminution of a debtor's guarantee obligation functioned as "new value" conferred in exchange for a preferential transfer under § 547(a)(2). 904 F.2d at 595. The Eleventh Circuit rejected this argument on the grounds that a debtor's payment for release of or for credit on a contingent, antecedent obligation represents the very sort of transfer that § 547(b) was enacted to avoid. 904 F.2d at 595-596. "If 'new value' included credit toward such debts, thus rendering such transfers categorically unavoidable, section 547 would be rendered a tautological nullity." 904 F.2d at 595-596.

(d) An agreement by an undersecured creditor to waive its right to foreclose on collateral essential to a debtor's operations in order to allow a debtor to continue operating does not qualify as "new value" under § 547(a)(2). See *Wendel v. Leasing Service Corp. (In re Air Conditioning of Stuart)*, 845 F.2d 293, 298 (11th Cir. 1988). "Forbearance from exercising pre-existing rights does not constitute new value within § 547(c)(1) as defined by § 547(a)(2)." *Air Conditioning,* 845 F.2d at 298.

(e) The defendant has the burden of proving both that the parties *intended* the transfer to be a contemporaneous exchange and that the transaction was, in fact, a substantially contemporaneous exchange for new value. *E.g.*, *APS Management Services, Inc. v. ABX Enterprises,* 282 B.R. 795, 800 (Bankr. D. Del. 2002) (the

three elements are (i) new value was extended to the debtor), (ii) the parties intended the new value to be a contemporaneous exchange, and (iii) the exchange was, in fact, substantially contemporaneous).

(f) The "intent" requirement is a question of fact, subject to proofs such as the agreement between the parties or the course of dealing between the parties. *E.g.*, *Official Committee of Unsecured Creditors v. CRST, Inc. (In re CCG 1355, Inc.),* 276 B.R. 377, 386 n.15 (Bankr. N.J. 2002). The "critical inquiry" is whether the parties intended the transfer to be contemporaneous. *ABX Enterprises,* 282 B.R. at 800.

(g) One line of cases follows a flexible, fact-sensitive approach to determine whether an exchange was, in fact, substantially contemporaneous. *E.g., Pine Top Ins. Co. v. Bank of America Nat'l Trust & Savings Ass'n,* 969 F.2d. 321, 328-329 (7th Cir. 1992)*; In re Marino,* 193 B.R. 907, 913-914 (9th Cir. B.A.P. 1996)*, aff'd*, 117 F.3d 1425 (9th Cir. 1997). Under these cases, relevant circumstances include "length of delay, reason for delay, nature of the transaction, intentions of the parties, possible risk of fraud." *Pine Top,* 969 F.2d at 328 (3-week delay in transferring collateral following extension of credit deemed substantially contemporaneous when the parties intended contemporaneous exchange, despite delay in processing security documents and absent harm to other creditors); *Marino,* 193 B.R. at 915 (14-day delay in recording mortgage following extension of loan deemed substantially contemporaneous when the parties intended contemporaneous exchange and the delay in recording was unavoidable). *See In re Mantelli,* 22 B.R. 649, 653 (Bankr. D. Colo. 1982) (45 days); *In re Lyon,* 35 B.R. 759, 763 (Bankr. D. Kan. 1982) (20 days); *In re Barbette,* 14 B.R. 795, 803 (Bankr. E.D. Tenn. 1981) (20 days).

(h) At least one court has adopted an inflexible approach to determining whether a transfer was, in fact, substantially contemporaneous. In *In re Barnett,* 731 F.2d 358, 363 (6th Cir. 1984), the court applied a strict 10-day boundary adopted from the allowed interval of § 547(e)(2) (which specifically applies to the perfection of security interests).

(2) The Ordinary Course of Business Defense under § 547(c)(2). Under the ordinary course of business defense, a debtor in possession or trustee may not avoid a transfer to the extent that the transfer was (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, (B) made in the ordinary course of business or financial affairs of the debtor and the transferee, and (C) made "according to ordinary business terms." § 547(c)(2). As discussed in more detail below, the defendant must establish each of these elements to prevail in this defense. "In sum, the creditor

must show that as between it and the debtor, the debt was both incurred and paid in the ordinary course of their business dealings and that the transfer of the debtor's funds to the creditor was made in an arrangement that conforms with ordinary business terms -- a determination that turns the focus away from the parties to the practices followed in the industry." *Gulf City Seafoods,* 296 F.3d at 369. The ordinary course of business defense is meant to deter the race to the courthouse and enable a struggling debtor to continue operating its business. *Arrow Electronics, Inc. v. Justes (In re Kaypro),* 218 F.3d 1070, 1073 n.3 (9th Cir. 2000). It is difficult, therefore, to prevail on a motion for summary judgment. *See ABX Enterprises,* 282 B.R. at 803 ("based on the current record, one could reasonably infer that a check payment made 65 days after the date of invoicing was made in the ordinary course of business between the parties; or one could reasonably infer the opposite"); *LCG 1355*, 276 B.R. at 383 (the ordinary course determination requires a "peculiarly factual analysis").

(a) Incurred in the Ordinary Course of Business of the Debtor and Creditor within the Meaning of § 547(c)(2)(A). In the typical preference case, there is no dispute that the debt was incurred in the ordinary course of the debtor's and creditor's business or financial affairs. *Robin v. Lerner (In re Diagnostic Instrument Group, Inc.),* 276 B.R. 302, 309 (Bankr. M.D. Fla. 2002) ("most of the unsecured debt of a typical chapter 11 debtor is debt incurred for the purpose of services and materials"). In the *Robin* case, the court found that the obligation was not incurred in the ordinary course of the business of the debtor and creditor. Instead, the defendant made an "extraordinary loan" to the debtor after the debtor could not borrow any more under its line of credit. Therefore, the loan was not in the ordinary course of the debtor's business. Similarly, because the defendant creditor was a doctor, the loan was not in the ordinary course of the defendant's business. Finally, the court found that the terms of the loan were "highly unusual" because the interest rate was usurious under applicable state law. 276 B.R. at 310-11.

(b) Made in the Ordinary Course of Business of the Debtor and Creditor within the Meaning of § 547(c)(2)(B). According to the Eight Circuit, the controlling factor under § 547(c)(2)(B) is whether the timing of the payments from the debtor to the creditor during the preference period were consistent with the timing of the payments before the preference period. *E.g., Peltz v. Bridge Information Systems, Inc. (In re Bridge Information Systems, Inc.),* 287 B.R. 258, 264 (Bankr. E.D. Mo. 2002). The controlling factor in the analysis under § 547(c)(2)(B) is whether the timing of the payments from the debtor to the creditor during the preference period were consistent with the timing of the payments before the preference period. Thus, where the average payment outside the preference period was 56 days, and the average payment period within the preference period was 31 days, the payments were not made according to the ordinary business terms between the debtor and creditor, according to the court in *Bridge.* 287 B.R. at 264.

(i) If there is a change in the timing and pattern of the payments within the preference period, the payments were not made in the ordinary course of business between creditor and debtor under § 547(c)(2)(B)." *Bridge,* 287 B.R. at 265. The analysis under § 547(c)(2)(B) "must focus on the consistency between the payments at issue and the prior history between the specific creditor and debtor." *Bridge,* 287 B.R. at 265.

(ii) In *Bridge*, the court found that payments were outside the ordinary course of business within the meaning of § 547(c)(2)(B) if there was a change in the timing or pattern of the payments during the preference period, even if the creditor did not undertake any unusual collection efforts. *Bridge,* 287 B.R. at 265.

(iii) Any evidence as to the practice between the creditor and its other clients is irrelevant as to § 547(c)(2)(B), even though it may be relevant as to the ordinary course of business in the industry under § 547(c)(2)(C), as discussed below. *Jones v. United Savings & Loan Assoc. (In re U.S.A. Inns),* 9 F.3d 680, 685 (8th Cir. 1993).

(iv) "Median time intervals between invoice date and payment date, both before and during the preference period, are logical comparisons in making" the § 547(c)(2)(B) determination. *LCG 1355,* 276 B.R. at 383. "Comparison of the 'mix' of distribution of payments against old invoices is also relevant." *Id.*

(c) Ordinary Business Terms in the Industry, or Prevailing Industry Standards within the Meaning of § 547(c)(2)(C). Ordinary business terms means that the payment must be ordinary in relation to prevailing business standards. *Arrow Electronics, Inc. v. Justes (In re Kaypro),* 218 F.3d 1070, 1073 n.3 (9th Cir. 2000). Whether a transaction is ordinary within the meaning of § 547(c)(2)(C) "must be resolved by consideration of the practices in the industry – not by the parties' dealings with each other." *Gulf City Seafoods,* 296 F.3d at 369.

(i) Courts have held that the "prevailing business standards" means the standards employed by similarly situated debtors and creditors facing the same or similar problems. If the terms are ordinary for industry participants under financial distress, then that is ordinary for the industry. *Id.*

(ii) Payments falling within the "broad range"of ordinary business terms in the applicable industry may fall within the defense. The majority of circuits have concluded that "ordinary business terms" means the "broad range" of ordinary business. In the most recent case, *Jan Weilert RV, Inc. v. Ganis Credit Corporation,* 315 F.3d 1192 (9th Cir. 2003), the Ninth Circuit

expressly adopted the Seventh Circuit test articulated in *Tolona Pizza,* 3 F.3d at 1033 ("only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope of subsection C"). Most of the circuit courts have adopted some form of the *Tolona Pizza* standard, including the Second Circuit in *Lawson v. Ford Motor Co. (In re Roblin Indus.*, Inc.), 78 F.3d 30, 42 (2d Cir. 1996) (adopting *Tolona Pizza*), the Third Circuit in *Fiber-Lite Corp. v. Molded Acoustical Prods., Inc. (In re Molded Acoustical Products, Inc.)*, 18 F.3d 217, 224-25 (3d Cir. 1984) (using the word "usual" instead of "idiosyncratic"), the Fourth Circuit in *Advo-System, Inc. v. Maxway Corp.,* 37 F.3d 1044, 1055 (4th Cir. 1994) (adopting *Toleno Pizza* as modified by the Third Circuit in *Molded Acoustical*), the Fifth Circuit in *Gulf City Seafoods,* 296 F.3d at 368 (expressly following *Tolona Pizza,* noting that the practices do not need to be identical to industry standards, and that "the statutory language should not be used to place businessmen in a straightjacket"*),* the Sixth Circuit in *Carled,* 91 F.3d at 818 (in order for a late payment to meet ordinary business standards the creditor does not have to establish lateness as a pattern for a significant percentage*),* the Eight Circuit in *U.S.A. Inns,* 9 F.3d at 685 (using the word "usual" instead of "idiosyncratic"), and the Eleventh Circuit in *In re A.W. & Associates, Inc.,* 136 F.3d 1439, 1442-43 (11th Cir. 1998) (the "broad range" of objective industry standards are applicable under § 547(c)(2)(C)).

(iii) In *Jan Weiler,* 315 F.3d at 1198, the Ninth Circuit expressly rejected the practice of determining whether a payment was made according to industry norms by using an "average, or mean time." 315 F.3d at 1205 (reversing lower court's rejection of the ordinary course of business defense, and rendering judgment in favor of the defendant). In *Jan Weiler*, because the broad range was one to 45 days, payments made on the 21st and 41st days were made according to the prevailing industry standard.

(iv) The defendant has the burden of proving that the transfers were within the ordinary course of business in the industry. To satisfy this burden, it is not sufficient to show that the arrangements between the debtor and creditor were similar to arrangements between other customers of the creditor, or that they were similar to the arrangements that the debtor had with other creditors. Instead, under the "objective" test, the defendant bears the burden of proving that the arrangements were ordinary in the industry. The defendant may satisfy its burden through testimony by its own company representatives about the practices of other creditors and debtors in the industry, subject to applicable evidentiary rules. Whether such testimony is appropriately reliable is a matter that the trial court should resolve. *Gulf City Seafoods,* 296 F.3d at 368 n.5.

(v) It may be difficult to define the appropriate industry for determining whether the transactions were within the ordinary course of business under this "objective" standard. Under the Fifth Circuit's analysis, "the creditor should provide evidence of credit arrangements of other debtors and creditors in similar markets, preferably both geographic and product." *Gulf City Seafoods,* 296 F.3d at 368 ("Ludwig might provide evidence, to the extent that it is reasonably available, of credit practices between suppliers to whom Gulf City might reasonably turn for its seafood supply and firms with whom Gulf City competes for consumers, from which a judge can determine whether there is some basis to find that the Ludwig/Gulf City arrangement is not a virtual stranger in the industry").

(vi) In *Moulded Acoustical,* 18 F.3d at 227 n.12, the Eight Circuit suggested that the court should look to market definition principals from antitrust law to determine the relevant industry for comparison.

(vii) There are situations in which the debtor has only one or two companies to which it can reasonably turn for supplies or credit. In these "small market" cases, the Fifth Circuit has concluded that "the creditor may show similar credit arrangements in other local industries which similar characteristics." *Gulf City Seafoods,* 296 F.3d at 369 n.8.

(3) The Subsequent New Value Defense under §547(c)(4). Under § 547(c)(4), a trustee or debtor in possession may not avoid a transfer to or for the benefit of a creditor to the extent that, after such transfer, the creditor gave new value to or for the benefit of the debtor (A) not secured by an otherwise unavoidable security interest, and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor. Because there is no question about the subjective intent of the parties, as in the case of the contemporaneous exchange defense, or the prevailing industry standards, as in the case of the ordinary course of business defense, the subsequent new value defense is the easiest to establish for settlement discussions, summary judgment or trial.

(a) The policy rationale underlying this defense is to encourage creditors to deal with a financially distressed firm in the hope of rehabilitating the firm. *S. Technical College v. Hood (In re S. Technical College)*, 89 F.3d 1381, 18284 (8th Cir. 1996).

(b) Some courts have held that, for purposes of the § 547(c)(4) defense, a preferential transfer occurs on the date the debtor delivers the check to the creditor, as opposed to the date that the check is paid. *E.g., Krohn Bros Development Co. v. Continental Construction Engineering (In re Krohn Bros. Development Co.)*, 930

F.2d 648, 651 (8th Cir. 1991); *Bridge,* 287 B.R. at 264.

(c) Section 547(c)(4) does not apply to postpetition advances of new value. *Berquist v. Anderson-Greenwood Aviation Corp. (In re Bellanca Aircraft Corp.),* 850 F.2d 1275, 1248 (8th Cir. 1988).

(d) Some courts have described §§ 547(c)(4)(B) as requiring the subsequent advance to go "unpaid." *See, e.g., Krohn Bros.*, 930 F.2d at 652; *New York City Shoes, Inc. v. Bentley Int'l, Inc. (In re New York City Shoes, Inc.)*, 880 F.2d 679, 680 (3d Cir.1989); *Charisma Investment Company, N.V. v. Airport Sys., Inc. (In re Jet Florida Sys., Inc.)*, 841 F.2d 1082, 1083 (11th Cir.1988) (*"Jet Florida I")*; *In re Prescott*, 805 F.2d 719, 731 (7th Cir.1986). In *Jet Florida I,* the Eleventh Circuit listed three elements to the subsequent new value defense, including the requirement that the "new value" remain unpaid. 841 F.2d at 1083. As noted by the Fifth Circuit, the discussion of the requirement that the new value remain "unpaid" was *dicta* in *Jet Florida I*, because the parties conceded that the new value was unpaid. *Laker v. Toyota of Jefferson, Inc. (In re Toyota of Jefferson, Inc.),* 14 F.3d 1088, 1093 n.2 (5th Cir. 1088).

(e) Other courts have rejected the requirement that the subsequent new value must remain unpaid. For example, after reviewing the Eleventh Circuit's opinion in *Jet Florida I,* the Fifth Circuit concluded as follows: "[a]lthough this description may be an adequate shorthand description of §§ 547(c)(4)(B), a more complete statement of the (c)(4) exception would be that a creditor who raises it has the burden of proving that (1) new value was extended after the preferential payment sought to be avoided, (2) the new value is not secured with an otherwise unavoidable security interest, and (3) the new value has not been repaid with an otherwise unavoidable transfer." *Toyota of Jefferson,* 14 F.3d at 1093 (where some of the new value was repaid).

(f) The major opinion in the Fifth Circuit dealing with the subsequent new value defense is *Williams v. Agama Systems, Incorporated (In re Micro Innovations Corp.),* 185 F.3d 329 (5th Cir. 1999). The defendant in *Micro*, Agama, engaged in a credit transaction, whereby Agama would sell and deliver goods to the debtor, Micro. Upon most deliveries, Agama received a postdated check for the delivered goods. During the 90 days before Micro's bankruptcy, this basic transaction occurred on fifty-four occasions. During the same period, Agama shipped goods collectively valued at $279,905, while Micro's payments to Agama totaled $313,292. The trustee in *Micro* convinced the lower courts that the subsequent advance defense was inapplicable because each particular shipment (or advance) occurred *before* the preferential transfer, rather than "after such transfer," as required by § 547(c)(1). The Fifth Circuit reversed the lower courts' rulings, and found that the advance need not be directly

connected to the preceding preferential transfer for the subsequent advance defense to apply. Put differently, § 547(c)(4) "contemplates carrying forward the net balance of prior preferences in determining the effect of subsequent value" as opposed to" limiting the except to one subsequent advance." *Katz v. IDA K. Stark Trust (In re Van Dyck/Columbia Printing),* 2003 U.S. Dist. LEXIS 3042, *25-26 (D. Conn. February 28, 2003).

(g) To qualify for the subsequent new value defense, the new advance must *not* be secured by a security interest that is "otherwise unavoidable." The trustee in *Micro* argued that the court should examine whether a security interest existed at the time of the transfers. Because Agama's security interest was extinguished by the transfers or payments, rather than by operation of any voiding power action under the Bankruptcy Code. The trustee argued that Agama was secured by a security interest not otherwise voidable within the meaning of § 547(c)(4). *Micro*, 185 F.3d at 335. The Fifth Circuit refused to address this circular argument, instead concluding that the proper temporal focus is the time of the bankruptcy, rather than the "historical existence of security interests." *Id.* at 336.

(h) Each individual repayment should be analyzed to see if it was *followed by* the extension of a new loan. "Since the last repayment was not, the repayment could be avoided regardless of excess new value the creditor had advanced prior to that repayment." *Id.* at 337

(i) Some courts have adopted the "carry over" rule first articulated in *In re Thomas Garland, Inc.,* 19 B.R. 920 (Bankr. E. D. Mo. 1982), including the Ninth Circuit in *Moiser v. Ever Fresh Food Co. (In re IRFM, Inc.),* 52 F.3d 228, 229, 233 (9th Cir. 1995), the Fourth Circuit in *In re Meredith Manor, Inc.,* 902 F.2d 257, 258-59 (4th Cir. 1990), and the Fifth Circuit in *Micro*.

(H) Non-Statutory Defenses. There are a number of defenses created by case law that are not codified in § 547(c).

(1) "Earmarking." Earmarking is said to be an extra-statutory defense to a preference action that has been created by case law. Earmarking is an extra-statutory defense to a preference action that has been created by case law. The defense stems from the court's interpretation of the statutory requirement that a voidable preference must involve a transfer of an interest of the debtor in property. Money that is considered "earmarked" to pay an antecedent debt is not the debtor's property.

(a) Under certain circumstances, a transfer from a third party to a creditor of the debtor is not avoidable as a preference. Such transfers do not offend the policy

behind the preference action where the only change is in the identity of the creditor, without a corresponding depletion of the bankruptcy estate. *Neponset River Paper Comp. v. The Travelers Insurance Comp. (In re Neponset River Paper Comp.)*, 231 B.R. 829 (B.A.P. 1st Cir. 1999).

(b) Cornerstones of the earmarking doctrine are (i) the absence of control by the debtor over the disposition of new funds provided by a new creditor to pay an original creditor; and (ii) the absence of diminution of the debtor's estate as a result of the transfer. *Id.; e.g., McCluskey v. National Bank of Waterloo (In re Bohlen Enterprises, Ltd.),* 859 F.2d 561, 565 (8th Cir. 1988) (adding a requirement that there exist an agreement that the funds will be used to pay a specified antecedent debt, except in the case of a guaranty).

(c) The key elements of the earmarking defense are that: (i) there was an agreement by the debtor and the new creditor that "new" funds given to the debtor would be used to pay a specified antecedent debt; (ii) the agreement between the parties was performed according to the terms of that agreement; and (iii) the transaction viewed as a whole did not result in any diminution of the estate. *Id.*

(d) Diminution of the estate occurs when the transfer reduces the pool of funds available to all, so that creditors in the same class do not receive as great a percentage as the preferred creditor. *Id.*

(e) The key inquiry in determining whether a third party transfer is voidable is the source of control over the new funds. If the debtor controls the disposition of the funds and designates the creditor to whom the monies will be paid independent of the third party whose funds are being used, the payments made by the debtor constitute a preferential transfer. *In re Superior Stamp & Coin Co.***,** 223 F.3d 1004 (9th Cir. 2000).

(f) The rule is the same regardless of whether the lender transfers the proceeds of the loan directly to the creditor or the proceeds are paid to the debtor with the understanding that the funds will be paid to the creditor in satisfaction of the specified antecedent debt, so long as such proceeds are clearly earmarked for payment to the old creditor. *Id.*

(2) Constructive Trusts. The laws of many states impose a constructive trust in cases where an express trust has failed, or in cases of fraud or unjust enrichment. When legal title to property was held by the debtor in trust for the benefit of another, the property may be excluded from the debtor's estate under preference laws. Where the debtor held funds in a constructive trust, the trust property was not "an interest of the debtor in property" within the

meaning of § 541(d) or § 547(b). Under § 541(d), "property of the estate" includes all property in which the debtor has legal title except "to the extent of an equitable interest in such property that the debtor does not hold." *See McCafferty v. McCafferty*, 96 F.3d 192, 196 (6th Cir. 1996).

(a) Even if property is held in a constructive trust, the courts are split on whether a trustee or debtor-in-possession may use § 544(a) to defeat the beneficiaries' claim to the trust property. *See City National Bank of Miami v. General Coffee Corp.,* 828 F.2d 699, 704-06 (11th Cir. 1987) (noting the split in authority as to whether § 544(a) would bring trust property into the bankruptcy estate in spite of § 541(d)). The Eleventh Circuit did not "resolve the tension between §§ 541 and 544(a)." *White v. Abrass (In re Abrass), 2*68 B.R. 665, 682 (Bankr. M.D. Fla. 2001); *e.g., In re Poffenbarger,* 281 B.R. 379, 394 (Bankr. S.D. Ala. 2002) (reviewing the split in authority and concluding that, just as in *General Coffee,* it was unnecessary to resolve the tension between the two sections). Other cases directly or indirectly addressing the issue include *XI/Datacomp, Inc. v. Wilson (In re Omegas Group Inc.)*, 16 F.3d 1443 (6th Cir. 1994); *Haber Oil Co. Inc. v. Swineheart (In re Haber Oil Co. Inc.)*, 12 F.3d 426 (5th Cir. 1994); *Beliste v. Plunkett*. 877 F.2d 512 (7th Cir. 1989); *Chbat v. Tleel (In re Tleel),*876 F.2d 769 (9th Cir. 1989); *Sanyo Electric Inc. v. Howard's Appliance Corp. (In re Howard's Appliance Corp.)*, 874 F.2d 88 (2d Cir. 1989); *In re Quality Holstein Leasing*, 752 F.2d 1009 (5th Cir. 1985).

(i) Section 544(a) is a "strong-arm" provision of the Bankruptcy Code that permits a trustee or debtor in possession to avoid secret liens against property in the debtor's possession. It grants the trustee or debtor in possession the rights of an essentially ideal lienholder against property in which the debtor does not possess complete title. *General Coffee*, 828 F.2d at 704.

(ii) Fundamentally, the issues are whether a constructive trust, under applicable state law, creates an equitable lien, and whether the equitable lien could be avoided under § 544(a). In *General Coffee,* the Eleventh Circuit "intimated [but did not rule] that a trustee's powers as a judicial lienholder and execution creditor must yield to the rights and interests of a constructive trust beneficiary, but that a trustee's powers as a bona fide purchaser of real property overpower the rights and interests of a constructive trust beneficiary, unless the interest was properly recorded before the bankruptcy case was filed." *Abrass*, 268 B.R. at 682 (analyzing the *General Coffee* opinion).

(iii) More recently, in *Poffenbarger,* 281 B.R. at 390-92, after noting the split in authority as to whether child support arrearages are property

of a custodial parent's Chapter 7 bankruptcy estate, the court imposed a constructive trust on funds representing payment of past due child support. The court then reviewed the analysis in *General Coffee* concerning the conflict between § 541(a) and § 544(a), and concluded that, under Alabama law, the minority children had priority over the Chapter 7 trustee. *Poffenbarger,* 281 B.R. at 395.

(b) Bankruptcy courts are hesitant to find that a constructive trust exists because such a finding directly conflicts with the well-established bankruptcy policy of ratable distribution among similarly situated creditors. *See Omegas Group,* 16 F.3d at 1453 (constructive trusts are "anathema to the equities of bankruptcy since they take from the estate, and thus directly from competing creditors, not from the offending debtor"); *Haber*, 12 F.3d at 431 ("[j]ust as medieval alchemists bent all their energies to discovering a formula that would transmute dross into gold, so too do modern creditors' lawyers spend prodigious amounts of time and effort seeking to convert their clients' general, unsecured claims against a bankrupt debtor into something more substantial"). In fact, "what a constructive trust is and when it arises have been and remain the subject of strident debate and considerable uncertainty." R. Keach, *The Continued Unsettled State of Constructive Trusts in Bankruptcy: Of Butner, Federal Interests and the Need for Uniformity*, 103 Com. L.J. 411 (1993).

(c) The defendant in a preference action bears the burden of establishing the existence of the constructive trust. *Haber,* 12 F.3d at 436.

(d) With the exception of tracing, the actual elements necessary to establish a constructive trust are governed by state law. *Southmark Corp. v. Crosz (In re Southmark),* 49 F.3d 1111, 1118 (5th Cir. 1995)*; General Coffee,* 828 F.2d at 702-04 (applying Florida law to the constructive trust analysis); *Poffenbarger,* 281 B.R. at 386 (applying Alabama law).

(e) Under the law of some states, the imposition of a constructive trust is an equitable remedy within the court's discretion. *See In re Dynamic Technologies Corp*., 106 Bankr. 994, 1007 (Bankr. D. Minn. 1989) (applying Minnesota law), *citing Thompson v. Nesheim*, 280 Minn. 407, 159 N.W.2d 910 (Minn. 1968).

(f) Where trust funds have been commingled with other funds, bankruptcy courts will require tracing even where state law expressly dispenses with tracing requirements. The defendant bears the burden of tracing the funds if they were commingled. *Advent Management Corporation v. Taylor Associates (In re Advent Management Corporation),* 104 F.3d 293, 296 (9th Cir. 1997).

(g) Courts applying tracing requirements have ruled that federal bankruptcy law must preempt state law when state law attempts to dispense with the tracing requirement. *See Elliott v. Bumb,* 356 F.2d 749, 745-55 (9th Cir. 1966) (even though state law imposed a constructive trust where commingled trust assets could not be traced, the bankruptcy court refused to find a constructive trust where funds could not be adequately traced).

(h) The elements necessary to establish a constructive trust vary from state to state. As a general proposition, however, to prevail on a constructive trust argument, the defendant would have to establish "unjust enrichment," or that debtor received a benefit that, for reasons of fairness, it should not retain. Unjust enrichment may result as a consequence of the defendant's fraud, or abuse of an agency, fiduciary or confidential relationship, or because property was transferred to the defendant by mistake, but a finding of unjust enrichment is by no means dependent on any of these specific instances. In *Poffenbarger,* Judge Mahoney examined the elements necessary to establish a constructive trust under Alabama law. 281 B.R. at 388-89. "Under Alabama law, it is unnecessary that there be the presence of fraud, wrongdoing, abuse of a confidential relationship, or other unconscionable conduct in order for a constructive trust to arise." *Id.* at 288.

(i) The defendant in a preference action relying upon the constructive trust defense must be able to identify the trust property. This may be difficult if the trust property was money that was commingled with other funds. The bankruptcy court may permit the defendant to follow the funds where the amount of the deposit, at all times since the commingling of funds, equaled or exceeded the amount of the trust fund. On the other hand, after a transfer into an account and commingling, if all of the moneys are withdrawn, the defendant might not prevail even though money from other sources may have been deposited thereafter. In the intermediate case where the account is reduced to a smaller sum than the trust fund, the latter must be regarded as dissipated, except as to the balance, and funds subsequently added from other sources cannot be subjected to the equitable claim of the beneficiary. If new money is deposited before the balance is reduced, the reduction should be considered to be from the new money and not from the monies held in trust. This analysis is referred to as the ``lowest intermediate balance test." 5 Collier on Bankruptcy, at 541.11. This is the same rule used where proceeds of collateral are commingled with cash that is not the proceeds of collateral. *See* 9B *Hawland Revised UCC*, § 9315:3, at page 9-221 and n.9 (2001 ed.).

(3) The "Mere Conduit Defense." An agent that acts as a "mere conduit" for the transfer of funds from the prepetition debtor to another entity is not liable in a preference action. *E.g., Pope v. Haas & Wilkerson* (*Matter of Alabama State Fair Auth.*), 232 B.R. 252 (N.D. Ala. 1999); *Rosenberg v. Rollins, Burdick, Hunter Co.* (*In re Presidential*

Airways, Inc.), 228 B.R. 594 (Bankr. E.D. Va. 1999); *Official Comm. of Unsecured Creditors for Dairy Stores, Inc. v United States Dept. of Labor* (*Matter of Dairy Stores, Inc.*), 148 B.R. 6 (Bankr. D.N.J. 1992); *Salomon v. Nedlloyd, Inc.* (*In re Black & Geddes, Inc.*), 59 B.R. 873 (Bankr. S.D.N.Y. 1986); *Gropper v. Unitrac, S.A.* (*In re Fabric Buys of Jericho, Inc.*), 33 B.R. 334 (Bankr. S.D.N.Y. 1983). Courts so holding have reasoned that the agent who receives and then disburses the funds is not an "initial transferee" under § 550 and, therefore, cannot be liable for return of the funds. *E.g., Black & Geddes*, 59 B.R. at 875.

(a) The Fifth Circuit has ruled that "a party that receives a transfer directly from the debtor will not be considered the initial transferee unless that party gains actual dominion or control over the funds." *Security First Nat'l Bank v. Brunson* (*Matter of Coutee*), 984 F.2d 138, 140-41 (5th Cir. 1993).

(b) Other courts have reasoned that transfers to an agent for a disclosed principal are not "to or for the benefit of" that agent as a creditor. *Dairy Stores*, 148 B.R. at 9. Under either reasoning, however, the result is the same–a "mere conduit" should not liable for the return of a preferential transfer.

(c) *Fabric Buys* is one of the seminal cases recognizing a "mere conduit" defense to a preference action. 33 B.R. 334. In *Fabric Buys*, the debtor had been a defendant in a lawsuit brought by Unitrac that was filed and settled before the debtor filed for bankruptcy relief. When the parties settled the case, the debtor made the settlement check payable both to Unitrac's counsel and to Unitrac. Unitrac's counsel deposited the check in his client escrow account and then paid over the entire settlement to Unitrac. When the debtor thereafter filed for bankruptcy, the trustee filed a preference action against Unitrac's counsel. Because Unitrac's counsel was a "mere conduit" for the funds from the debtor to the plaintiff, received no benefit whatsoever from the payment, and was not a creditor of the debtor, the court found counsel was not liable. *Id.* at 337.

(d) Three years later, the same court seemingly extended the holding of *Fabric Buys* to encompass situations where the agent or conduit may have a small financial interest in the payment in *Black & Geddes,* 59 B.R. 873. Before filing for bankruptcy, the debtor in *Black & Geddes* had retained the services of the defendant, Nedlloyd, a "steamship agency" for a disclosed, common carrier principal. After receiving the debtor's payment, Nedlloyd paid over the monies to its principal, "save only for the amount of its commission." *Id.* at 874. The debtor thereafter filed for bankruptcy relief and sued Nedlloyd for the allegedly preferential payment. But the court ruled that Nedlloyd was not liable because it was a "mere conduit of funds."

(e) A relatively recent case involving an insurance broker found that the

broker was a conduit or agent and thus not an "initial transferee" from whom a preference is recoverable. *Alabama State Fair,* 232 B.R. at 256, 272-73. In *Alabama State Fair*, the defendant procured several insurance policies for the prepetition debtor, which paid the premiums in installments. Although the installment payments were made within the preference period, the court granted summary judgment in favor of the broker because it was not an initial transferee. The court held, consistent with § 550, that a preference recovery can only be had from an "initial transferee" or the "entity for whose benefit such transfer was made." 232 B.R. at 271. To be an initial transferee, the court held that one must control the funds of the debtor as opposed to being a mere agent or conduit. *Id.* The court noted that the broker-defendant "had no authority to take those funds for its own accounts or to distribute it to anyone other than National Fire [the insurer], with the exception, perhaps, of its own commissions." *Id.* at 272. Accordingly, because "the defendant had no right to use those funds for any purpose other than to pass them along to the insurer," the court affirmed summary judgment for the broker. *Id.*

(f) At least one court has found the "mere conduit" defense inapplicable where the agent advanced monies to pay the debtor's invoices. *Fonda Group, Inc. v. Marcus Travel* (*In re the Fonda Group, Inc.*), 108 B.R. 956 (Bankr. D.N.J. 1989).