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# The Earmarking Defense to Voidable Preference Liability: A Reconceptualization

*by*

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When borrowers drift into financial difficulty, lenders often want out. Yet the federal law of voidable preference prevents the lenders from withdrawing assets from their borrowers, to the extent the lenders are unsecured.[1]

Refinancing, however, may save the day for lenders looking for a way out and for borrowers who wish to replace disgruntled creditors. If an angry creditor (whom we shall call "the bad creditor," or "TBC")[2] is replaced with a benevolent "new" creditor (whom we shall call "NC"), the borrower may prevent immediate acceleration and may preserve the prospect of rehabilitation outside of bankruptcy court, preserving equity value and avoiding significant transaction costs that always accompany insolvency proceedings.

If bankruptcy ensues nevertheless, has TBC, paid by refinancing, received a voidable preference? The answer is no. Courts have vindicated unsecured refinancing of unsecured debt. The basis for this vindication is the "earmarking defense."

Earmarking is said to be an extra-statutory, judge-created exception to § 547(b) liability.[3] In this Article, we will show that this is not so. Earmark-

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[1]Repayment of secured debt, in contrast, is not a preference. It does not diminish the estate or disadvantage other unsecured creditors. *See* 11 U.S.C. § 547(b)(5) (1994). *See generally* David Gray Carlson, *Security Interests in the Crucible of Voidable Preference Law*, 1995 U. ILL. L. REV. 211, 256-58.

[2]We use the shorthand TBC even when the creditor has a valid defense. In justification, we note that the refinanced creditor had a duty to remain an unsecured creditor and be equal with his fellows. Refinancing permits TBC to escape this duty, but only because some sacrificial, gallant NC comes to the rescue.

[3]*See* McCuskey v. National Bank (*In re* Bohlen Enters., Ltd.), 859 F.2d 561, 565 (8th Cir. 1988); Hansen v. MacDonald Meat Co. (*In re* Kemp Pacific Fisheries, Inc.), 16 F.3d 313, 316 n.2 (9th Cir. 1994) (calling earmarking "a creature of equity").

ing, invented by the great Learned Hand in 1938,[4] was and is a version of the "contemporaneous exchange" defense now codified under Bankruptcy Code § 547(c)(1).[5] Section 547(c)(1) has displaced the pre-Code common law doctrine that a trustee can only recover to the extent of "diminution of the estate"—a notion that is even older than its adoption in the earmarking doctrine. To date, courts have overlooked the fact that § 547(c)(1) codifies and therefore abolishes earmarking as well as any other doctrine related to diminution of the estate.

Our argument is that courts have striven to articulate the earmarking concept, but they have only half-glimpsed its true nature. Our concept of it should be viewed as an installment of the evolutionary process in which the implicit nature of law works itself out in order to make itself express. To quote a very grand philosopher for a modest proposal:

> A further word on the subject of *issuing instructions* on how the world ought to be: philosophy . . . always comes too late to perform this function. As the *thought* of the world, it appears only at a time when actuality has gone through its formative process. . . . it is only when actuality has reached maturity that the ideal appears . . . and reconstructs this real world, which it has grasped in its substance, in the shape of an intellectual realm. . . . the owl of Minerva begins its flight only with the onset of dusk.[6]

We claim that the "owl of Minerva" announces that the earmarking doctrine is simply an imperfect incarnation of the "contemporaneous exchange" concept in § 547(c)(1).

If courts were to agree that § 547(c)(1) governs refinancing, the earmarking doctrine would change dramatically. Currently, courts focus on whether NC intended to refinance TBC, or, alternatively, whether NC intended generally to lend to the debtor ("D").[7] In the former case, courts announce that the funds received by TBC never became property of the debtor. Hence, TBC has received no voidable preference. In the latter case, D owned the

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[4]Grubb v. General Contract Purchase Corp., 94 F.2d 70 (2d Cir. 1938).

[5]According to 11 U.S.C. § 547(c)(1) (1994), the trustee may not avoid a transfer

> to the extent that such transfer was—
>
> (A) 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
>
> (B) in fact a substantially contemporaneous exchange[.]

[6]GEORG W.F. HEGEL, ELEMENTS OF THE PHILOSOPHY OF RIGHT 23 (Allen W. Wood trans., Cambridge University Press 1991).

[7]*See* Glinka v. Bank of Vermont (*In re* Kelton Motors, Inc.), 97 F.3d 22, 27-28 (2d Cir. 1996).

loan proceeds and wrongfully diverted them to TBC. Accordingly, TBC is guilty of voidable preference.

In distinguishing between refinancing and lending to the debtor, courts determine whether D "controls" the flow of funds from NC to TBC.[8] If so, courts deny the earmarking defense. We will show that, since § 547(c)(1) governs, NC's intent and D's "control" are irrelevant.[9] Rather, the issues are precisely as § 547(c)(1) sets them forth: (A) intent of D and TBC that a transfer to TBC be contemporaneous with new value given to D[10] and (B) substantial contemporaneity of that exchange.[11] Control is and always was a mere proxy for these elements of exchange. If § 547(c)(1) supplies the rule, courts can simply avoid the unseemly inquiry into power that "control" currently requires.

This change in criteria is especially important in cases involving checks written to a creditor on insufficient funds ("NSF checks"). Courts now claim that earmarking is inappropriate because the debtor "controls" the bank's payment of an NSF check.[12] Once control drops out of the equation, it becomes possible to see NSF checks as a valid instance of earmarking—though we hasten to add that NSF checks written on provisional credits stand differently.[13]

In addition, if courts focus on the dual requirements of intent and contemporaneity, it becomes clear that drawing down preexisting loan commitments to pay TBC is preferential. NC's commitment is an asset of D. It is what Uniform Commercial Code Article 9 would call "general intangible" property.[14] This asset should not be diverted to old creditor claims. Rather, it should be used to benefit D's estate generally, in the hope that no bankruptcy will ensue. Because the old commitment neither is, nor was intended to be, contemporaneous with the transfer of funds to TBC, TBC will be ineligible for the earmarking defense.

Perhaps the greatest killer of bankruptcy fiction is Judge Frank Easterbrook, who in the famous case of *Levit v. Ingersoll Rand Financial Corp.* (the "*Deprizio*" case),[15] laid to rest the notorious "two transfer" theory invented under the Bankruptcy Act of 1898.[16] This same judge, however, validated

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[8]*See infra* notes 21-63 and accompanying text.

[9]*See infra* notes 150-74 and accompanying text.

[10]11 U.S.C. § 547(c)(1)(A) (1994).

[11]*Id.* § 547(c)(1)(B).

[12]*See* Hansen v. MacDonald Meat Co. (*In re* Kemp Pacific Fisheries, Inc.), 16 F.3d 313, 317 (9th Cir. 1994); *In re* Smith, 966 F.2d 1527, 1539 (7th Cir. 1992), *cert. dismissed* 506 U.S. 1030 (1992).

[13]*See infra* notes 181-211 and accompanying text.

[14]U.C.C. § 9-106 (1995).

[15]874 F.2d 1186, 1190 (7th Cir. 1989). The debtor in this case was V. N. Deprizio & Co. Hence, the ubiquitous nickname.

[16]Pub. L. No. 55-171, 30 Stat. 544 (repealed 1978).

another fiction—the "initial transferee" of a voidable preference who merely processes funds without taking a beneficial interest in them is a "mere conduit"[17] and hence not an initial transferee at all.[18] Like the "two-transfer" theory, this fiction was invented to prevent a palpable injustice. Yet if Judge Easterbrook had our thesis before him, he would have seen that his "mere conduit" was entitled to the "earmarking" defense, as reconstituted as a mere example of the "contemporaneous exchange" defense in § 547(c)(1).

Our rewriting of the earmarking defense, then, will simply erase the embarrassment of court-made doctrines in violation of the black letter of the Bankruptcy Code. The Supreme Court has sternly lectured the lower courts about judicial legislation.[19] The earmarking doctrine and the "mere conduit" notion, as currently described, are precisely examples of such prohibited legislation.[20] Yet if it could be shown that earmarking actually is properly within the domain of the (c)(1) defense, then courts would no longer be guilty of legislation.

This Article will proceed as follows. First, the earmarking doctrine as promulgated today will be described. Second, we will review the history of voidable preference jurisprudence under the Bankruptcy Act in order to establish that the implied element of "diminution of the estate" applied only in cases involving contemporaneous exchanges and refinancings. Once the added step of recognizing refinance as a form of contemporaneous exchange is taken, the earmarking doctrine falls under § 547(c)(1). In the third part of this Article, we will discuss the elements of the (c)(1) defense and how its application to refinancing would change results. Part Four will focus on the special problems caused by check clearance. The (c)(1) defense may or may

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[17]Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890, 891 (7th Cir. 1988).

[18]*See* 11 U.S.C. § 550(a)(1) (1994) (making all initial transferees liable for another's voidable transfer).

[19]*See* United States v. Noland, 517 U.S. 535, 541-42 (1996); Butner v. United States, 440 U.S. 48, 55-56 (1979).

[20]In *Official Bondholders' Committee v. Eastern Utilities Associates (In re EUA Power Corp.)*, 147 B.R. 634 (Bankr. D.N.H. 1992), a creditor's committee seeking to recover a preference claimed that the enactment of the Bankruptcy Code put an end to the earmarking doctrine. Judge James Yacos, however, disagreed.

> The "earmarking doctrine" has continued as an integral aspect of the preference statute for several reasons. The judicial development of the "earmarking doctrine" under the Bankruptcy Act was well established by case law, the statutory language regarding preferences under the Bankruptcy Act is essentially identical to the language of the preference section in the Bankruptcy Code, and there is no indication that Congress intended to abolish this well-established judicial interpretation of the statute. The Court reaches this conclusion with the guidance regarding statutory construction set forth in *Dewsnup v. Timm.*

*Id.* at 640-41. In *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992), Justice Harry Blackmun suggested that, unless the legislative history signals otherwise, old Bankruptcy Act practices survive intact under the Bankruptcy Code.

not apply in tripartite check cases, depending on whether the debtor is creating overdrafts in her account or writing checks against provisional credits in the account. This latter possibility includes the very challenging problems of check kiting schemes and the effect voidable preference law has on creditors who successfully obtain funds in the midst of such fraudulent schemes.

## I. CURRENT EARMARKING DOCTRINE

### A. Unsecured Refinancing

The basic earmarking situation is simple. It is merely unsecured refinancing of unsecured debt. A debtor (D) is insolvent. A "bad creditor" (TBC) clamors to be paid, even though preference law imposes on TBC a duty of modest stillness and humility, enjoying mere equality with other unsecured creditors. D, however, locates a "new creditor" (NC) who is willing to refinance TBC's claim on an unsecured basis.[21] In spite of the refinancing, bankruptcy ensues within ninety days of TBC's receipt of funds.[22] In such circumstances, courts proclaim that TBC is innocent of voidable preference liability. A preference requires a finding that TBC has received a transfer of D's property.[23] Earmarking alleges that TBC has received none. Rather, it has received only NC's property.[24]

Descriptively, this account is inaccurate. Even when NC wires funds directly to TBC, NC intends for D to reimburse NC. Clearly NC "lends" to D when D advances funds directly to TBC.[25] Courts defend this bad description by means of an economic observation. In the above transaction, TBC

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[21]There might be a series of NCs. In *Glinka v. Bank of Vermont (In re Kelton Motors, Inc.)*, 97 F.3d 22 (2d Cir. 1996), $NC_1$ borrowed money from $NC_2$ in order to refinance TBC on behalf of D. $NC_2$ therefore issued a check to D, which D forwarded to TBC. Earmarking was nevertheless upheld. Under current earmarking doctrine as inadequately formulated by the courts, TBC would have been guilty of preference if D ever "controlled" the loan proceeds. Therefore, Judge John M. Walker, Jr., had to explain that D never "possessed" the check even though D endorsed it over to TBC. As we have reformulated it, it does not matter whether D possessed the check or not, so long as D and TBC intended a contemporaneity between the transfer to TBC and the new value given to D. *See infra* notes 116-25 and accompanying text.

[22]The preference period is one year for insiders. *See* 11 U.S.C. § 547(b)(4)(B) (1994). We will assume, however, that TBC is not an insider, unless otherwise indicated.

[23]This requirement can be found in the preamble to § 547(b).

[24]*See In re* Smith, 966 F.2d 1527, 1538 (7th Cir. 1992) (Flaum, J., dissenting) ("If a third party earmarks—meaning designates and allocates—funds to satisfy the debt owed a particular creditor, the debtor never really obtains a property interest in the earmarked funds, and hence transferring the funds does not diminish the debtor's estate."), *cert. dismissed* 506 U.S. 1030 (1992); Mandross v. Peoples Banking Co. (*In re* Hartley), 825 F.2d 1067, 1070 (6th Cir. 1987); Sun Railings, Inc. v. Silverman (*In re* Sun Railings, Inc.), 5 B.R. 538, 539 (Bankr. S.D. Fla. 1980).

[25]In criticizing the earmarking doctrine, Professor Harry Flechtner points out that "the oft-repeated assertion that earmarking prevents the transferred property from becoming property of the debtor represents a misguided attempt to create a statutory basis for the judge-made earmarking doctrine, and should be rejected." Harry M. Flechtner, *Preferences, Post-Petition Transfers, and Transactions Involving a Debtor's Downstream Affiliate*, 5 Bankr. Dev. J. 1, 14-15 (1987) (footnotes omitted).

has escaped D's bankruptcy proceeding. But TBC's escape has not imposed a loss on the other unsecured creditors. The only thing that has really happened is that the identity of the unsecured creditor has changed. Without refinancing, TBC would have the honor of filing a proof of claim in the bankruptcy, thence to collect a pro rata share of the bankruptcy estate. Now, in light of refinancing, NC's name will appear on the proof of claim. Other unsecured creditors, in the main, are not harmed by refinancing, and may even be helped (if refinancing enables D to survive an economic downturn).[26]

In order to determine whether NC intends to refinance TBC directly (in which case TBC supposedly receives NC's property) or whether NC lends to D (in which case TBC has received D's property), courts interest themselves in NC's intent.[27] As a proxy for this issue, courts ask whether D "controls" the flow of funds from NC to TBC.[28] If so, then NC has lent to D. TBC has received D's property, and TBC has liability for a voidable preference.

Our review of the case law shows that "control" is too manipulable a criterion. For example, sometimes, NC pays TBC directly. Nevertheless, D has control and TBC is liable for a voidable preference.[29] At other times, D holds cash or bearer paper for a time.[30] Nevertheless, NC intends to refinance and TBC escapes liability. By way of example, if NC writes or buys a cashier's check payable to D, D must indorse it over to TBC and deliver it. Some courts hold that earmarking exists; NC intended to refinance.[31] Other courts hold NC lent to D because D "controlled" the check at the time of indorsement.[32] The criterion of control is comfortable with either result.

Sometimes bank deposits have been ruled as proof of D's control. D must

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[26]*See* Glinka v. Bank of Vermont (*In re* Kelton Motors, Inc.), 97 F.3d 22, 25 (2d Cir. 1996) ("Under the earmarking doctrine, where a third party lends money to a debtor for the purpose of paying a specific creditor, the loan is not a preferential transfer. Instead the third party simply is substituted for the original creditor."); *In re* Smith, 966 F.2d at 1538 (Flaum, J., dissenting) ("Such transactions involve nothing more than a swap of creditors; the third party merely replaces the transferee as the debtor's new creditor, with no adverse impact upon the quantity or quality of the assets held, or increase in the liabilities owed, by the debtor."); *In re* Loring, 30 F. Supp. 758, 759 (D. Mass. 1939).

[27]*See In re* Kelton Motors, Inc., 97 F.3d at 27-28; *In re* Smith, 966 F.2d 1527, 1539 (7th Cir. 1992).

[28]*In re* Smith, 966 F.2d at 1539; Gray v. Travelers Ins. Co. (*In re* Neponset River Paper Co.), 231 B.R. 829, 835 (B.A.P. 1st Cir. 1999); Hargadon v. Cove State Bank (*In re* Jaggers), 48 B.R. 33, 36-37 (Bankr. W.D. Tex. 1985); Genova v. Rivera Funeral Home (*In re* Castillo), 39 B.R. 45, 47 (Bankr. D. Colo. 1984).

[29]*See* Smyth v. Kaufman (*In re* J.B. Koplik & Co.), 114 F.2d 40 (2d Cir. 1940); Cassirer v. Herskowitz (*In re* Schick) 234 B.R. 337, 346-47 (Bankr. S.D.N.Y. 1999).

[30]*See* Forker v. Duenow Management Corp. (*In re* Calvert), 227 B.R. 153 (B.A.P. 8th Cir. 1998).

[31]*See In re* Kelton Motors, Inc., 97 F.3d 22 (concluding D indorsed but did not "control" check written by NC); Grubb v. General Contract Purchase Corp., 94 F.2d 70 (2d Cir. 1938); Schilling v. Electronic Realty Assocs., Inc. (*In re* Hearn), 49 B.R. 143 (Bankr. W.D. Ky. 1985).

[32]*See* New York City Shoes, Inc. v. Best Shoe Corp., 106 B.R. 58 (E.D. Pa. 1989).

write the check and could choose not to do so.[33] At other times, D is held not to control funds deposited in *D*'s own checking account, if they were supplied by NC,[34] even if considerable time passes between NC's deposit and D's check.[35] Once again, "control" provides no guidance to courts whatever.

Certainly a fecund source of unsecured refinancing will be from insiders. Yet courts have used "control" in order to say the insider refinancing is per se illegitimate. That is, D, who is in "control" of NC (its subsidiary), may not cause NC to issue a check to TBC.[36] Because control was the issue, one court ruled that D "owned" NC's bank account and that earmarking was inappropriate.[37] Cases such as this, in effect, pierce the corporate veil and consolidate diverse estates into one. Other courts, however, decline to find that the parent automatically controls the assets of its subsidiaries, thereby permitting insider earmarking.[38]

One court implied that refinancing by related corporate entities is theoretically possible, but, disturbingly, it permitted the insider after the fact to testify about what NC intended in self-serving ways. Thus, NC (an insider) borrowed from TBC (a bank) to pay back TBC on behalf of D. TBC wrote a check payable to NC. NC indorsed it to D. Immediately thereafter, on behalf of D, the insider indorsed the check in blank and handed the check to TBC. The insider later had the bad taste to testify that he intended to lend to D. Through the act of the insider, D then "controlled" the funds by diverting them to TBC. TBC was therefore found guilty of a preference.[39]

*In re Smith*[40] also illustrates how control is a criterion incapable of determining the result. In *Smith*, D wrote a check on NC's provisional credit, based on a "kited" check.[41] TBC presented the check to NC, and NC elected

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[33]*See In re* Smith, 966 F.2d 1527, 1540 (7th Cir. 1992), *cert. dismissed* 506 U.S. 1030 (1992); Hovis v. Powers Constr. Co. (*In re* Hoffman Assocs., Inc.), 194 B.R. 943, 957-58 (Bankr. D.S.C. 1995).

[34]*See* Hoffer v. Marine Midland Trust Co., 294 F. Supp. 187 (S.D.N.Y. 1968); International Ventures, Inc. v. Block Properties VII (*In re* Int'l Ventures, Inc.), 214 B.R. 590, 595-96 (Bankr. E.D. Ark. 1997) (denying earmarking defense because NC was secured).

[35]*See* Dubis v. Heritage Bank & Trust Co. (*In re* Kenosha Liquidation Corp.), 158 B.R. 774, 777 (Bankr. E.D. Wis. 1993) (discussing three-day gap).

[36]*See* Knapp v. Applewhite (*In re* Knapp), 119 B.R. 285 (Bankr. M.D. Fla. 1990); Hargadon v. Cove State Bank (*In re* Jaggers), 48 B.R. 33 (Bankr. W.D. Tex. 1985).

[37]*See* Official Bondholders' Comm. v. Eastern Utils. Assocs. (*In re* EUA Power Corp.), 147 B.R. 634, 643-44 (Bankr D.N.H. 1992) (suggesting the danger of insider abuse prevents expansion of earmarking doctrine); Howdeshell of Ft. Myers v. Dunham-Bush, Inc. (*In re* Howdeshell of Ft. Myers), 55 B.R. 470, 474-75 (Bankr. M.D. Fla. 1985).

[38]*See* Ragsdale v. Bank South, N.A. (*In re* Whitacre Sunbelt, Inc.), 206 B.R. 1010 (Bankr. N.D. Ga. 1997).

[39]*See* Telephone Stores of Am. Inc. v. Banquest Nat'l Bank (*In re* Telephone Stores of Am., Inc.), 54 B.R. 25 (Bankr. D.N.M. 1985).

[40]966 F.2d 1527 (7th Cir. 1992), *cert. dismissed* 506 U.S. 1030 (1992).

[41]That is, D had deposited a bad check, and its bank (NC) gave a provisional credit which it was not contractually bound to honor.

to honor it. TBC was paid. The court saw the issue as devolving into whether D ever "controlled" the funds supplied by NC. A majority of the three-judge panel found that control existed. Dissenting in *Smith*, Judge Joel Flaum thought the opposite, though he agreed that "control" was the governing criterion. It bothered him that, since NC paid TBC directly, D did not "control" the loan proceeds for an appreciable time.[42] Hence, both the majority and the dissent thought "control" favored their side of the argument.

"Control" certainly led to a wrong result in *Herzog v. SunarHauserman (In re Network 90°, Inc.)*,[43] where TBC, an unsecured supplier, demanded that D remit all checks on its accounts directly to TBC. Thus, account debtors were instructed to make checks payable to D and TBC jointly. In light of this instruction (which, presumably D could cancel),[44] Judge Ilana Diamond Rovner ruled that TBC had an earmarking defense, because D had no "control" over its account debtors.[45] Without question, this case was wrongly decided. Thanks to confusion over the empty notion of "control," D was able to divert its property—accounts—to an unsecured creditor.[46]

These examples should suffice to show that "control" is an unpredictable

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[42]According to Judge Flaum:

> [T]he Debtor had dispositive control over the transferred funds neither before nor after the transfer. My colleagues seem to implicitly acknowledge this, for after exploring the issue in some depth, they ultimately conclude that the Debtor obtained a property interest "[a]t the moment . . . the Debtor's payment to [TBC] was achieved," namely when the Bank honored Debtor's check to [TBC]. Control, in other words, vested instantaneously at the time of transfer. But it would have had to have vanished immediately thereafter, or maybe at the same time. It might be of some philosophical interest to ponder what actually happened, if anything, at this existential moment, but any such exercise would provide a slim reed upon which to rest a conclusion that the Debtor exercised any kind of dispositive control over the transferred funds.

966 F.2d at 1540 (citations omitted).

[43]126 B.R. 990 (N.D. Ill. 1991).

[44]If D could not cancel this instruction, then it follows that TBC had an unperfected security interest in the accounts (or perhaps no security interest, if no written "security agreement" existed).

[45]Judge Rovner was not bothered by this fact:

> [T]he earmarking doctrine does not necessarily require that there be a new creditor which supplies money to pay off a debt to an existing creditor. The foundation of the earmarking doctrine lies not in the relationship of the old and new creditors and the debtor, but in the debtor's control (or lack of control) over the assets which were transferred.

*In re* Network 90°, 126 B.R. at 994. We disagree strongly with this view. New value (not mere allocation of old value) is absolutely essential to earmarking, because earmarking is nothing but an example of the (c)(1) defense.

It should be noted that, in *Network 90°*, TBC continued to supply D on open account. This would tend to give TBC defenses under § 547(c)(4). On this defense, based on giving back new value after an admitted preference has been received, see *infra* note 118 and accompanying text.

[46]For a similar case in which "control" led to an erroneous result, see Steelvest, Inc. v. Frank Messer & Sons Constr. Co. (*In re* Steelvest, Inc.), 112 B.R. 852 (Bankr. W.D. Ky. 1990).

and manipulable criterion—an empty vessel with no content.[47] In all the above cases, NC lent to D, whether or not D "controlled" the loan proceeds. In fact, D was in control. D could have refused to borrow, thereby denying TBC payment. If, on the other hand, earmarking is brought under § 547(c)(1), control drops out of the equation. TBC always receives D's property. The only issue is whether TBC and D intended for D to receive new value (from NC).

### B. Secured Refinancing

Unsecured refinancing of unsecured debt is eligible for earmarking, but, as it currently stands, only if NC "controlled" the vector of loan proceeds and intended that vector to point toward TBC. What if NC insists on security as the price for its refinancing? Suddenly courts lose all interest in "control" of the funds and proclaim TBC guilty of voidable preference in all cases.

Secured refinancing can occur in many guises. In the classic case of *Dean v. Davis*,[48] TBC threatened criminal prosecution if D did not pay, because D had forged some notes tendered as collateral. NC (D's brother-in-law) intervened to pay TBC directly, but NC insisted on a mortgage on D's real property to secure this timely refinancing. The court in dictum made clear that TBC had received a preference (though the trustee, in *Dean*, was suing the brother-in-law, NC).[49]

Another common situation involves the standby letter of credit. TBC clamors for payment. NC is D's bank. NC will issue a letter of credit to TBC, but it insists on collateral. Courts insist that TBC has received a preference.[50]

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[47]In fairness, one can certainly find "control" cases that were rightly decided. Thus, in *Lingley v. Stuart Shaines, Inc. (In re Acme-Dunham Inc.)*, 50 B.R. 734 (D. Me. 1985), NC committed to lend, but NC did not have the funds. NC's insider, TBC, therefore made the advance. D "paid" TBC a few months later and expected NC's advance to follow. A month later, the money came back to D from NC.

Judge Gene Carter concluded that D "controlled" the funds used to pay TBC and hence TBC could be liable for a voidable preference. *Id.* at 738-39. We would say, in contrast, that all payments to TBC are D's property, regardless of degree of "control." The true issue is whether TBC and D intended that D's payment to TBC be contemporaneous with NC's advance to D. The answer is clearly no. NC committed to lend in advance of lending. This commitment constitutes D's property. As such, it constituted "old value," not new value. Hence, TBC did not have a valid (c)(1) defense.

Ironically, Judge Carter ruled that TBC did not show that NC "was in any sense bound to make the $100,000 loan to [D] for the express purpose of replenishing the $100,000 paid to [TBC]." *Id.* at 739. But TBC was in control of NC. Undoubtedly, TBC could and did commit NC to lending.

[48]242 U.S. 438 (1917).

[49]NC was held innocent of preference but guilty of having received a fraudulent conveyance, since NC knew he was financing a voidable preference to TBC. *See* 242 U.S. at 445-46.

[50]*See* American Bank v. Leasing Serv. Corp. (*In re* Air Conditioning, Inc.), 845 F.2d 293 (11th Cir. 1988). The exact theory for establishing this liability is undertheorized and, in fact, disastrously self-defeating, for reasons we explain at length in David Gray Carlson & William H. Widen, *Letters of Credit, the Independence Doctrine, and Voidable Preference Law*, 54 Bus. Law. 1661 (1999).

In cases such as these, courts rule that earmarking does not apply.[51] Economically, they observe that secured refinancing depletes the bankruptcy estate. No longer is the identity of the unsecured creditor being changed. Now an unsecured creditor is being replaced by a secured creditor, to the detriment of all remaining unsecured creditors.[52] The bankruptcy estate has been "diminished" by secured refinancing of unsecured debt.

Doctrinally, this result is explained in an absurd fashion. It is said that TBC has now received D's property.[53] The assertion is absurd because, whether or not NC takes collateral, the refinancing is identical from TBC's standpoint. In both cases, NC sends the money it has lent to D over to TBC.[54]

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[51]*See* Brown v. Mt. Prospect State Bank (*In re* Muncrief), 900 F.2d 1220, 1224 n.4 (8th Cir. 1990); Estate of Love v. First Interstate Bank (*In re* Love), 155 B.R. 225 (Bankr. D. Mont. 1993).

[52]*See Brown*, 900 F.2d at 1224 n.4; Steel Structures, Inc. v. Star Mfg. Co., 466 F.2d 207, 217-18 (6th Cir. 1972).

[53]*See* Glinka v. Bank of Vermont (*In re* Kelton Motors, Inc.), 97 F.3d 22, 28 (2d Cir. 1996); *accord*, Barry E. Adler, *Accelerated Resolution of Financial Distress*, 76 WASH. U.L.Q. 1169, 1182 (1998) ("Thus, as the bankruptcy statute requires, courts formally consider whether a challenged earmarked transfer is from property of the debtor. Logic notwithstanding, however, the answer to that question has become 'no' if, in the court's view, the transfer does not ultimately diminish the bankruptcy estate.").

Although we agree with Adler on this point, we disagree with his recommendation for reform. Adler proposes to punish refinancing, not by recovering preferences, but by avoiding NC's claim if bankruptcy ensues. Adler apparently would permit NC to file for amounts TBC could have filed for. Any increase stemming from changes in interest rates or advantage from shortened maturities would be disallowed, because it would be prejudicial to other unsecured creditors.

First, we are baffled by any reference to maturities, as bankruptcy treats creditors with varying maturities alike. Second, disallowance of higher interest at a minimum creates unworkable complexities not fully acknowledged by Adler. Higher interest rates on a new loan may be caused by changes in market conditions unconnected with changing credit quality of a borrower. Indeed, at times a credit-improved borrower may still need to borrow at a higher rate; at other times a credit-impaired borrower may be able to refinance at lower rates than were available at the time of the initial loan (even though it was a better credit at that time). It is doubtful that a simple benchmark could be devised to mediate between these market effects. Third, Adler would punish refinancing, because refinancing permits a debtor to survive longer and make bad investment decisions. Yet he would permit new credit for bad investments directly. This makes no sense to us. Why is an initial loan to a CCC credit-rated loan somehow acceptable but the same loan used to refinance an old loan discouraged? Adler's proposal does not affect a leveraged asset purchase when a B credit sells assets to a new company with a CCC credit rating and uses the proceeds of sale to repay existing debt; however, if the same management refinances old debt, that new debt is punished.

Fourth, Adler would disable refinancing, but old creditors could increase interest rates or maturities without punishment (in effect tying debtors to old, quasi-monopolistic creditors). New creditors could buy old debt and then increase the interest rate without fear of harm. Hence, Adler's proposal is easily evaded in the absence of byzantine regulation. Furthermore, is a loan facility with grid pricing (e.g., prenegotiated spreads above LIBOR (London Interbank Offered Rate) that change based on the credit rating of the borrower from time to time) one loan or a series of refinanced loans? What about loan facilities that contain commitment extensions for a fee? What if a loan facility is amended and restated? Suppose some banks remain in the syndicate and others drop away following restatement? What if a bank assigns or participates its loan to another lender on the day that an interest rate is reset upwards? These and many other related troubles follow from Adler's proposal.

[54]*See* Estate of Love v. First Interstate Bank (*In re* Love), 155 B.R. 225, 231 (Bankr. D. Mont. 1993)

In perhaps the most striking example of absurdity, suppose NC insists on receiving a security interest. This means that NC has lent to D, according to earmarking. But, through error, suppose NC fails to perfect, so that the security interest is invalid in the debtor's bankruptcy. In *In re Loring*,[55] the court ruled that the loan proceeds of this secured loan were never debtor property. Such a holding ignores an important point: one of the elements of attachment of a consensually created security interest is that NC must give value to D.[56] Hence, the very admission that NC had an unperfected security interest contradicts the conclusion that TBC never received debtor property.

If the *Loring* result were to apply under the modern Bankruptcy Code, then, to borrow Jeremy Bentham's metaphor, nonsense truly parades about on stilts.[57] Under § 547(e), all unperfected secured parties are given a ten-day grace period. If NC perfects in this grace period, the transfer is deemed to have occurred when the security interest attached.[58] If NC perfects beyond the ten-day grace period, then NC is deemed to have received a transfer on the date of perfection.[59] As applied to secured refinancing, the grace period implies that, initially, when NC forwards funds to TBC but NC has not yet perfected, TBC has received NC property. TBC is paid by NC but not preferred by D. If, however, NC files a financing statement within the grace period, then history is rewritten. TBC's payment is retroactively deemed to be D property and becomes voidable. Obviously, descriptive violence is being done in order to protect unsecured refinancing while punishing secured refinancing.[60]

Meanwhile, debtor control, which determines the difference between valid and invalid unsecured refinancing, suddenly becomes irrelevant when NC takes a security interest. No matter how rigidly NC insists on forwarding funds to TBC,[61] TBC receives debtor property if NC has obtained security. This inconsistency further proves that "control" is not a proper criterion.

We maintain that, whether the refinancing is secured or unsecured, NC

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("Common sense is stretched to the breaking point when a court finds that the funds loaned to a debtor, even for the specific [sic] purpose of paying an existing creditor, do not become property of the estate [sic].") (quoting (with changes shown) McGoldrick v. Juice Farms, Inc. (*In re* Ludford Fruit Prods.), 99 B.R. 18, 21 (Bankr. C.D. Cal. 1989)).

[55]30 F. Supp. 758, 760 (D. Mass. 1939).

[56]*See* U.C.C. § 9-203(1)(b) (1995).

[57]*See* J. Bentham, *A Critical Examination of the Declaration of Rights*, *in* POLITICAL THOUGHT 257, 269 (B. Parekh ed., 1973) (describing natural law discourse as "nonsense on stilts").

[58]*See* 11 U.S.C. § 547(e)(2)(A) (1994).

[59]*See id.* § 547(e)(2)(B).

[60]For a case in which TBC was denied the earmarking defense when NC took an unperfected security interest, see *International Ventures, Inc. v. Block Properties VII (In re Int'l Ventures, Inc.)*, 214 B.R. 590, 596 (Bankr. E.D. Ark. 1997).

[61]This occurred in *Dean v. Davis*, 242 U.S. 438 (1917).

lends to D. In both cases, D's property interest in the loan is identical. Under our analysis, "control" simply becomes irrelevant to the analysis. What counts is whether TBC, prima facie guilty of voidable preference, can carry the burden of proving[62] the (c)(1) defense.[63]

### C. Undersecured Refinancing

Sometimes, NC has received limited collateral in exchange for refinancing.[64] When NC is undersecured, courts have in part allowed the earmarking

[62]According to Bankruptcy Code § 547(g), a creditor has the burden of proving any defense under § 547(c). If a court believes earmarking to be inherent in § 547(b)—instead of § 547(c)—the trustee has the burden to prove earmarking does *not* apply. *See* Kaler v. Community First Nat'l Bank (*In re* Heitkamp), 137 F.3d 1087, 1089 (8th Cir. 1998) (imposing burden on trustee); Tolz v. Barnett Bank (*In re* Safe-T Brake of S. Fla., Inc.), 162 B.R. 359, 364 (Bankr. S.D. Fla. 1993); Dubis v. Heritage Bank & Trust Co. (*In re* Kenosha Liquidation Corp.), 158 B.R. 774, 777 (Bankr. E.D. Wis. 1993). *Cf.* Wasserman v. Village Assocs. (*In re* Freestate Management Servs., Inc.), 153 B.R. 972, 981-82 (Bankr. D. Md. 1993) (imposing burden on TBC).

[63]Secured refinancing of secured debt is not ordinarily an issue. If TBC is fully secured, then it is privileged to receive any transfers from D. A trustee can never make out the element of § 547(b)(5) against TBC—the hypothetical liquidation test. Oversecured creditors have no duty to be equal. Hence, refinancing of secured debt is never dangerous to TBC.

In *Kaler v. Community First National Bank (In re Heitkamp)*, 137 F.3d 1087 (8th Cir. 1998), the district court wrongly invoked earmarking in a context in which the concept does not fit. In this case, materialmen had real estate liens on D's house. NC advanced funds directly to the lien creditors. D granted a mortgage to NC. NC, however, forgot to record this mortgage until a few days before the debtor's bankruptcy petition. Clearly the mortgage should have been deemed a voidable preference.

Judge George Fagg disagreed—on earmarking grounds. Thus, earmarking is supposed to be a defense for TBC, but under Judge Fagg's reasoning, it becomes a defense for NC's later perfection of its security interest.

Judge Fagg thought the late-perfected mortgage "merely replaced the subcontractors' security interest," and hence "there was no transfer . . . avoidable under § 547(b)." 137 F.3d at 1089. The citation to § 547(b) in the above quote is clearly inapt. If Judge Fagg had said that a prima facie voidable preference had occurred, but that it was defended under § 547(c)(1) because the subcontractors' liens were released, the analysis would have been more straightforward. But such a citation likewise requires the view that the release of the statutory liens (in November 1995), *see* 137 F.3d at 1088, was "substantially contemporaneous" to the recordation of the mortgage (in March 1996). *Accord*, Krigel v. Sterling Nat'l Bank (*In re* Ward), 230 B.R. 115 (B.A.P. 8th Cir. 1999). So re-interpreted, the case stands for a very liberal view of contemporaneity. It also stands for the availability of (c)(1) to cure NC's perfection error. Many courts insist that (c)(1) cannot be used to cure perfection errors beyond the grace period set forth in § 547(e)(2)(A). *See* Gower v. Ford Motor Credit Co. (*In re* Davis), 734 F.2d 604, 606 (11th Cir. 1984); Ray v. Security Mut. Fin. Corp. (*In re* Arnett), 731 F.2d 358, 361 (6th Cir. 1984). *Heitkamp* is best read as not an earmarking case, which covertly invokes the (c)(1) defense, but as a case suggesting that (c)(1) is available to correct grace period errors by TBCs who perfect late.

[64]This may arise because D has a claim against NC. If NC lends to D to refinance TBC, NC obtains a new setoff right against D. *See* Hoffer v. Marine Midland Trust Co., 294 F. Supp. 187 (S.D.N.Y. 1968) (permitting full earmarking defense in spite of NC's new setoff opportunity). The setoff right is, to NC, as good as a security interest. Indeed, § 506(a) of the Bankruptcy Code directly defines a setoff right as a security interest, for bankruptcy purposes. *See* 11 U.S.C. § 506(a) (1994) ("An allowed claim of a creditor . . . that is subject to setoff under section 553 of this title, is a secured claim to the extent of the . . . amount subject to setoff.").

defense and in part disallowed it.[65] TBC must in effect reimburse the trustee for collateral given to NC, but is allowed to keep the funds NC paid in excess of value of the collateral.[66] Given the pretense of the doctrine—that the loan is either debtor property (or not) depending on the presence of a security agreement between NC and D—courts necessarily take the view that the same loan is in part debtor property and part not. NC's control is partly relevant to the case and partly irrelevant. The undersecured creditor cases prove how metaphysically unsatisfactory the earmarking theory is. In truth, NC always lends to D. The invocation of diminution of the estate is a strong clue that, instead of conceiving earmarking to be ad hoc judge-made law, courts must bring unruly earmarking under the jurisdiction of § 547(c)(1).[67]

D. Payment by Surety Contrasted

Earmarking involves a loan by NC to D, which D intentionally directs to TBC. Current doctrine wrongly assumes that TBC has not received D's property. Of course, D borrowed the money from NC and has directed that NC forward the proceeds to TBC. All refinancings entail the transfer of debtor property to TBC.

To be distinguished is payment to TBC by a surety. Some sources insist that suretyship is the same as earmarking.[68] That assessment, however, is erroneous. Indeed, it is a confusion based on the error that, in unsecured refinancing, NC transfers NC's own property to TBC. Only if this wrong premise is accepted do surety payments resemble unsecured refinancings.

At least where the suretyship is over ninety days old, payment by a surety is payment of its own antecedent debt. It is never preferential in D's bankruptcy because the payment is indeed never debtor property.[69] The difference is that a surety owes TBC independently. When the surety pays

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[65]*See* Glinka v. Bank of Vermont (*In re* Kelton Motors, Inc.), 97 F.3d 22, 29 (2d Cir. 1996); Kellogg v. Blue Quail Energy, Inc. (*In re* Compton Corp.), 835 F.2d 584 (5th Cir. 1988) (per curiam); Mandross v. Peoples Banking Co. (*In re* Hartley), 825 F.2d 1067, 1068 (6th Cir. 1987); Steel Structures, Inc. v. Star Mfg. Co., 466 F.2d 207 (6th Cir. 1972).

[66]*See In re* Hartley, 825 F.2d at 1068; Virginia Nat'l Bank v. Woodson (*In re* Decker), 329 F.2d 836 (4th Cir. 1964).

[67]In *Hoffer v. Marine Midland Trust Co.*, 294 F. Supp. 187 (S.D.N.Y. 1968), Judge Walter Mansfield permitted full earmarking, even though NC's advance (to D directly, who then paid TBC) created a setoff opportunity for NC. This case is a rare exception in which a court permitted earmarking even though the estate would be reduced.

[68]*See* McCuskey v. National Bank (*In re* Bohlen Enters.), 859 F.2d 561, 565 (8th Cir. 1988); Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351, 1356 (5th Cir. 1986) (earmarking analysis applied to acquit creditor who applied five-month-old deposit by surety to extinguish partially secured claim against debtor); Geremia v. Fordson Assocs. (*In re* Int'l Club Enters.), 109 B.R. 562, 567 (Bankr. D.R.I. 1990) (refusing to extend earmarking "beyond" suretyship).

[69]*See, e.g.*, Brown v. First Nat'l Bank, 748 F.2d 490 (8th Cir. 1984). It might, however, be preferential in NC's ensuing bankruptcy. *See* Goldberg v. Torell (*In re* Rundlett), 149 B.R. 353 (Bankr. S.D.N.Y. 1993).

TBC, the surety is not lending to D. The loan to D occurred when the suretyship was first created. Thereafter, the surety satisfies its own independent obligation to TBC with its own funds.[70] One could say, of course, that the surety's payments are proceeds of a transfer of debtor property. This debtor property, however, was successfully alienated to TBC before the preference period. TBC owns those rights free and clear of D's bankruptcy trustee, and, of course, TBC owns proceeds of this property as well.

Unlike refinancing, no new claim against D arises when a surety pays its preexisting obligation to TBC. The surety, prior to paying TBC, already had a contingent reimbursement claim against D. Once the surety pays TBC, this contingent claim becomes vested.[71] But vesting (disappearance of a condition precedent) is different from a transfer of property.[72] Hence, vesting cannot constitute new value given back to the debtor.[73]

Payment of a preexisting suretyship obligation comprises a transfer of NC's dollars to TBC. But NC's initial agreement to be a surety is on a different footing. Creation of the suretyship obligation constitutes a loan to D. For instance, suppose D owes TBC on old debt. To placate TBC, D arranges for NC to guaranty D's note. NC has given "new value" to D. "New value," in turn is defined in § 547(a)(2) 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 by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an

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[70]*Accord*, Aulick v. Largent, 295 F.2d 41, 49 (4th Cir. 1961); Bank of Am. Nat'l Trust & Savs. Ass'n v. Small (*In re* Zaferis Bros. & Co.), 67 F.2d 140, 141 (9th Cir. 1933); Gold v. Alban Tractor Co., 202 B.R. 424, 427 (E.D. Mich. 1996), *aff'd*, 142 F.3d 433 (6th Cir. 1998).

[71]*See* 11 U.S.C. § 502(e)(2) (1994).

[72]*See* Sullivan v. Willock (*In re* Wey), 854 F.2d 196, 199 (7th Cir. 1988). On this distinction, see Carlson, *supra* note 1, at 235-38.

[73]Still another tricky distinction occurs when the surety owes D, chooses to pay D on the receivable, and D chooses to divert this payment to TBC. This ought to be a voidable preference, but, in *Citizens' National Bank v. Lineberger (In re Kirby-Warren Co.)*, 45 F.2d 522 (4th Cir. 1930), an overly generous court helped TBC out from its plight. In this case, the surety owed the receivable to D and also had cosigned D's notes. In an eleventh hour workout, the surety borrowed money from TBC, used the money to pay down the receivable, and caused D to pay the same money to TBC. The point of this circular procedure is mysterious. TBC already had a suretyship claim against the surety. Now it would have a claim for repayment of a direct loan.

Be that as it may, the bankruptcy trustee sued the obligee for voidable preference and should have recovered. The proceeds of the account were clearly D's property. D paid these proceeds to TBC. Yet TBC still prevailed against the bankruptcy trustee. In essence, Judge John J. Parker allowed the parties to re-characterize the transaction after the fact for their own benefit. Parker effectively treated the surety's payment to the debtor as a payment directly to the obligee (not a payment on the receivable), followed by a setoff of the receivable.

obligation substituted for an existing obligation . . .[74]

NC's new suretyship is new credit extended to D.[75] If NC takes a security interest contemporaneous with its loan, then the new suretyship is secured refinancing of unsecured debt, and TBC has received a voidable preference.[76]

Similarly, if NC has issued a letter of credit to TBC on NC's antecedent debt, NC pays the letter of credit with its own funds. In effect, the letter of credit is a suretyship obligation. *Creation* of the letter of credit, however, constitutes new credit given to D. Creation might be a voidable preference. But if the letter of credit is issued prior to the preference period, NC's payment to TBC can never be considered preferential.[77]

Thus, a case often cited as a fount of earmarking wisdom is not an earmarking case at all, but the simple case of TBC realizing on collateral provided by a guarantor. In *Coral Petroleum, Inc. v. Banque Paribas-London*,[78] TBC had demanded that NC (D's subsidiary) provide collateral for D's debt. The collateral was a deposit by the subsidiary in TBC's London branch. The deposit constituted a transfer of D's property, but, as it occurred prior to the preference period, the transfer could not be avoided.

Just prior to bankruptcy, TBC caused its London branch to reduce the surety's account to zero, thus realizing on its suretyship rights. Although the court acquitted TBC on earmarking grounds, in fact and more properly the court should have said that TBC did receive D property—the creation of the nonrecourse suretyship right in the deposit. But this transfer occurred outside the preference period. The actual setoff within the preference period is therefore a non-event, insofar as D's bankruptcy estate was concerned. Earmarking should never have been mentioned.

The *ab initio* creation of suretyship is a loan (i.e., new value) to D. Extension of this new value directly to TBC might be a voidable preference for which TBC might be liable. Payment of an old suretyship obligation, however, is payment of NC dollars. TBC never receives a voidable preference when a surety pays its suretyship obligation, when that obligation is over ninety days old.[79]

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[74] 11 U.S.C. § 547(a)(2) (1994).

[75] *See* Reigle v. Mahajan (*In re* Kumar Bavishi & Assocs.), 906 F.2d 942 (3d Cir. 1990) (holding that guaranty constituted new value for §547(c)(1) purposes).

[76] *See* Aulick v. Largent, 295 F.2d 41, 52 (4th Cir. 1961). The *Aulick* court involved suit against TBC. It avoided the question whether NC could be made to pay. We have defended the possibility that the trustee steps into TBC's shoes and can sue NC on TBC's suretyship rights. *See* Carlson & Widen, *supra* note 50, at 1719-35.

[77] 295 F.2d at 50.

[78] 797 F.2d 1351 (5th Cir. 1986).

[79] This distinction is particularly difficult in construction cases. Hence, if, under applicable law, the real estate owner owes the subcontractor directly and pays the subcontractor directly, and if the contractor files for bankruptcy, the real estate owner is a surety, and the payment is not a transfer of contractor

E. Assignments

In the last section, we distinguished refinancing from payment of a surety's antecedent debt to TBC. The former is potentially preferential, because it entails a transfer of debtor property. The latter is not preferential (when the suretyship was created before the preference period), because it entailed the transfer of NC property.

A like distinction must be made between refinancing and the purchase of a claim against the debtor. Earmarking involves NC's loan to D, who forwards these funds to TBC. As such, it is quite different from NC's simple purchase of TBC's claim. An assignment involves NC paying TBC in exchange for the claim. In no sense do we have a loan to D.

The borderline between assignment and refinancing consists of whether NC deals only with TBC, or whether NC and D agree that NC will send funds to TBC.[80] In the very case that introduced the phrase "earmarking," the border was wrongfully transgressed. In *Smyth v. Kaufman (In re J.B. Koplik & Co.)*,[81] D wrote TBC a check that was sure to bounce. NC was D's landlord, willing to give credit to keep D afloat. In warning TBC that his check might bounce, D recommended that TBC bring the check to the landlord, who would pay the cash amount of it. TBC did so, and was paid. Judge Augustus Hand ruled that NC had lent to D. He went on to find that D "controlled" access to NC's funds. Hence, TBC was declared unworthy of the newly born earmarking defense. Judge Hand, however, easily could have found that NC's purchase of the check was an assignment of TBC's claim. If so, then TBC never would have received D's property.

As we will analyze earmarking, the metaphysics of assignment versus new loan to D will not ordinarily be outcome-determinative. Even under Hand's misdescription of the check negotiation, TBC would not have been liable, because D and TBC intended there to be a contemporaneous exchange: NC extended new value (the loan), and TBC received a transfer of debtor property (also the loan).[82]

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dollars. *See* Crocker v. Braid Elec. Co. (*In re* Arnold), 908 F.2d 52 (6th Cir. 1990). If, however, there is no direct obligation, the real estate owner who pays the subcontractor is advancing funds to D, and the subcontractor is a TBC. *See* Mason v. Southern Sanitation, Inc. (*In re* Underground Storage Tank Technical Servs. Group, Inc.), 212 B.R. 574 (Bankr. E.D. Mich. 1997).

[80]In *McCuskey v. National Bank (In re Bohlen Enters.)*, 859 F.2d 561 (8th Cir. 1988), Judge Irving Hill comments: "Where a guarantor pays the old creditor directly, the requirement of an agreement between the new lender-guarantor and the debtor is inapplicable. For the reasons discussed *supra*, no voidable preference can exist even in the absence of a specific agreement." *Id.* at 566 n.11. This is correct with regard to assignments but not as to suretyship, where the surety and D have an agreement either expressly or as implied in law under the doctrine of subrogation.

[81]114 F.2d 40, 43 (2d Cir. 1940).

[82]*See infra* notes 115-25 and accompanying text.

F. SUMMARY

Unsecured refinancing, satisfaction of old suretyship claims, and assignment of old claims are not preferential. But the reasons for this differ. Unsecured financing involves new value extended to D. Unsecured financing escapes liability because the new loan is intended to be contemporaneous with payment of TBC. When NC wires TBC directly, the new value extended by NC *is* the transfer of debtor property to TBC.

Suretyship payments and assignments are conceptually different. In neither case does NC advance new value to D. The suretyship in fact constitutes old value. Once the suretyship comes into existence and is not itself a voidable preference,[83] NC must pay the suretyship obligation with its own dollars. Meanwhile, an assignment involves no new value to D at all. Here NC buys TBC's claim without any debtor involvement. Hence, the purchase price consists only of NC dollars—never D's dollars.

## II. THE HISTORY OF EARMARKING

Earmarking doctrine grew up amidst the theoretical poverty of preference law under the Bankruptcy Act of 1898.[84] Because § 60 of the Bankruptcy Act was so severely metaphysically disabled, courts had to innovate with fictions that did not make much sense, in order that the natural law of intuition might align with the positive content of Bankruptcy Act § 60.[85]

Two fictions will concern us here. First, § 60(a) punished transfers "for the benefit" of creditors who never received a transfer of debtor property. Section 60(b) provided for liability of transferees only. Hence, courts had to explain why non-transferees were liable because they "benefited" from transfers made to some other entity. To solve this problem, courts invented the "two transfer" theory, in which "benefits" were said to be transfers, and beneficiaries were thus "transferees" within the meaning of § 60(b). Second, courts had to explain why TBC who took transfers in part on antecedent debt and in part for new value should have a partial defense to the extent new value was tendered. Section 60 deemed the entire transfer void—not just part of it. Today, TBC would have a clear defense under Bankruptcy Code § 547(c)(1), but Bankruptcy Act § 60 provided for no such defense. Hence, courts decided that, implicit in § 60(a) was the rule that the trustee could avoid a transfer only *to the extent* that the bankruptcy estate was diminished.[86]

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[83]Creation of the suretyship, however, is the extension of new value. If it occurs in the preference period, TBC may well have received a preference. *See* Carlson & Widen, *supra* note 50, at 1689-92.

[84]Pub. L. No. 55-171, 30 Stat. 544, *as amended to* April 8, 1976 (repealed 1978).

[85]Because it is no longer easily obtained, the full text of § 60, *as amended to* April 8, 1976, is presented in the Appendix to this Article.

[86]The emphasized words "to the extent" appear expressly in § 547(c)(1).

A. THE TWO-TRANSFER THEORY

A notorious example in which fate and metaphysical aid crowned § 60 withal was the "two transfer" theory. Section 60(a)(1), like Code § 547, made not merely the transferee of a preference liable. It also made non-transferees liable as well. Thus, if a non-transferee "benefited" from a transfer to a third party, the transfer was deemed a preference. The archetypical example of illicit benefit was when a surety guaranteed payment to TBC and D paid TBC within the preference period. Although the surety received nothing, it very much benefited when TBC was paid. Hence, courts early on ruled that non-transferees might be liable,[87] and, in 1938, the Chandler Act ratified this judicial innovation by adding this holding to the language of § 60(a)(1).[88] Unhappily, Congress failed to conform § 60(b)—the remedial provision. Section 60(b) provided only for the liability of a *transferee*. It did not provide for the liability of nontransferee beneficiaries.[89]

To "solve" this dilemma, courts began to declare that the "benefit" itself

[87]*See* National Bank v. National Herkimer County Bank, 225 U.S. 178, 184 (1912) ("To constitute a preference, it is not necessary that the transfer be made directly to the creditor. It may be made to another, for his benefit."). In that case, D had a claim against its affiliate. It was also liable on a promissory note held by TBC. Shortly before bankruptcy, the affiliate purchased D's note held by TBC and used it to set off its obligation to D. Then as now, assignments of unsecured claims during the preference period obtained to create a setoff were disallowed. *See* Bankruptcy Act of 1898, § 68(b); 11 U.S.C. § 553(a)(2) (1994).

The affiliate, however, was insolvent and had no assets. The bankruptcy trustee therefore tried to recover from TBC on a preference theory. Apparently, the trustee alleged that the money paid by the affiliate to TBC was in fact the debtor's property—proceeds of the receivable the affiliate owed D. If so, then TBC received debtor property on antecedent debt.

The lower court had ruled that the bank could not be liable for the preference because it was never the transferee of debtor property. *See* Mason v. National Herkimer County Bank, 172 F. 529 (2d Cir. 1909) *aff'd*, 225 U.S. 178 (1912). In affirming, Justice Charles Evans Hughes denied that only transferees could be defendants in voidable preference actions.

[88]Chandler Act, ch. 575, § 60, 52 Stat. 840, 869-71 (1938) (repealed 1978). Subsequent to the Chandler Act, amendments adopted on March 18, 1950, by the 81st Congress, Public Law 461, retained § 60(a) as renumbered § 60(a)(1) and added § 60(a)(2)-(8). See full text of amended § 60(a) in an Appendix to this Article.

[89]According to § 60(b):

> Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: *Provided, however*, That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State

must be a transfer. Under such a premise, § 60(b) authorized recovery from the beneficiary. Hence, under § 60(b), there were always two transfers. First, the initial transferee received a transfer. Second, the person benefited received a transfer as well.[90]

If benefits are transfers, then they are absolutely separate and diverse. The security interest that benefits TBC may have been given to NC. Section 60(b) declares that security interest "void" if it is a preference. Yet courts did not therefore deprive NC of the security interest. Under the two-transfer theory, the security interest is divorced from the benefit. Hence, NC's security interest would be valid, because, in exchange for it, NC extended a loan. Simultaneously, TBC could be liable for receiving the benefit, because TBC's benefit was on antecedent debt.

Such reasoning is implicit in the famous case of *Dean v. Davis*.[91] In that case, TBC clamored for payment. NC was willing to refinance TBC, but only in exchange for security. D granted NC a mortgage, and NC forwarded funds to TBC. The trustee chose to sue only NC in order to destroy the mortgage.

Judge Charles A. Woods of the Fourth Circuit ruled that NC had received a voidable preference, but on inadequate grounds:

> Looking away from the form to the substance, by his participation as agent of the insolvent debtor in paying the bank and taking up the notes and securing the debt, Dean tied himself to the old debt, and the notes given to him must be regarded mere substitution of new papers for the old.
>
> . . . If it were otherwise, the purpose of the statute in securing equality among creditors could be defeated at the will of the debtor by the device of substituting a new debt for the old.[92]

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> court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.

Chandler Act, ch. 575, § 60(b), 52 Stat. 840, 870 (1938) (repealed 1978). Notice the first sentence refers to non-transferees, but only to require that they have the requisite *mens rea*. Recovery is governed by the second sentence, which allows the trustee to recover the property or a conversion judgment from the person who converted the property.

[90]*See* David Gray Carlson, *Tripartite Voidable Preferences*, 11 BANKR. DEV. J. 219, 298-305 (1995).

[91]242 U.S. 438 (1917).

[92]Dean v. Davis (*In re* Jones), 212 F. 88, 91 (1914), *aff'd*, 242 U.S. 438 (1917). Earlier cases reached this result, mainly on consequentialist reasoning. *See* Walters v. Zimmerman, 208 F. 62 (N.D. Ohio 1913) (avoiding NC's security interest as preference because it knew proceeds would go to refinance old debt); *In re* Beerman, 112 F. 663, 666 (N.D. Ga. 1901) ("If transactions of this sort are to be permitted, then, instead of a creditor taking a mortgage himself, when a debtor is in failing circumstances, he will get someone else to advance the money, agreeing that the person advancing the money shall suffer no loss, and thereby obtain by indirection a preference which he would be unable to get if he had acted directly with the debtor, provided, of course, that the debtor within four months thereafter becomes a bankrupt.").

The theory on display here was that, because NC was the "agent" of D in paying TBC, NC bore liability along with D, as a kind of coconspirator. On this logic, the corporate treasurer, who signs checks on behalf of an insolvent debtor, bears liability for helping to convey away debtor property. Needless to say, this was an unsatisfactory theory. Section 60(b) does not impose liability on any agent of D who helped bring the voidable preference about. Only transferees of debtor property could be liable.

On further appeal, Justice Louis Brandeis ruled that NC had not received a voidable preference.

> The mortgage was not voidable as a preference under § 60b. Preference implies paying or securing a pre-existing debt of the person preferred. The mortgage was given to secure Dean for a substantially contemporary advance. The bank, not Dean, was preferred. The use of Dean's money to accomplish this purpose could not convert the transaction into a preferring of Dean, although he knew of the debtor's insolvency. Mere circuity of arrangement will not save a transfer which effects a preference from being invalid as such. But a transfer to a third person is invalid under this section as a preference only where that person was acting on behalf of the creditor . . . . Here Dean acted on the debtor's behalf in providing the money and taking up the notes.[93]

*Dean v. Davis* therefore implicitly relies on the "two-transfer" theory. For NC to be acquitted of prima facie liability, it must have been true that NC was not the initial transferee of a security that benefited TBC. The benefit must have been an entirely separate transfer altogether. If it were otherwise, one might observe that NC was the initial transferee of TBC's voidable preference. Since the lien was void, NC must forfeit it and, in effect, bear the liability properly visited on TBC.

In 1978, with the enactment of the Bankruptcy Code, Congress eliminated the need for the fiction of two transfers. Thereafter, § 550(a) would provide for the in personam liability of non-transferees who were benefited by preferences (and other voidable conveyances). Hence, courts are free to declare the true situation—benefits are not transfers. Rather, benefit radiates from a transfer given to some initial transferee. Thus, in *Dean v. Davis*, we would say of NC's mortgage that NC was the initial transferee of TBC's voidable preference, and TBC received the benefit. This security interest was in exchange for new value NC gave to D. Hence, the security interest is protected by the contemporaneous exchange defense in § 547(c)(1). Sepa-

[93]Dean v. Davis, 242 U.S. 438, 443 (1917) (citations omitted).

rately, we would say that TBC received the proceeds of a loan to D and therefore was liable for this quite separate preference. Neither TBC nor NC is liable for the security interest granted to NC in exchange for the loan.

Congress also elected in 1978, however, to extend the preference period for insiders to one year, even as it shortened the preference period for ordinary creditors from the Bankrutpcy Act's four months to ninety days. This innovation led to the famous *Deprizio* result.[94] In *Deprizio*, TBC lent to D, and X, an insider, guaranteed it. TBC received payment more than ninety days before bankruptcy. Noninsider creditors who are paid and who then wait out the preference period tend to think they have cheated the devil. But Judge Frank Easterbrook would prove that this was not the case. The payments "benefited" X. X's preference period was one year, not ninety days. Accordingly, the money paid to TBC was a voidable preference. TBC, as initial transferee, had to return the funds. The *Deprizio* opinion effectively lengthened TBC's preference period from ninety days to one year, because TBC took care to obtain X's guaranty.

Prior to *Deprizio*, courts attempted to avoid extending the preference period to noninsider creditors by sustaining the outmoded "two-transfer" fiction made superfluous by § 550(a). Borrowing the bad metaphysics of the Bankruptcy Act, these courts reasoned that TBC received one transfer, and X received a quite separate transfer—the benefit.[95] TBC was therefore not the initial transferee of X's preference, but was the initial transferee of a transfer more than ninety days before bankruptcy. On the "two-transfer" theory, TBC escaped the *Deprizio* result.

In *Deprizio*, however, Judge Easterbrook pointed out that the "two-transfer" theory was an outmoded fiction—an emperor whose clothes had been overthrown by Congress in its revolutionary frenzy. The naked truth was that TBC received the one and only transfer. Since this one transfer benefited an insider, TBC was liable as the initial transferee of a transfer void under § 547. Accordingly, § 550(a)(1) made TBC liable, even though the transfer was more than ninety days old by the time of D's bankruptcy.

Following *Deprizio*, courts largely agreed that the "two- transfer" theory was dead. Congress amended § 550(a) in 1994 in attempt to repeal *Deprizio*, but, for technical reasons, may not have succeeded in doing so.[96]

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[94]Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186 (7th Cir. 1989). *See supra* note 15 for the source of the *Deprizio* nickname.

[95]In support of this proposition was *Dean v. Davis*, 242 U.S. 438 (1917), where NC advanced funds to TBC in exchange for a mortgage. Justice Louis Brandeis ruled that NC had not received a voidable preference. Only TBC was preferred. *See id.* at 443. This remark could only be true if TBC's benefit was somehow separate from NC's mortgage. Otherwise, NC was the initial transferee of TBC's mortgage.

[96]Bankruptcy Reform Act of 1994, Pub. L. No. 103-94, § 102, 108 Stat. 4106. The difficulty is that Congress's amendment repealed actions "under § 550(a)," but a trustee can avoid *Deprizio* preferences directly under § 547, without any reliance on § 550(a), and, in any case, can avoid and preserve the

We have related this familiar story, because it shows that courts must give up the old fictions of § 60(a). Like the "two- transfer" theory, earmarking, in its current form, is one of the old fictions that has been overthrown in the new regime.

B. The Contemporaneous Exchange Defense

Today, § 547(c) provides TBC with a defense "to the extent" that TBC contemporaneously gives D new value in return. Bankruptcy Act § 60(a), however, had no such defense in it.[97] If the thing was transferred in violation of § 60(a), the thing had to be returned under § 60(b). Yet courts recognized the overwhelming equity favoring TBC if TBC paid in part for the preference with new value.

A typical case of this sort was *Abramson v. St. Regis Paper Co. (In re Abramson),*[98] where the debtor sold property worth $186,000 to an unsecured creditor for $66,500. The difference—$119,500—happened to coincide with the amount of the creditor's antecedent debt, which the parties deemed to be canceled as part of the sale. Hence, the sale was simultaneously a contemporaneous exchange *and* a transfer that extinguished an antecedent debt. Judge John R. Brown ordered the creditor to pay the difference between the value of the equipment purchased and the new value the creditor paid. He achieved this result by finding that implicit in § 60 was the requirement that the trustee could only recover to the extent the bankruptcy estate was diminished.

If *Abramson* could be revisited under the Bankruptcy Code, one would say that the entire transfer—worth $186,000—was prima facie voidable under § 547(b), but that § 547(c)(1) provides a partial defense "to the extent" new value of $66,500 was given contemporaneously. In short, § 547(c)(1) displaces diminution of the estate which, under § 60 of the Bank-

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preference under § 551. *See generally* David Gray Carlson, *Bankruptcy's Organizing Principles*, 26 Fla. St. U. L. Rev. 549, 593-96 (1999).

[97]One seemingly relevant provision was § 60(a)(8), which misleadingly holds:

> If no such requirement of applicable law specified in paragraph (7) exists, a transfer wholly or in part, for or on account of a new and contemporaneous consideration shall, to the extent of such consideration and interest thereon and the other obligations of the transferor connected therewith, be deemed to be made or suffered at the time of the transfer.

Bankruptcy Act of 1898, § 60(a)(8), *as amended by* Pub. L. No. 461, 81st Cong. (1950). Paragraph (7), *id.*, set forth the twenty-one day grace period for perfection. It whittled down the grace period below twenty-one days whenever state law had a lesser grace period—as in U.C.C. § 9-301(2), which typically provides for ten days. Hence the meaning of paragraph (7) is that, where state law provides no grace period, a transfer that is at least partly a contemporaneous exchange, shall be deemed made at the time of the transfer. This is quite useless information—a truism. No defense is established here, and no court opinion has been found that ever made use of this provision.

[98]715 F.2d 934 (5th Cir. 1983).

ruptcy Act, was the only way to reach the just result in light of the statutory language.[99]

A similar dilemma occurred when Debtor sold assets to a buyer (B), who then agreed to assume liability for some (but not all) of D's unsecured creditors. In *Palmer v. Radio Corp. of America*,[100] D was insolvent and B was solvent. B agreed to pay TBC and D accordingly reduced its price on goods sold to B dollar for dollar to the extent of TBC's debt. When only a select few of the debts are assumed, those creditors with third-party beneficiary rights against B in effect capture the value of the assets conveyed to B, because D will have discounted the price by the amount of these claims. Those creditors with no rights against B would therefore face a diminished estate. Hence, on the diminution theory, the *Palmer* court ruled that TBC was liable to pay the value of what it received from B, because TBC received an "indirect transfer." The buyer of course was not liable at all.[101]

If *Palmer* could be revisited under § 547(c)(1), one could say that B received a transfer, which benefited TBC on TBC's antecedent debt. But B gave new value to D: the cash price plus the promise to pay TBC. The promise to pay TBC is in effect a loan to D, with the proceeds directed to TBC. Hence, none of the sold assets is a voidable preference. Separately, TBC has received a second transfer—the buyer's promise to pay. This promise to pay is the voidable preference. TBC must either return the right to collect from the buyer to the bankruptcy estate, or TBC must pay the value of this right (if the court so directs).[102]

Such cases as *Abramson* and *Palmer* allowed the trustee to recover only to the extent the bankruptcy estate was diminished. This requirement of diminution of the estate was how courts expressed what § 547(c)(1) now describes. Instead of viewing non-diminution as a defense, courts thought the diminution requirement was part of the trustee's affirmative prima facie

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[99]Because § 547(c)(1) displaces the need to imply a "diminution of the estate" rule, some scholars have suggested that "diminution of the estate" is no longer a viable voidable preference concept. *See* Thomas M. Ward & Jay A. Shulman, *In Defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing*, 61 WASH. U.L.Q. 1, 40-41 (1983). Some courts disagree, however, and insist that the requirement survives. *See In re* Smith, 966 F.2d 1527, 1535-36 (7th Cir. 1992), *cert. dismissed* 506 U.S. 1030 (1992); Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351, 1355-56 (5th Cir. 1986); Lingley v. Stuart Shaines, Inc. (*In re* Acme-Dunham Inc.), 50 B.R. 734, 737 (D. Me. 1985) ("In addition to the express statutory requirements of a preference, many courts . . . have held that for a transfer to be preferential in the forbidden sense, it must 'diminish the fund to which creditors of the same class can legally resort for the payment of their debts.'") (quoting Kapela v. Newman, 649 F.2d 887, 892 (1st Cir. 1981)).

[100]453 F.2d 1133 (5th Cir. 1971).

[101]For a modern case denying that earmarking saves a creditor with rights against the buyer under assumption of liability, see *Buckley v. Jeld-Wen, Inc. (In re Interior Wood Products Co.)*, 986 F.2d 228 (8th Cir. 1993).

[102]*See* 11 U.S.C. § 550(a)(1) (1994).

case.[103]

Our review of the history of "diminution of the estate" as a concept shows that it was used in only two contexts: (1) contemporaneous exchanges—the territory now governed by § 547(c)(1);[104] and (2) earmarking cases[105]—which we argue are a disguised version of a contemporaneous exchange.[106] Just as § 547(c)(1) has "retired" the diminution requirement as an element of the trustee's prima facie case (transferring the concept into defensive material), so it should retire earmarking as well, transferring the concept from the prima facie case to the defensive domain of § 547(c)(1).

### C. Earmarking Under the Bankruptcy Act

Cases like *Abramson* and *Palmer* supplemented the defects of § 60 with a diminution requirement. "Earmarking" likewise relies heavily on the same

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[103]The earliest use of the phrase is *New York County National Bank v. Massey*, 192 U.S. 138 (1904). In this case, TBC was a bank, which had filed a proof of claim in D's bankruptcy. The trustee objected to this claim on the theory that TBC had received a voidable preference. Then as now, no claim was allowable if its owner had received a voidable preference. *See* Bankruptcy Act of 1898, § 57(g); *cf.* 11 U.S.C. § 502(d) (1994).

Prior to bankruptcy, D deposited funds in its checking account, and TBC later manifested a setoff. Then as now, setoffs were not preferences, so long as TBC did not conspire to obtain the "setup for a setoff" to evade the debtor's bankruptcy. *See* Bankruptcy Act of 1898, § 68(b).

The trustee did not contest the right of TBC to its setoff. Rather, he claimed TBC received a preference at the time of the deposit, so that the balance of TBC's claim should be disallowed. The court disagreed, ruling that the deposits had not diminished the bankruptcy estate—as they could have been withdrawn by the debtor. *See* Massey, 192 U.S. at 145-46. Because there was no diminution the deposits were not transfers at all.

In fact, TBC's setoff right was prior to the debtor's right of withdrawal. In truth, TBC now had a security interest in these deposits. *See* 11 U.S.C. § 506(a) (equating setoff opportunities with security interests). The better analysis for the court was to admit that the deposit was a transfer and that a security interest was created on antecedent debt, but that voidable preference may never interfere with TBC's valid right of setoff. In short, § 553(a), which protects setoffs, now constitutes a defense to voidable preference attack which might interfere with the setoff. *See* Carlson & Widen, *supra* note 50, at 1698-1705.

[104]*See* Engstrom v. Wiley, 191 F.2d 684, 686-87 (9th Cir. 1951); Thomas v. Gulfway Shopping Ctr., Inc., 320 F. Supp. 756 (S.D. Tex. 1970); Engelkes v. Farmers Coop. Co., 194 F. Supp. 319 (N.D. Iowa 1961); Newberry Corp. v. Fireman's Fund Ins. Co., 106 B.R. 186 (D. Ariz. 1989).

[105]*See* Mandross v. Peoples Banking Co. (*In re* Hartley), 825 F.2d 1067, 1070 (6th Cir. 1987); Tolz v. Barnett Bank (*In re* Safe-T Brake of S. Fla., Inc.), 162 B.R. 359, 362 (Bankr. S.D. Fla. 1993).

[106]Hoping to profit from semantic confusion, creditors tried to export "diminution of the estate" to cover the case of transfers of exempt property to TBC in the preference period. In other words, TBC argues that, because the bankruptcy estate must expel exempt property from the estate at D's request, the transfer of D's exempt property cannot be a preference because there is no diminution of the estate. In recent times, this argument has been rightly disallowed. *See* Deel Rent-a-Car, Inc. v. Levine, 721 F.2d 750 755-58 (11th Cir. 1983); Goldberg v. Torell (*In re* Rundlett), 149 B.R. 353, 358 (Bankr. S.D.N.Y. 1993). Clearly, TBC has received a voidable preference. The only issue is whether the estate may keep the recovery or must remit the recovered property to D, as it is exempt. In effect, if D voluntarily conveyed the exempt property to TBC, D forfeits the exemption, and the recovery belongs to the trustee. If D involuntarily lost the exempt property to TBC, D may still exempt the recovered item. *See* 11 U.S.C. § 522(g)(1) (1994).

principle of diminution, but courts failed to recognize that unsecured refinancing is simply an example of a contemporaneous exchange, no different from those partially upheld (and partially struck down) in *Abramson* and *Palmer*.

Unsecured refinancing is not instantly recognizable as identical to the asset sales described above. But indeed it is. TBC receives payment and NC gives D new value on behalf of TBC. Hence, TBC is like the buyer of an asset, with the proviso that NC is paying the price of this asset. Because D and TBC intend this result, earmarking presents, in disguised form, a standard example of a contemporaneous exchange.

What is odd about unsecured refinancing, and what may explain the failure to note the homology with asset sales, is that the new value *to* D is also the transfer *from* D. Yet nothing in (c)(1) prevents new value from coinciding with the transfer voidable under § 547(b).

The very first earmarking case missed this point and introduced almost all of the misconceptions that would later encumber the law of refinancing. In *Grubb v. General Contract Purchase Corp.*,[107] D had no less than three NCs, whom we shall call $NC_1$, $NC_2$, and $NC_3$. Each contributed to the payment of TBC. Each presented a different aspect of the earmarking situation.

$NC_1$ promised to lend for the specific purpose of retiring the claim of TBC.[108] D therefore signed a promissory note to $NC_1$, which responded by crediting the amount of the note to D's checking account. D then obtained a cashier's check from $NC_1$, made out to TBC. D gave the cashier's check directly to TBC, who was paid thereby. With regard to $NC_1$'s cashier's check, Judge Learned Hand ruled that TBC was innocent of voidable preference liability. It had only received $NC_1$'s property, Hand thought.[109] $NC_1$ was like a surety who owed TBC and who made good on the suretyship. $NC_1$ never intended to give D any property. It was conveyed directly to TBC. Hence, D conveyed nothing to TBC in this transaction.

Earmarking was off to a bad start. Judge Hand failed to distinguish unsecured refinancing from suretyship payments and therefore thought that the loan never became debtor property unless the debtor "controlled" the proceeds. In fact, the debtor always controlled the loan. Without the debtor's consent, there would have been no loan. What Judge Hand should have emphasized was the intended contemporaneity of the exchange. Clearly TBC receives debtor property when NC lends to D. But an exchange occurs if NC advanced funds for the purpose of refinancing.

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[107]94 F.2d 70 (2d Cir. 1938). The actual phrase "earmarking," however, was coined by cousin Augustus Hand. *See* Smyth v. Kaufman (*In re* J.B. Koplik & Co.), 114 F.2d 40, 43 (2d Cir. 1940).

[108]TBC had collateral, but apparently forged and hence worthless "chattel paper." *See* Grubb v. General Contract Purchase Corp., 18 F. Supp. 680 (S.D.N.Y. 1937), *aff'd*, 94 F.2d 70 (2d Cir. 1938).

[109]*Accord*, *In re* Henry C. Reusch & Co., 44 F. Supp. 677, 680 (D.N.J. 1942).

$NC_2$ was on a different footing. $NC_2$ lent to D by crediting D's checking account. $NC_2$ then issued a cashier's check to TBC and gave it to D. This time D kept the cashier's check for a while and gave it to TBC later that day. In light of D's retention of the cashier's check for a period of time, Judge Hand had more trouble with $NC_2$ than he had with $NC_1$. For a few hours D "controlled" NC's check made payable to TBC (whereas D controlled $NC_1$'s check for less than a minute). During the hours of D control, TBC could not say that the check was TBC's property. TBC's in rem claim to the check depended upon its delivery to TBC.[110] If D did not deliver the check, D was entitled to return it to $NC_2$ and obtain a refund.[111] Judge Hand was unwilling to say that $NC_2$ intended D to be the trustee of the check for the benefit of TBC.[112] Instead, Judge Hand stated more simply that the loan was intended to refinance. From $NC_2$'s intent Judge Hand deduced that the loan never became debtor property. In other words, D was the trustee of $NC_2$ but not of TBC in handling the proceeds of the loan. Because D never had a beneficial interest in the check, TBC was innocent of voidable preference liability.

Here, at least, Judge Hand perceived that the intent of the parties was relevant. $NC_2$ intended to refinance, and the new value given by $NC_2$ to D was substantially contemporaneous with its transfer to TBC. An intended exchange occurred, and TBC should have escaped liability for this reason.[113]

$NC_3$ was on yet a different footing. $NC_3$ had committed to lend before actually lending. $NC_3$ was not very particular as to what this loan might be used for. Later, $NC_3$ borrowed funds from a bank. The bank credited his checking account. $NC_3$ used that loan to obtain the bank's cashier's check, made payable to TBC. $NC_3$ gave the check directly to TBC.

$NC_3$'s commitment to lend should have been viewed as debtor property. In Article 9 parlance, the commitment to lend was D's general intangible property.[114] It should have been used to benefit all the unsecured creditors

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[110]*See Grubb*, 94 F.2d at 72-73.

[111]*See* Hall-Mark Elecs. Corp. v. Sims (*In re* Lee), 179 B.R. 149, 159-61 (B.A.P. 9th Cir. 1995), *aff'd*, 108 F.3d 239 (9th Cir. 1997).

[112]*See Grubb*, 94 F.2d at 72-73. If this had been the case, TBC would have an in rem claim to the proceeds of the loan in D's bankruptcy. *Cf.* 11 U.S.C. § 541(d) (1994) (concluding bankruptcy estate includes the legal interest but not the equitable interest in trust property).

[113]If NC intends to lend but not to refinance, earmarking fails to protect TBC. *See* Inter-State Nat'l Bank v. Luther (*In re* Garden Grain & Seed Co.), 221 F.2d 382, 393 (10th Cir. 1955), *cert. dismissed*, 350 U.S. 944 (1956); Smyth v. Kaufman (*In re* J.B. Koplik & Co.), 114 F.2d 40, 43 (2d Cir. 1940).

[114]*See* U.C.C. § 9-106 (1995). Bankruptcy practitioners tend to overlook this point, because commitments to lend cannot be assumed in bankruptcy. But outside bankruptcy, a commitment to lend is a contingent claim by D upon the creditor who commits. This gives rise to a puzzle: If D signs a security agreement with TBC making all general intangible property thereafter acquired collateral for TBC, can TBC claim that the proceeds of any commitment to lend belong to TBC? If so, TBC is well secured whenever other creditors have committed to lend.

equally. D wrongfully diverted this asset to the use of TBC. Here no contemporaneous exchange was intended. $NC_3$ gave new value earlier, when it committed to lend. *Actually* lending constituted the conversion of old value into the form of cash. The committed value was not contemporaneous with nor intended to be contemporaneous with the transfer of D's property to BC.

Judge Hand disagreed, however:

> Nor was [$NC_3$'s] promise to lend the money to the bankrupt an asset of the estate, even though it created an obligation; for the loan was to be for only a few days, and the damages recoverable upon the breach of such a promise would have been scarcely more than nominal.[115]

These were not good objections, however. The amount of damages in case $NC_3$ refused to lend was entirely immaterial. This is tantamount to saying that a debtor's leasehold in real property is not property of the estate when the market rate exceeds the contract rate, because damages from breach of the lease would be nominal. Even if market rates matched the promised contract rate, the promise to lend must be recognized as an asset of the debtor. Similarly, the loan proceeds of the loan commitment should have belonged pro rata to all the unsecured creditors. $NC_3$ was a mere pro rata claimant to this (and other) debtor property. Furthermore, that a commitment is only a few days old is irrelevant, unless, when created, it was dedicated to the specific use of TBC.

The real question should have been whether $NC_3$ intended to "buy" D's payment to TBC. As this seems not to have been the case, no exchange occurred. TBC should have been viewed as having received D's property.

## III. EARMARKING AS A § 547(c)(1) DEFENSE

The above history shows that, under the old Bankruptcy Act, courts always permitted an offset of voidable preference to the extent a preferred creditor gave back new value. TBC's right to an offset was manifested in the view that a bankruptcy trustee could only recover a transfer to the extent it diminished the bankruptcy estate. Courts failed from the beginning to see that earmarking represented a contemporaneous exchange. In effect, NC pays for the transfer to TBC.

Under the Bankruptcy Code, the contemporaneous exchange defense is now codified under § 547(c)(1). Hence, it is time to recognize earmarking as entirely governed by this source.

According to § 547(c)(1), a trustee may not avoid a transfer

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[115]See *Grubb*, 94 F.2d at 72-73.

> to the extent that such transfer was—
>
> (A) intended by the debtor and the creditor to [whom] or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
>
> (B) in fact a substantially contemporaneous exchange[.][116]

"New value," in turn is defined in § 547(a)(2) 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 by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation[.][117]

Thus, (c)(1) defends a preference if the parties intend a transfer to be contemporaneous with the provision of new value.

An important aspect of (c)(1) is that it does not require TBC to give new value. It only requires that new value be "given"—voluntarily transferred—by someone, under conditions that D and TBC intended. Thus, NC might give the new credit, but the intent of TBC and D are the intents that count in the general case of unsecured refinancing.

### A. Substantially Contemporaneous

#### 1. *Unsecured Refinancing*

Unsecured refinancing potentially gives rise to the (c)(1) defense. In unsecured refinancing, two transfers occur: (1) NC transfers loan proceeds to D, giving D new value; and (2) D transfers these same loan proceeds (or perhaps different funds) to TBC. This second transfer constitutes a prima facie voidable preference, if we concede that NC's loan to D makes any proceeds of the loan into D's property.

To protect the transfer made by D to TBC, § 547(c)(1) requires that new value be given to D but, significantly, it does not require that TBC provide the new value. This section only requires *intent* and *contemporaneity*.

A comparison may be made to a different defense—the one set forth in § 547(c)(4), which provides that a trustee may not avoid a preferential transfer

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[116] 11 U.S.C. § 547(c)(1) (1994).

[117] *Id.* § 547(a)(2).

> to or for the benefit of a creditor, to the extent that, after such transfer, such 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[.][118]

This defense involves an admitted voidable preference but gives a setoff to the extent the preferred creditor gives back new value later. This time, it is essential that the preferred creditor give back the value, because there is no pretense of a contemporaneous exchange in this defense. If a preferred creditor could assert any subsequent extension of new value to the debtor by any stranger, then few voidable preferences could ever be recovered.

The (c)(1) defense, however, is different. In effect, it assesses whether, at the time of the preference, the entire bankruptcy estate was diminished. If not, (c)(1) defends the preference. Hence, new value given by third parties for the benefit of TBC is eligible to be counted.

When NC lends to D by means of forwarding funds to TBC, the fact of a contemporaneous exchange is met automatically. In an unsecured refinancing, the new value given to D is the loan proceeds. The property transferred by D is the very same loan proceeds. In other words, the new value is simultaneously the property transferred. Nothing in § 547(c)(1) prevents the application of that defense to such a situation. Similarly, the intention of a simultaneous exchange is automatically satisfied for D insofar as D intends to repay TBC with loan proceeds received from NC. Hence, the earmarking doctrine can be understood as simply an ordinary case of the § 547(c)(1) defense.

Courts have occasionally insisted that earmarking, as it is conventionally conceived, requires a strict tracing rule.[119] Section 547(c)(1) suggests other-

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[118]11 U.S.C. § 547(c)(4) (1994). This provision carries forward § 60(c) of the former Bankruptcy Act. *See* Vern L. Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 781-83 (1985). Old § 60(c) provided:

> If a creditor has been preferred, and afterward in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him.

[119]*See* Sierra Steel, Inc. v. S&S Steel Fabrication (*In re* Sierra Steel, Inc.), 96 B.R. 271, 274-75 (B.A.P. 9th Cir. 1989). *But see* Hoffer v. Marine Midland Trust Co., 294 F. Supp. 187 (S.D.N.Y. 1968) (permitting an earmarking defense in spite of deposit of NC's funds in a commingled account).

wise. If NC gives new value to D and D gives different property to TBC, TBC still has the defense, so long as the common will of D and TBC agree that the two events are connected. Thus, aggressive cash management by NC should ordinarily shield TBC. In cash management, NC (an insider) funds D's bank account daily only to the extent necessary to cover the checks D has written. However, Judge John Waites, in *Hovis v. Powers Construction Co. (In re Hoffman Assocs., Inc.)*,[120] refused to protect TBC in this context. First, he ruled that earmarking should never be extended beyond sureties.[121] In short, since earmarking and suretyship payments must be distinguished,[122] earmarking does not exist at all.[123] Second, "there was no evidence of any specific 'earmarking' agreement regarding the application of the funds advanced."[124] True, NC's agent and D's agent are the same human being. Yet this human being has two different capacities. The agent for NC can agree with the agent for D that NC will fund D's checks. Meanwhile, TBC can ratify NC's decision to refinance TBC's debt by funding D's checks. Third, and most egregiously, Judge Waites wrote:

> The transactions in this case also fail to satisfy the . . . requirement, that the transaction not result in any diminution of the estate. Under § 541(a)(3), property of the estate includes any amounts recovered by the trustee under § 550. Thus, property of the estate includes any amounts recovered as preferences. If the earmarking doctrine were applied here, the property of the estate would be reduced because the funds provided by [NC] would be credited as subsequent advances of new value and would thus diminish the preference recovery . . . .[125]

This argument simply says that, if earmarking exists, the estate will be diminished because the trustee will not recover. As this is true by definition, this surely cannot be what "diminution of the estate" means. It must mean that the estate of the *debtor* is diminished (because NC received collateral). If, however, (c)(1) is recognized as the true foundation for earmarking, "diminution of the estate" drops out of the analysis entirely.

Cash management should, in principle, qualify for the (c)(1) defense, in

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[120] 194 B.R. 943, 957-59 (Bankr. D.S.C. 1995).

[121] *See id.* at 958.

[122] *See supra* notes 68-79 and accompanying text.

[123] Judge Waites wrote, "This Court has found no Fourth Circuit law directing the application of the earmarking doctrine beyond the guarantor situation. . . ." 194 B.R. at 958. But Judge Waites has overlooked *Virginia National Bank v. Woodson (In re Decker)*, 329 F.2d 836, 839 (4th Cir. 1964), which *partially* allowed earmarking for a new loan by an undersecured NC.

[124] 194 B.R. at 958.

[125] *Id.* at 959.

spite of *Hoffman Associates.* Cash management represents a decision to keep a corporate subsidiary uncapitalized. While various legal doctrines might punish NC for managing D in this way—piercing the corporate veil or equitable subordination, for example—voidable preference law is in no way offended by cash management.

2. *Commitments to Lend*

Sometimes, D has a committed line of credit which it can draw upon. This line of credit constitutes an asset of D's estate, and voidable preference law suggests it should be used for the equal benefit of all. If instead it is used to take out TBC, voidable preference law is offended and TBC should be liable.

Under the Uniform Commercial Code, commitments to lend are equated with loans. Thus U.C.C. § 1-201(44) defines value to include mere commitments to lend. For this reason, a security interest attaches upon commitment, if the debtor has signed a security agreement and if the debtor already has rights in the collateral. This is so even if the commitment is heavily subject to onerous conditions subsequent.[126] The debtor's property right in a commitment may be conditional, but the commitment is an asset of the debtor's estate nevertheless.

The commitment to lend is, in effect, "old value" diverted to TBC, when it is drawn down and cash is paid to TBC. As such, draws from committed lines of credit ought not to be eligible for the earmarking defense. In (c)(1) terms, the commitment was not contemporaneous, nor intended to be contemporaneous, with the payment of TBC.[127]

Recognition of this principle would constitute a major change in earmarking doctrine. For example, in *Steinberg v. NCNB National Bank (In re Grabill Corp.),*[128] D obtained a $150 million unsecured commitment from NC (a syndicate of banks). Some months later, D drew down some of this credit by ordering NC to wire funds to TBC, an undersecured creditor. Within ninety days (but nine months after NC committed to lend), D was bankrupt.[129] Judge John Squires held that the earmarking doctrine protected TBC, be-

[126]*See* U.C.C. § 9-105(1)(k) (1995) ("An advance is made 'pursuant to commitment' if the secured party has bound himself to make it, whether or not a subsequent event of default or other event not within his control has relieved or may relieve him from his obligation.").

[127]Drawing the commitment is like ordering an account debtor to pay TBC directly. Clearly the diversion of a receivable to TBC is preferential. *See* Rieser v. Bruck Plastics Co. (*In re* Trinity Plastics, Inc.), 138 B.R. 203 (Bankr. S.D. Ohio 1992).

[128]135 B.R. 101 (Bankr. N.D. Ill. 1991).

[129]We are told that the commitment was created in May 1988, and that bankruptcy petitions were filed in January 1989. Therefore, the payment to TBC was at least five months after the commitment by NC was made. *Id.* at 104-5.

cause the money was wired directly from NC to TBC. In short, D never "controlled" the payment.

Such a holding overlooks the fact that D *ordered* NC to wire the funds. NC was nothing more than D's "account debtor," obliged to follow D's instructions. Surely this means that D "controlled" disposition of the line of credit. Once again, "control" obfuscated the real issue: did the parties intend a contemporaneous exchange, and was the exchange substantially so? Here, regardless of what was intended, the wire to TBC was not substantially contemporaneous but was at least five months after the commitment was obtained. Hence, the case was wrongly decided.[130]

In contrast, in *Bergner v. Bank One, Milwaukee, N.A. (In re P.A. Bergner & Co. Holding Co.)*,[131] Judge Dee McGarity reached the correct result—earmarking defenses cannot be founded on drawing down committed credits. In that case, D drew down an old credit from NC, which wired TBC directly. Judge McGarity dismissed the defense on these grounds:

> The "earmarking doctrine," developed to interpret whether an interest of the debtor in property has been transferred, clearly does not apply to these facts. Earmarking occurs only when a new creditor advances funds, and the parties intend that those funds be used to pay an antecedent creditor. Payment of the old creditor is a condition for obtaining the new credit. This type of transfer results only in the substitution of creditors, and there is no diminution in the debtor's property. [NC] loaned the funds with no agreement as to their use to pay [TBC]; in fact, [NC's] representative testified at his deposition that [NC] had no right under the loan agreement to direct how [D] used its bor-

[130]In *Cambridge Meridian Group, Inc. v. Connecticut National Bank (In re Erin Food Services, Inc.)*, 117 B.R. 21 (Bankr. D. Mass. 1990), an insider guaranteed undersecured creditors, who also offered unsecured revolving credit. The debtor drew down unsecured credit to pay interest on the secured claim. Judge Harold Lavien ruled that the voidable preference liability of the undersecured parties was canceled by a § 547(c)(1) defense. That is, the revolving credit was substantially contemporaneous with the payment of interest. Meanwhile, the insiders could rely on obligees' (c)(1) defense to prevent their own liability.

The trouble with this holding is that the payment of interest to the undersecured creditors was not contemporaneous with the giving of new value (by the same creditors). The new value was "pursuant to commitment" and so not available as (c)(1) defensive material.

Later, Judge Lavien seems to have changed his mind and ruled that the undersecured parties were liable after all. From this unreported *changement de coeur* the undersecured parties appealed. In *Travelers Insurance Co. v. Cambridge Meridian Group, Inc. (In re Erin Food Services, Inc.)*, 980 F.2d 792 (1st Cir. 1992), Judge Conrad Cyr found that no benefit to insiders existed, thereby defeating any prima facie case and obviating any need to consider the status of any defense under § 547(c).

[131]187 B.R. 964, 981-82 (Bankr. E.D. Wis. 1995), *aff'd in part, rev'd in part*, 140 F.3d 1111 (7th Cir. 1998).

rowed funds. Therefore, the earmarking doctrine does not apply.[132]

In the above passage, Judge McGarity notes the fact that NC's commitment to D was not contemporaneous with D's decision to use the commitment to wire funds to TBC. This explains her emphasis on the lack of control by NC as to how the loan commitment would be used. Thus, Bergner could be seen, in the above passage, as limiting the earmarking defense to a discretionary advance made contemporaneously with the payment of the loan proceeds to the refinanced creditor.[133]

Diversion of a commitment to lend might also be used to explain the result in the difficult case of *Rabin v. B & M Realty Corp. (In re Plechaty)*,[134] where D placed his funds in his wife's name. Whenever D wished to pay TBC, D would prepare a check for his wife's signature. The wife was held to be so dominated by D that she was certain to sign any check D presented to her. In effect, the wife had "committed to lend" to D, and D diverted this commitment to TBC. Hence, TBC was found guilty of voidable preference.

Notwithstanding the above remarks, a commitment to lend might be solicited in advance for the very purpose of refinancing. In such a case, where the commitment is conditioned on TBC obtaining the proceeds, the new value might be considered given only when funds are actually advanced at a closing. In other words, the commitment could be viewed as "new value," because it was subject to the condition precedent that the funds be tendered directly to TBC. The (c)(1) defense should be available under such a circumstance.[135]

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[132]*Id.* at 974 (citation omitted).

[133]Analytically similar is *Sierra Steel, Inc. v. S&S Steel Fabrication (In re Sierra Steel, Inc.)*, 96 B.R. 271 (B.A.P. 9th Cir. 1989). In this case, a contractor paid a subcontractor (TBC) and then filed for bankruptcy. TBC claimed an earmarking defense: the real estate owner made progress payment to D with the intent that the subcontractors be paid, so that the real estate owner's land would not be encumbered with statutory liens. Judge Elizabeth Perris properly rejected this claim. The real estate owner was not advancing credit. It was paying its obligation to D. Hence, the real estate owner was like the committed lender in *Bergner*. The dollars conveyed to D were old value, not new value.

As usual, the empty notion of "control" was used to settle the case. The real estate owner paid by check, and the check was deposited in D's commingled account. Hence, D "controlled" the funds when it paid TBC. *See id.* at 274. A better answer is that no new value was given contemporaneous with TBC's payment.

[134]201 B.R. 486 (Bankr. N.D. Ohio 1996).

[135]*See* Tolz v. Barnett Bank (*In re* Safe-T Brake of S. Fla., Inc.), 162 B.R. 359, 362 (Bankr. S.D. Fla. 1993) (using new commitment to retire TBC's revolving credit). In *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.)*, 100 B.R. 127 (Bankr. D. Mass. 1989), NC committed funds specifically to pay TBC, who had signed an agreement with D to redeem TBC's shares. One might argue that no antecedent debt existed in this case. TBC did not tender shares until the closing at which D paid cash. Nevertheless, assuming antecedent debt did exist, the commitment was so heavily conditioned on being directed to TBC that it could not be considered new value until TBC performed and became eligible for "refinancing."

### 3. *Mere Conduits*

Recognition that earmarking is and always was the (c)(1) defense also allows us to gentrify another legal fiction that courts have introduced, in apparent derogation of the statutory language of the Bankruptcy Code. In truth this fiction is yet another version of earmarking. This is the doctrine of the "mere conduit."

The fiction was validated by Judge Frank Easterbrook—the very exposer of fictions in *Deprizio*[136]—to solve an obvious injustice. In *Bonded Financial Services, Inc. v. European American Bank*,[137] D wrote a check payable to its bank (NC) and ordered NC to deposit the funds in the bank account of X, an insider. X later used this account to pay some independent loan X owed NC.

The payment by D was a fraudulent transfer to X. D's bankruptcy trustee, however, pointed out that NC was the "initial transferee" of X's fraudulent transfer. As such NC was liable for it,[138] much as TBC was liable in *Deprizio* for receiving payment 100 days before bankruptcy, which payment benefited an insider (subject to a one-year preference period). Whereas Judge Easterbrook followed the literal meaning of § 550(a)(1) in *Deprizio*, he felt constrained by natural law not to do so in *Bonded Financial Services*. Instead, he ruled that NC was a mere conduit. Mere conduits were simply to be ignored or erased. In philosophical terms, they are vanishing mediators. To be a transferee meant being the beneficial transferee—one who is free to play the lottery with the proceeds, according to Judge Easterbrook.[139] Hence, NC was treated as utterly transparent. X was instead deemed to be the initial transferee.

As a legal fiction, this doctrine is highly popular, but doubtful in its believability.[140] If, as a result of NC's wiring funds to X, D was overdrawn with NC, for example, NC could have kept the wire transfer.[141] Hence, NC was no mere conduit, as, for example, the corporate treasurer might be. In addition, if the test is whether the initial transferee is free to "play the lottery," it may be pointed out that *all* voidable conveyances are held for the benefit of the bankruptcy estate. Any such person diverting the voidably conveyed asset to the lottery would face in personam conversion liability with regard to that asset.[142]

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[136]*See supra* notes 94-96 and accompanying text.

[137]838 F.2d 890 (7th Cir. 1988).

[138]*See* 11 U.S.C. § 550(a)(1) (1994).

[139]*See* 838 F.2d at 894.

[140]*See* Craig H. Averch, *Protection of the "Innocent" Initial Transferee of an Avoidable Transfer: An Application of the Plain Meaning Rule Requiring Use of Judicial Discretion*, 11 BANKR. DEV. J. 595 (1995).

[141]As occurred in *Nordberg v. Société Generale (In re Chase & Sanborn Corp.)*, 848 F.2d 1196 (11th Cir. 1988).

[142]*See* Averch, *supra* note 140, at 608.

A better answer is that NC received the funds as part of an exchange. That is, NC received the wire on condition that NC transfer the funds to X. Hence, NC was an initial transferee, but NC could assert that the transfer was for a reasonably equivalent value, or that it had the bona fide purchaser defense of § 548(c) for the wire it received. As for the wire X received from NC, X could assert no like consideration. The wire from NC to X was a separate transfer of D's property. For this transfer X was the initial transferee with no defenses.[143]

"Mere conduit" arose in a fraudulent transfer case, but it has been exported to voidable preference cases as well.[144] Hence, where X is TBC, the wire to NC, coupled with an instruction, qualifies NC for the (c)(1) defense. But since NC uses the entire defense, none is left over for TBC, who faces liability for receipt of D's property (unless some other defense besides (c)(1) is available). In short, "mere conduit" is yet another guise of earmarking, which is itself an example of the (c)(1) defense.[145]

4. *Secured Refinancing*

Section 547(c)(1) protects unsecured refinancing, but quite the opposite is true with regard to the secured refinancing of unsecured debt. In unsecured refinancing, there are two transfers. In secured refinancing of unsecured debt, three transfers occur—not two: (1) NC transfers loan proceeds to D, giving D new value; (2) D transfers a limited interest in its property to NC in the form of a security interest; and (3) D transfers the loan proceeds to TBC. In this case, we must attend particularly to the limitation contained in § 547(c)(1) which states that a transfer may not be avoided "to the extent

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[143]Why did not Judge Easterbrook see that the § 548(c) defense obviated the need to invent the "mere conduit" fiction? First and foremost, § 548(c) has a good faith component, which Easterbrook may have wished to avoid. Another possibility is that he failed to see that, in *Bonded Financial*, there were two transfers—one to NC and one to X. Perhaps Judge Easterbrook feared that, if NC availed itself of the § 548(c) defense, X would have the defense as well. But not so. X was the initial transferee of different debtor property than NC was. X had no § 548(c) defense for his separate transfer.

[144]*See* Security First Nat'l Bank v. Brunson (*In re* Coutee), 984 F.2d 138 (5th Cir. 1993) (per curiam); *In re* Maxwell Newspapers, Inc., 151 B.R. 63 (Bankr. S.D.N.Y. 1993).

[145]In contrast, Craig Averch, *supra* note 140, who disbelieves the "mere conduit" fiction, thinks that courts always have discretion to decide whom the trustee may sue—the initial transferee or some other party. This view is based on § 550(a)(1), which states:

> [T]o the extent that a transfer is avoided under section . . . 547 . . . the trustee may recover, for the benefit of the estate, the property transferred, or, *if the court so orders*, the value of such property, from—
>
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made[.]

11 U.S.C. § 550(a)(1) (1994) (emphasis added). The emphasized language, however, only grants discretion to substitute an in personam judgment against a person in lieu of a replevin of the thing conveyed. Averch innovates in maintaining that a court also has discretion over the identity of the defendant. Yet, if innovation is permitted, one might as well stick with "mere conduit" as with the nonstatutory result Averch prefers.

that such transfer was . . . for new value given to the debtor."[146]

In secured refinancings, there is one increment of new value—the loan by NC to D—but two transfers to which it could apply. It cannot be applied to both. Rather, § 547(c)(1) protects voidable transfers *to the extent* of new value. "To the extent" indicates that the defense is an exhaustible asset. This finite limit to the defense compels a choice: we can elect to protect the security interest transferred by D to NC or we can protect the transfer of loan proceeds by D to TBC. We cannot protect both transfers.

We believe the allocation of the defense must be made to NC on the following basis. First, the determination is supported by the expectation of the parties—particularly the expectation of NC who supplies new value in the form of secured credit. Section 547(c)(1) makes relevant the intent of D and "the creditor to [whom] the transfer was made." The transfer of the security interest was made to NC, and so NC's intent governs. In addition, allocation of the defense to NC is appropriate because the transfer of the security interest to NC is often temporally prior (as where NC's commitment to wire funds precedes the actual wire to NC). Accordingly, the defense is already used up by the time TBC receives the transfer of the loan proceeds. NC is first in time and hence first in right. Or even if somehow NC's security interest and TBC's rights in the loan proceeds are simultaneously created, it can be said that NC's loan is analogous to a "purchase money" loan that brings the transfer to TBC into existence. TBC's rights in the loan proceeds are "after-acquired" and related to TBC's antecedent debt. Hence, allocation of the defense to NC constitutes a species of purchase-money priority, which favors the lender that causes the debtor's asset to come into existence. The intuition that leads to purchase-money priority also leads to allocation of the § 547(c)(1) defense to NC.[147]

For this reason, (c)(1) protects NC's security interest but not TBC's transfer. What is not to be missed here is that TBC is benefited by NC's security interest, and this benefit is received on TBC's antecedent debt. Therefore, the trustee can plead a prima facie case of voidable preference against TBC. But TBC, in the end, is not liable for mere benefit. In effect, TBC has standing to assert NC's (c)(1) defense to immunize its receipt of benefit, just as NC would use the defense to immunize itself from "initial transferee" liability for its security interest. TBC, however, is separately liable for a direct transfer—the diversion of funds from D's estate to TBC.[148]

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[146]11 U.S.C. § 547(c)(1) (1994).

[147]*See* Robert H. Skilton & Darrell W. Dunham, *Security Interests in Returned and Repossessed Goods Under Article 9 of the Uniform Commercial Code*, 17 WILLAMETTE L. REV. 779, 808 (1981).

[148]In other words, whereas in *Deprizio* there was only one transfer by the debtor (the payment to the creditor, which benefits the insider guarantor), in secured refinancing there are genuinely two transfers of debtor property (and three transfers altogether).

As for this separate transfer, TBC has no defense.[149]

B. INTENT

Section 547(c)(1) makes relevant the intents of "the debtor and the creditor to [whom] or for whose benefit such transfer was made (i.e., TBC)."[150] Of course, where D's receipt of new value is merely a coincidence, TBC will have no (c)(1) defense. Purpose, not accident, is the hallmark of § 547(c)(1).[151] Left out of (c)(1) is NC, the person who gave the value. Nevertheless, NC must "give" value. We interpret this to mean that NC must knowingly and voluntarily "give," but NC need not "intend to refinance."

In the more familiar (c)(1) case—i.e., not an earmarking case—TBC gives the value. TBC is the creditor to [whom] or for whose benefit the transfer is made. Hence, the intent of the giver will be relevant. But courts have recognized that third parties might give the value that benefits TBC. In such cases, the giver's intent is irrelevant. For example, in *Gulf Oil Corp. v. Fuel Oil Supply & Terminaling, Inc. (In re Fuel Oil Supply & Terminaling,*

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[149]TBC cannot defend itself when it has received the proceeds of NC's secured loan. But, of course, TBC may have forwarded other new value to D, thereby defending TBC after all. By way of example, suppose TBC is undersecured. It claims $100 against D and has $80 in collateral. D borrows $50 from NC in exchange for security, and NC wires these funds to TBC. This transfer of $50 is prima facie voidable, but TBC could also claim that, in exchange for the $50, TBC effectively released $30 worth of collateral for D. Hence, TBC has a partial $30 (c)(1) defense and owes only $20—the amount of the unsecured deficit paid by the $50. In this example, NC has a (c)(1) defense for its $50 security interest. *See* Carlson, *supra* note 1, at 280-82. TBC does not attempt to double-dip with regard to NC's defense. Rather, TBC has its own independent (c)(1) defense—release of TBC's own collateral.

Something like this occurred in *American Honda Finance Corp. v. Angelle, Inc. (In re Angelle, Inc.)*, 230 B.R. 287 (Bankr. W.D. La. 1998), *modified*, 230 B.R. 306 (Bankr. W.D. La. 1998). There, TBC claimed $100 and had $80 of collateral. It received $50 from NC. But, in exchange for the $50, TBC subordinated its security interest to that of NC. When the dust settled, NC claimed $50 and had $50 of collateral. TBC claimed $50 and had only $30 of collateral. It was never paid on its unsecured deficit and so was not preferred. In effect, it released collateral in exchange for the payment.

Judge Gerald Schiff ruled in favor of TBC on the ground of earmarking—NC's funds were never under the control of the debtor. In fact, the case was not an earmarking case at all but simply one in which TBC released collateral in exchange for equivalent cash.

[150]11 U.S.C. § 547(c)(1) (1994). Because intent of the debtor is vital, creditors who garnish bank accounts encumbered by potential setoff rights could not be defended under § 547(c)(1). *See* Titan Energy Corp. v. Central Oilfield Supply Co. (*In re* Titan Energy Corp.), 82 B.R. 907 (Bankr. S.D. Ohio 1988).

[151]*See In re* Windor Indus. Inc., 459 F. Supp. 270 (N.D. Tex. 1978) (TBC received transfers and NC advanced new credit or new investments, but they were not intended to be related, even though the estate was not diminished). Thus, in *Bergner v. Bank One, Milwaukee, N.A. (In re P.A. Bergner & Co. Holding Co.)*, 187 B.R. 964, 981-82 (Bankr. E.D. Wis. 1995), *aff'd in part, rev'd in part*, 140 F.3d 1111 (7th Cir. 1998), an unsecured TBC received payment minutes before it honored a letter of credit to a beneficiary. This payment was a transfer to TBC on antecedent debt and hence prima facie voidable. *See* Carlson & Widen, *supra* note 50, at 1695-98. TBC tried to claim that, because the beneficiary of the credit in effect returned it to D, TBC could have a (c)(1) defense. Judge Dee McGarity properly ruled that, because the return of the draw was pure coincidence, TBC could not show an intended exchange. *See Bergner*, *supra*, at 984.

*Inc.),*[152] two banks issued letters of credit to the debtor's supplier, in exchange for a security interest in collateral, ample enough to keep the banks fully secured. The supplier sent products to the debtor and thereby became an unsecured creditor of the debtor. Instead of calling in the letter of credit, the creditor accepted payment directly from the debtor. The creditor received a voidable preference under § 547(b), but it had a full defense under § 547(c)(1).[153] Every dollar the debtor paid released a dollar of collateral earlier pledged to the sureties. In such a case, the party giving the value was not TBC. Rather, the issuing banks gave value—the reduction of their lien. Yet TBC was able to assert the (c)(1) defense. *Fuel Oil Supply* proves that the giver's intent is irrelevant in (c)(1) cases, when the "creditor to [whom] or for whose benefit" receives the to-be-defended transfer.

1. *Frauds on the Refinancing Creditor*

The irrelevance of NC's intent has some aspects that may seem disturbing at first but are not. Does our theory of (c)(1) suggest that, if NC is duped into lending by fraud, TBC still has the defense, so long as D's fraud was intended by D and TBC to benefit TBC? As NC's intent is irrelevant, may NC be tricked, robbed, and cheated?

This point in any case is much mitigated by this observation: if TBC and D conspire to cheat NC, TBC is often held to be the constructive trustee of the funds for the benefit of NC. NC can seek restitution of those funds at its leisure outside bankruptcy court. For preference purposes, however, it can be observed that D conveyed to TBC a worthless legal title to a constructive trust. Since TBC received worthless title, TBC has not been preferred. Under the hypothetical liquidation test of § 547(b)(5), TBC has no prima facie liability for the preference in the first place.[154] Hence, our theory of the (c)(1) defense cannot be blamed for this unseemly result.[155]

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[152] 837 F.2d 224 (5th Cir. 1988).

[153] By way of comparison, if the issuing bank is undersecured, the initial dollars paid to TBC release no collateral claimed by the issuing bank, and hence TBC has no (c)(1) defense. *See* Committee of Creditors Holding Unsecured Claims v. Koch Oil Co. (*In re* Powerine Oil Co.), 59 F.3d 969 (9th Cir. 1995). Even more surprising, those same initial dollars are "for the benefit" of the issuing bank's antecedent debt, and so the issuing bank is likewise liable for TBC's voidable preference on *Deprizio* grounds. *See* Michael St. Patrick Baxter, *Letters of Credit and the Powerine Preference Trap*, 53 Bus. Law. 65, 86-87 (1997).

[154] *See* Ragsdale v. Bank South, N.A. (*In re* Whitacre Sunbelt, Inc.), 206 B.R. 1010, 1022 (Bankr. N.D. Ga. 1997) (dictum).

[155] Section 547(b)(5) provides that a transfer is a voidable preference if it

> enables such creditor to receives more than such creditor would receive if—
> (A) the case were a case under chapter 7 of this title,
> (B) the transfer had not been made; and
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Applying this test, TBC returns the trust property to D, but the trust property is worth zero to D. It must be returned to NC. Hence, TBC received in "real life" exactly what it would have received in the

These remarks cohere, after a fashion, with the premises if not the result in *McLemore v. Third National Bank (In re Montgomery)*,[156] a "colossal"[157] check kiting case. In *Montgomery*, TBC was a bank that had a large overdraft. TBC had become aware that D was a check kiter, so that TBC knew that D very likely did not own the funds it so freely distributed between its many bank accounts. D paid TBC by depositing sufficient funds and soon filed for bankruptcy.

TBC argued that it received no preference to the extent the funds were proceeds of kited checks. This should have been a good claim. If a deposit with TBC constituted a loan dishonestly obtained from NC, NC had a valid constructive trust claim against TBC, who took these funds with guilty knowledge. If NC had a valid claim, then D must have conveyed to TBC a legal title of no value. Because the debtor's property conveyed was worth zero, the trustee deserves to recover zero, to the extent the proceeds of the fraud could be traced to TBC.

Judge David Nelson gave sufficient credence to this analysis. He wrote:

> If the fruits of Mr. Montgomery's check kiting scheme had somehow been segregated, thus being held in constructive trust for the victimized institutions, the funds would not have been part of the debtors' estate and the bankruptcy would not have prevented the institutions from recovering their money. . . . And if segregated funds impressed with a constructive trust had been returned to the victimized institutions during the 90 days prior to bankruptcy, the transfer would not have been a voidable preference because it would not have been the debtors' money that was being transferred.
>
> But that is not this case. There is no contention here that the debtors preserved the separate identity of the funds obtained from any of the banks at which checks were being kited, and there is no contention that any trust, actual or constructive, arose here.[158]

hypothetical bankruptcy proceeding required by § 547(b)(5). David Gray Carlson, *Voidable Preferences and Proceeds: A Reconceptualization*, 71 AM BANKR. L.J. 517, 540-42 (1997).

[156]983 F.2d 1389 (6th Cir. 1993).

[157]*Id.* at 1391.

[158]*Id.* at 1393 (citations omitted). The penultimate remark—no preference if TBC returned embezzled funds to NC—is curious. Are we to think that if TBC retains the embezzlement, instead of returning it to NC, TBC must instead return the funds to D's bankruptcy trustee? If so, TBC faces a double liability, as NC is not barred by *res judicata* if a court concludes that TBC should pay the trust proceeds over to NC.

The very next year, the Sixth Circuit, in a burst of legislative usurpation, declared constructive trusts to be dead in bankruptcy. *See* XL/Datacomp, Inc. v. Wilson (*In re* Omegas Group, Inc.), 16 F.3d 1443 (6th Cir. 1994). Hence, Judge Nelson was anticipating the abolition of the constructive trust in this remark.

Hence, because TBC did not prove that it dishonestly held embezzled funds for NC, it had to return the funds to D's bankruptcy trustee.[159] Otherwise, Judge Nelson concurred that a constructive trust by NC would contradict the voidable preference rights of D's bankruptcy trustee.

TBC, however, may not be a party to the fraud, but may still intend to receive funds. Suppose TBC and D agree that D will obtain refinancing, but, unbeknownst to TBC, D obtains the funds through a check kiting scheme—a fraud on NC. In such a case, TBC can claim to be a good faith purchaser of the funds who takes free and clear of NC's constructive trust claim. After all, TBC has antecedent debt and no knowledge of the constructive trust[160]—though TBC does intend to obtain a preference in violation of federal law. Nevertheless, TBC does not have the (c)(1) defense. TBC and D did not have the same intent that an "exchange" occurred. Rather, TBC intended an exchange, and D intended a fraud. Furthermore, NC has not "given" new value. Rather, new value was "taken" from NC through fraud.

These facts occurred in *McCuskey v. National Bank (In re Bohlen Enterprises)*.[161] There, TBC had old debt of roughly $192,000. D arranged a loan from $NC_1$ for $200,000, but D falsely claimed that only $125,000 would be used to pay TBC. The rest D would use for "miscellaneous purposes."

$NC_1$ agreed to the loan and, expecting that its checking account would be credited with all $200,000, D wrote a check to TBC for $192,000. Unexpectedly, however, $NC_1$ decided to issue its check to D and TBC jointly for $125,000. Only the balance of $75,000 was credited to the account. D's check would bounce, unless D came up with extra funds. To make sure his check to TBC would clear, D wrote NSF checks for $125,000 drawn on $NC_2$[162] and deposited them with $NC_1$. $NC_1$ responded by giving D a provisional credit for $125,000, so that D's account now contained more than $192,000. TBC presented the check, and $NC_1$ paid it. D was quickly forced into bankruptcy (by $NC_1$'s involuntary petition), and the trustee sued TBC for $192,000.

Based on our theory of earmarking, the trustee should have prevailed. TBC, at best, might have agreed that refinancing be obtained, but TBC did

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Interestingly, Nelson thought return of the funds to NC before D's bankruptcy would vindicate the constructive trust, which must mean the constructive trust existed prior to a judicial declaration of it. Yet the *Omegas* result turns on the premise that a constructive trust does not exist until it is judicially established. *See* 16 F.3d at 1449.

[159]Presumably, NC could claim that the voidable preference recovery was in fact a conveyance to the trustee of a legal title for the benefit of NC, with the proviso that, in the Sixth Circuit, NC forfeits its constructive trust interest under the *Omegas* rule. *See supra* note 158.

[160]Antecedent debt typically counts as "value" in constructive trust cases. Burtch v. Hydraquip, Inc. (*In re* Mushroom Transp. Co.), 227 B.R. 244, 259 (Bankr. E.D. Pa. 1998).

[161]859 F.2d 561 (8th Cir. 1988).

[162]Actually, $NC_2$ in this case was also TBC. Eventually TBC dishonored the check.

not agree on the fraud. (If it did, TBC would be constructive trustee for $NC_1$, and this would preclude preference liability to the bankruptcy trustee). On the assumption that $NC_1$ would never have honored D's check to TBC if it knew the facts, TBC could not show that a contemporaneous "exchange" ever occurred, or that new value was voluntarily "given" by $NC_1$.

In *Bohlen*, Judge Irving Hill ruled against earmarking, but on much different grounds, as we shall see.[163]

Judge Cudahy faced this issue head-on in *In re Smith*,[164] a case in which D had $164 in the world and then kited a check for $125,000. Judge Cudahy ruled that TBC had to return the check to the bankruptcy trustee. Hence, D had $164 just before NC paid TBC and zero just after the check was paid. The bankruptcy estate, however, would now have $125,000 in it from recovery of the preference.

> One is still left pondering the conundrum: How is it possible that property of the Debtor appeared out of thin air, only to disappear in a matter of days? And if it disappeared on its own, how could its transfer have diminished the Debtor's estate? . . .
>
> We think that some answers to these difficult questions may lie in considering the economic substance of the transaction at issue. In effect, the Debtor here obtained a loan from [NC] (through the check-kiting scheme) and used the loan proceeds to pay his debt to [TBC]. We might say that the loan was unauthorized or obtained by fraud, but it was nevertheless in economic reality a loan. That is the best explanation for the Debtor's sudden acquisition of control over $125,000 despite his previous actual wealth of only $164, and of his ability to direct a valid $ 121,000 payment to [TBC]. The situation is the same as if the Debtor had gone to [NC], taken out a five-day loan in cash and used the cash to pay [TBC].[165]

In short, D expropriates NC's property for the benefit of the estate. The bankruptcy trustee is therefore entitled to the $125,000, and NC is but an unsecured creditor in D's bankruptcy.[166]

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[163]See *infra* notes 209-11 and accompanying text.

[164]966 F.2d 1527 (7th Cir. 1992), *cert. dismissed* 506 U.S. 1030 (1992).

[165]*Id.* at 1532.

[166]Judge Cudahy's remarks are fully justified in the structure of the hypothetical liquidation test in § 547(b)(5), which demands that the trustee recover. *See supra* note 155. According to that test, we are to imagine that TBC returns the alleged preference to determine whether TBC received more from "real life" than from the hypothetical dividend that TBC would have received if no transfer had been made. The hypothetical dividend thus includes the $125,000 returned by TBC as preferential. Hence, TBC

The above analysis assumes that TBC is unaware of the fraud. In other words, TBC is a good faith purchaser who takes free of any constructive trust in the kited funds that NC might claim.[167] If TBC takes free and clear of this trust, is it not still true that TBC does not take any debtor property? Is not the fraudulent loan held in trust until the moment of the bona fide purchase, so that, at the very moment of the transfer, the debtor only loses a valueless legal title?

Apparently not. Courts routinely hold that TBC is guilty of voidable preference.[168] Such an assumption therefore assumes that D always expropriates constructive trust property for her own benefit at the very moment D conveys it to TBC. Under this fictive expropriation, we can say that D had a valuable equity in the payment which the bankruptcy trustee can capture, without having to return the payment to NC.[169] Or to state the proposition

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returns $125,000 but obtains only a pro rata share of that sum in the hypothetical liquidation. In the hypothetical liquidation, the bankruptcy estate is seen to have the $125,000 in it.

This is, we believe, what Judge Cudahy was in effect saying in the following passage:

> Ordinarily . . . any property of the debtor transferred in the preference period is also property that would have been available for bankruptcy distribution at the moment the estate came into existence. Things are different here, however. The money that [TBC] received would never have been available for bankruptcy distribution . . . because the Debtor's credit was revoked within five days of payment and his property shrank back down to $164 [more accurately, zero]—all before the bankruptcy petition was filed. Nevertheless, the transfer did "cheat" other creditors out of what they might otherwise have received, since the Debtor could have paid all creditors pro rata at the time he chose to pay [TBC]. This scenario reveals an ambiguity with regard to timing. To say that the estate has been diminished would initially seem to mean that the pool available to creditors at the commencement of the case has been depleted from what it would have been but for the transfer; in other words, the estate as it exists at the commencement of the case is compared to what the estate would have included if there had been no transfer. But it could also be interpreted more broadly to include diminishing the pool available to creditors at any time after the start of the 90-day preference period; then the debtor's pre-transfer property (that could be used to pay creditors) would simply be compared to its post-transfer property. . . . One can also argue that section 547 creates a functional "estate" 90 days before the filing of the petition, so that the diminution can occur during that earlier period. The very point of the preference-recovery provision is in a sense to engage in the legal fiction that the bankruptcy "estate" extends backward in time by 90 days.

*Id.* at 1536.

[167]It is not appropriate here to say that TBC is a holder in due course. That phrase suffices if some party makes an adverse claim to the check TBC presented. NC, however, is making a constructive trust claim to the funds it lent to D (but transmitted to TBC). As to these funds, TBC is a good faith purchaser, since the funds extinguished TBC's antecedent debt. *See* Coriell v. Hudson, 563 F.2d 978, 982 (10th Cir. 1977).

[168]*See, e.g.*, Hunter v. Society Bank & Trust (*In re* Blackoaks, Inc.), 137 B.R. 251, 253 (Bankr. N.D. Ohio 1992) (discussing controlling person's admission that D's checking account contained other people's money).

[169]*See* Carlson, *supra* note 155, at 546-49.

in different terms, the bankruptcy trustee avoids the transfer to TBC, preserves TBC's status as a bona fide purchaser for the benefit of the estate,[170] and asserts that status against NC. Or, in still other terms, the trustee can assert the "shelter principle" against NC, after having recovered TBC 's property.[171]

2. *Secret Refinancings*

Sometimes TBC may be unaware of unsecured refinancing. Since (c)(1) emphasizes TBC's intent that an exchange occur, must it be admitted that TBC is liable to return any secret refinancing? Such a result is counterintuitive.

TBC would still have the (c)(1) defense, however, on agency principles. Suppose D and NC secretly agree that NC will refinance TBC's claim. TBC covets a preference and behaves in a guilty fashion, but, like Count Altaviva in *Marriage of Figaro*, he is duped into behaving well. Thanks to NC's intervention, TBC escapes. If the loan is strictly intended to refinance TBC, TBC is the third party beneficiary of this loan agreement between NC and D. In effect, NC purports to be the agent of TBC. But NC is acting beyond the scope of authority from TBC. TBC, however, can cure this fault by ratifying the act. Ratifying after the fact makes NC's acts the acts of TBC. Thus, if TBC has wit enough to ratify the refinancing, it has access and passage to the (c)(1) defense.[172]

Of course there must be something to ratify. Hence, NC's intent must specifically be to refinance TBC. If NC simply agrees to lend to D generally, and if D is the only person intending to divert funds to TBC, then the (c)(1) defense will fail.[173] Thus, in *Sierra Steel, Inc. v. S&S Steel Fabrication (In re Sierra Steel, Inc.)*,[174] NC paid D, and the parties obviously intended in general that D would pay various creditors from this fund. D, however, made the allocational decisions. In such a case, NC did not intend specific funds be advanced to TBC. Hence, earmarking was properly denied. Or in *Van Huf-*

[170]*See* 11 U.S.C. § 551 (1994) ("Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.").

[171]According to the "shelter principle," if A, a bona fide purchaser, takes free and clear of B's adverse claim, and if A sells to C, who has knowledge of B's foreclosed rights, C takes free and clear of B's rights. C, however, may not be the very scoundrel who cheated B in the first place. *See* National Union Fire Ins. Co. v. Woodhead, 917 F.2d 752, 758 (2d Cir. 1990); *see generally* David Gray Carlson, *Bulk Sales Under Article 9: Some Easy Cases Made Difficult*, 41 ALA. L. REV. 729, 755 (1990).

[172]Of course, where D defrauds NC into lending without TBC's participation, TBC had no defense. In such a case, NC did not purport to be TBC's agent. Hence, TBC has no power to ratify and make NC's intent that of TBC. Furthermore, NC presumably has no intent to benefit TBC in the first place.

[173]*See* Wasserman v. Village Assocs. (*In re* Freestate Management Servs., Inc.), 153 B.R. 972, 982-83 (Bankr. D. Md. 1993).

[174]96 B.R. 271 (B.A.P. 9th Cir. 1989).

*fel Tube Corp. v. A & G Industries (In re Van Huffel Tube Corp.)*,[175] NC released collateral to D generally, and D allocated some of the proceeds to TBC. These proceeds were thus transferred to D's estate and D unilaterally diverted them to TBC. NC was not purporting to act on behalf of TBC, so that TBC could not ratify NC's acts.

C. CHECKS

Our proposed reformulation of earmarking has its greatest impact on preferences involving NSF checks which are nevertheless honored. We have divided this territory into three separate provinces: (1) NC's consent to honor the NSF check; (2) NC's honoring the check against a preexisting provisional credit; and (3) D's fraudulent activity commonly known as check kiting.

1. *Overdraws*

If § 547(c)(1) is viewed as the proper ground of earmarking, then checks creating an overdraw with a bank may generate a defense for TBC. Suppose first that D writes a check at a time when she has nothing in her checking account. TBC then personally shows up at NC's office to present the check.[176] NC honors D's check to TBC. TBC has been paid.

Under § 547(c)(1), TBC has a defense to voidable preference liability. According to that section, it matters not whence comes the new value, who gives it, or what motivated the giver. What matters is that TBC and D intended the payment to TBC be contemporaneous with the grant of new value to D. Thus, § 547(c)(1) upholds a defense if TBC and D agree that D obtain refinancing, even if NC is ignorant of the purpose of the loan.

When TBC presented the check to NC, NC did not have to honor it. NC chose to do so. Because the overdraw is in effect a loan to D, TBC has received debtor property. But honoring the check was also the advance of new value. Both TBC and D intended for the check to be honored. The payment thus is simultaneously the payment to TBC and the grant of new value by NC. Hence it is exactly contemporaneous.

NSF check cases, however, may amount to secured refinancing cases, as where NC honors the check upon the agreement that D will deposit funds immediately thereafter. *Hansen v. MacDonald Meat Co. (In re Kemp Pacific Fisheries, Inc.)*[177] presents the case of NC honoring the overdraft, but perhaps linked to D's promise to make deposits two days later. The deposits originated in a draw from yet another committed line of credit.

If NC honored the NSF check solely on the strength of this promise, then

[175] 74 B.R. 579 (Bankr. N.D. Ohio 1987).

[176] Typically, TBC will deposit her checks with a bank, which will then do the presenting. We simplify the example, however. The addition of a chain of collecting banks would not affect the analysis.

[177] 16 F.3d 313 (9th Cir. 1994) (per curiam).

the deposit with NC merits the (c)(1) defense. NC gave new value—it honored TBC's check—and it received the deposit. If these were intended to be contemporaneous and were substantially so, then NC deserves a (c)(1) defense. Accordingly, NC uses up the new value—payment to TBC—to defend its receipt of the deposit. Being used up, the new value defense is no longer valuable and hence not available to TBC. TBC would then be exposed for having received debtor property on antecedent debt within the preference period. Hence, the case was rightly decided, if indeed NC and D intended that paying the check and depositing the funds were contemporaneous, and the actual deposit was substantially so.

The *Kemp* court, however, ruled that TBC received debtor property because D "controlled" who would receive the check to be presented to NC. As we have argued, however, control is irrelevant. Whether D controlled the decision or NC (who did not have to honor the check), we believe NC lent to D, and so TBC received debtor property. Nevertheless, if NC can defend D's deposits with NC on (c)(1) grounds, NC exhausts the new value given, leaving TBC with none for its own defense. Assuming, as always, that the check to TBC was out of the ordinary course of business,[178] TBC would be liable for its receipt of a voidable preference.

The case would have been otherwise if two NCs existed. Suppose $NC_1$ had honored TBC's check, on the promise of substantially contemporaneous deposits. The deposits come from $NC_2$'s discretionary loan to D. In such a case, $NC_1$ can take $NC_2$'s new value to defend its deposit. TBC then could take $NC_1$'s new value (payment to TBC) to defend its transfer (payment to TBC as well). In short, a chain of earmarking defenses becomes viable, so long as every link in the chain complies with (c)(1) criteria.[179]

Finally, banks sometimes offer overdraft protection. Such protection amounts to a commitment to lend. A draw on such a commitment would not constitute the advance of new value by $NC_1$. Accordingly, TBC would have no (c)(1) defense, when a check is written on committed overdraft protection.[180]

### 2. *Provisional Credits*

The earmarking defense should not exist, however, if the overdraw results in the attachment of a new security interest for NC. This will occur routinely when NC honors checks on a provisional credit awarded to D when D has deposited checks that have not yet cleared.[181]

[178]Payments in the ordinary course of business and financial affairs of TBC and D are separately defended under Bankruptcy Code § 547(c)(2).

[179]*See* Glinka v. Bank of Vermont (*In re* Kelton Motors, Inc.), 97 F.3d 22, 27 (2d Cir. 1996) (referring to "double earmarking").

[180]*See* Rafool v. Citizens Equity Fed. Credit Union (*In re* Hurt), 202 B.R. 611 (Bankr. C.D. Ill. 1996).

[181]*See* U.C.C. § 4-210(a) (1995).

Suppose now that D writes a check at a time when she has nothing in her checking account. Immediately thereafter, D deposits checks D has received with NC. NC therefore grants to D a provisional credit. After the provisional credit is in place, TBC presents the check, and NC honors it.

The provisional credit is, in effect, a meaningless bookkeeping convention. It is definitely not the extension of new value to D, because NC can always charge it back, if the deposited item bounces.[182] Rather, new value is given by NC only when NC chooses to pay TBC.

Upon paying TBC, NC supposedly has a security interest in the deposited items and holds them in due course.[183] Typically, these checks are excellent collateral. Checks rarely bounce, as an empirical matter. Hence, NC is secured dollar for dollar, to the extent of the provisional credit.[184] Now NC has given new value to the debtor, as before, but D has, in return, given NC a security interest in the items about to be paid. Based on our earlier allocative analysis, the (c)(1) defense must first be dedicated to saving NC's security interests. If it is exhausted in the protection of NC's security interest, TBC has no (c)(1) defense. TBC is therefore liable for the preference.

This analysis must be amended formally—though not substantively—in light of the Supreme Court's holding in *Barnhill v. Johnson*.[185] In that case,

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[182]*See* Marine Midland Bank v. Graybar Elec. Co., 363 N.E.2d 1139, 395 (determining provisional credit cannot sustain NC's claim to be a holder in due course); Julian B. McDonnell, *Freedom from Claims and Defenses: A Study in Judicial Activism Under the Uniform Commercial Code*, 17 GA. L. REV. 569, 595-96 (1983). Judge Richard Cudahy, in *In re Smith*, 966 F.2d 1527 (7th Cir. 1992), *cert. dismissed* 506 U.S. 1030 (1992), in reaching the right result, nevertheless wasted valuable thought on the question whether D has property if NC has given a provisional credit to D. As evidence of D's property in a provisional credit, Judge Cudahy exalted the "control" D had over the provisional credit.

> The Debtor surely had something of value during the period when the Bank was extending the provisional credit. Instead of writing a check to [TBC] on September 22, the Debtor could have written several checks, paying off each of its creditors on a pro rata basis. Alternatively, the Debtor could have purchased a 40-foot yacht. The point is that the Debtor exercised significant control (over a significant amount of money) in choosing to pay off a single creditor.

*Id.* at 1531.

Whether D has property in a provisional credit is not relevant, because NC definitely loans to D if NC elects to pay TBC. The loan is debtor property, even if the preexisting provisional credit is not. Nevertheless, for the record, the better view of the provisional credit is that it does not represent property. Contrary to the court's express ruling, the provisional credit is only a bookkeeping entry, pending the clearance of the deposited check upon which it is based.

It should be noted that, in the end, Judge Cudahy concluded: "At the moment that the Debtor's payment to [TBC] was achieved (that is, when [NC] honored check number 1141), the provisional credit ripened into an interest in property of the Debtor." *Id.* at 1535. Judge Cudahy could have proceeded directly to this observation without theorizing about provisional credits at all.

[183]*See* U.C.C. §§ 4-210(a), 4-211 (1995). Our equivocation is based on Supreme Court doctrine to the contrary. *See infra* notes 185-88 and accompanying text.

[184]Laws v. United Mo. Bank, 98 F.3d 1047, 1050-51 (8th Cir. 1996).

[185]503 U.S. 393 (1992).

TBC received a check ninety-one days before bankruptcy. The check cleared on the eighty-ninth day. If TBC received debtor property on the ninety-first day, TBC was safe. If TBC received debtor property on the eighty-ninth day, TBC had received a voidable preference.

Chief Justice William Rehnquist ruled that TBC received debtor property on the eighty-ninth day.[186] On the ninety-first day, TBC had a piece of paper ordering the payor bank to pay, but this piece of paper was not the same as owning D's bank account.

According to U.C.C. § 4-210(a), $NC_1$ is supposed to have a security interest in the deposited item as soon as it has honored D's check against a provisional credit. But this legislative declaration cannot coexist with *Barnhill*. In effect, the Supreme Court ruled that the security interest in the deposited item cannot attach until the item is actually collected. Thus, if *Barnhill* had been a case in which the bank honored D's check on a provisional credit, the bank would have had no security interest on the ninety-first day. It only obtains debtor property upon collecting on the eighty-ninth day. In short, the Supreme Court implies that the Uniform Commercial Code awards a security interest before the debtor has rights in the collateral—something federal law expressly prohibits.[187] Thus, *Barnhill* effectively overrules U.C.C. § 4-210(a)—or perhaps *vice versa*.[188]

There is, however, no danger for $NC_1$ in this contradiction. As applied to payment on a provisional credit, $NC_1$ gives credit on Day One and obtains debtor property later, when D's payor bank ($NC_2$) pays. $NC_1$ nevertheless intended that the receipt of this debtor property be contemporaneous with the purchase of TBC's payment. If the check clears in due course, surely the exchange was substantially contemporaneous.[189] In fact, the legislative history reveals that (c)(1) was drafted precisely to protect merchants who sell

[186]On the 89th day, the observable events in the world were that the payor bank gave a withdrawable credit to TBC's collecting bank (who in turn gave a withdrawable credit to TBC soon thereafter). In addition, the payor bank posted the amount to the debtor's account—that is, the account reduced in amount. Why is this reduction of the bank account a transfer to TBC? Because the two events—credit to the collecting bank and debit to D—were united by the will of the payor bank. Simultaneously, the credit to the collecting bank was willfully connected with the credit to TBC. The united wills of the banks prove that TBC received debtor property.

[187]*See* 11 U.S.C. §547(e)(3) (1994).

[188]One might point out, contra to Justice Rehnquist, that a check is a piece of paper that D conveyed to TBC on the ninety-first day. That piece of paper was later traded for a cash equivalent. That D might stop payment goes to the *value* of the collateral—not to its existence on the ninety-first day before bankruptcy.

To our knowledge, no one has pointed out how *Barnhill*—considered a cornerstone of bankruptcy jurisprudence—contradicts the premises of Uniform Commercial Code Article 4, which awards a security interest on deposited items if NC elects to pay a check on a provisional credit. *See* U.C.C. § 4-210(a) (1995).

[189]*Accord*, Bernstein v. Alpha Assocs. (*In re* Frigitemp Corp.), 34 B.R. 1000, 1016-17 (S.D.N.Y. 1983), *aff'd*, 753 F.2d 230 (2d Cir. 1985).

goods on the personal checks of their customers.[190] $NC_1$ is, in effect, in the same position as the merchant.

3. *Check Kiting*

Check kiting schemes are not difficult to fathom in the basic conceptual structure of (c)(1). In a check kiting scheme, D aims to induce $NC_1$ to create provisional credits by depositing worthless checks. Typically, the checks are written by D herself on another bank ($NC_2$). TBC is paid on provisional credits and, if the kite succeeds, $NC_1$ collects items from $NC_2$ (because D has now deposited worthless checks with $NC_2$).

We saw earlier[191] that, where $NC_1$ is defrauded, the (c)(1) defense always fails. If TBC knows of the fraud, TBC is the constructive trustee of the funds for $NC_1$. TBC must return the funds to $NC_1$—not to the bankruptcy trustee. Earmarking fails, but so does the trustee's voidable preference action. Meanwhile, if TBC is a bona fide purchaser who takes free of the constructive trust, the trustee's preference cause of action exists, and TBC is not entitled to the (c)(1) defense. TBC may have intended a contemporary "exchange" in which $NC_1$ voluntarily "gives" new value, but that event never occurred. Instead, D procures the funds by fraud—precisely what TBC, *ex hypothesi*, did not intend.

This solution largely prevents a baffling valuation question from arising. At the time $NC_1$ honors D's check, $NC_1$ thought it was a fully secured creditor. Historically, in a successful kite, $NC_1$ collected dollar for dollar. If subsequent history can be considered, then $NC_1$ was fully secured when it paid TBC.[192] This would negate the (c)(1) defense for TBC. If $NC_1$ is secured, then $NC_1$ uses the (c)(1) defense to protect its security interest, and no value remains to protect TBC. But subsequent history can never be considered in a proper valuation. The court must consider only the facts that seemed to be true at the time of the exchange.

Full valuation is consistent with what the market thought about the kited checks at the time the checks were deposited. If, however, we value the security interest in a "perfect market," the collateral must be considered worthless. In a perfect market, everyone is supposed to have perfect knowledge. Under perfect market conditions, TBC has a valid defense. (But then, given perfect knowledge, $NC_1$ never gives a provisional credit and never honors a check, if these events are part of a fraudulent scheme.)

The answer to this valuation dilemma is that perfect markets do not ex-

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[190] *See* S. Rep. No. 95-989, at 88 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874 (citing U.C.C. § 3-503(2)(A), which defines ordinary course of business for check clearing as thirty days).

[191] *See supra* notes 154-71 and accompanying text.

[192] *See* Laws v. United Mo. Bank, 98 F.3d 1047, 1052 (8th Cir. 1996) (holding, in effect, that $NC_1$ was fully secured solely because $NC_1$ eventually collected).

ist. People value things based on what knowledge they have. In a perfect market, everyone buys the winning bet at the Kentucky Derby because everyone knows in advance who the winner is.[193] The real market for Kentucky Derby bets, however, is rife with uncertainty. The market for deposited checks is usually reliable. Hence, in analogy to the Kentucky Derby, kited checks should be given full value, as the market would have done at the time.

If the checks are given their face value, consistent with the facts thought to be true at the time, and if the checks later clear because the kite is successful, $NC_1$ is a fully secured creditor. $NC_1$ has received a security interest in the deposited items. $NC_1$ had good collateral, and history vindicated this belief. This security interest is for the benefit of TBC on TBC's antecedent debt. But the transfer is protected by (c)(1). That is, $NC_1$ received a security interest in "valuable" property, but $NC_1$ gave new value to D—a loan pending clearance of the deposited check. The trustee therefore has no cause of action for voidable preference with regard to this security interest, either against NC (the initial transferee) or TBC (the party who was benefited by the initial transfer). In defending the security interest, $NC_1$ exhausts the (c)(1) defense. Hence, as we consider the quite separate transfer of loan proceeds to TBC, TBC cannot use value given by $NC_1$ as the stuff of a (c)(1) defense. That "new value" has already been used up by $NC_1$.

What if the kite fails? In a failed kite, $NC_1$ thought it was fully secured when it paid TBC, but it ends up disappointed. How much was $NC_1$'s collateral worth when $NC_1$ paid TBC? Once again, beliefs reasonably held at the time of payment should govern. History proved disappointing, but history cannot be considered in valuation. Even in a failed kite, valuation should be based on the facts as they appeared at the time $NC_1$ paid TBC. In short, $NC_1$ is always secured in a kite, if it acted reasonably, regardless of subsequent history, and TBC is always guilty of receiving a voidable preference.

The most difficult case involves the circumstances in which $NC_1$ discovers the kite but does nothing in the hope that $NC_2$ will hold the tail of the kite when the scheme crashes.[194] In this case, $NC_1$ knows it is holding very risky collateral. How shall the collateral be valued?

One might say that, even though $NC_1$ knew the truth, the market thought the collateral was risk-free. Hence, if we value the collateral on the ruthless principle of *caveat emptor*, $NC_1$ is still a fully secured creditor, and TBC therefore has exposure for the payments it received from $NC_1$.

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[193]There is no time in the perfect market, so past, present, and future are perfectly known. *See* Jeanne L. Schroeder, *The End of the Market: A Psychoanalysis of Law and Economics*, 112 HARV. L. REV. 483, 534-41 (1998).

[194]*See, e.g.*, McLemore v. Third Nat'l Bank (*In re* Montgomery), 983 F.2d 1389 (6th Cir. 1993) (concerning $NC_1$ which took deposits after knowledge of the kite).

In *Laws v. United Missouri Bank*,[195] $NC_1$ had advanced large sums against uncollected deposits. It grew nervous and demanded a reduction of this exposure. D accomplished this by wiring funds to $NC_1$. Later, $NC_1$ collected all the kited items. The trustee alleged that the wire was a voidable preference.[196] On appeal, Judge Loken assumed $NC_1$ knew of the kite,[197] yet Judge Loken treated $NC_1$ as a fully secured creditor nevertheless. Obviously, if $NC_1$ thought it was fully secured, it would not have demanded a wire transfer to cover the exposure. $NC_1$ probably did not deserve full valuation when it knew of the kite.

In Laws, $NC_1$ knew of the kite, even when it paid TBC. This suggests that $NC_1$ was constructive trustee of funds for $NC_2$—the bank holding the tail of the kite. If so, D's bankruptcy trustee has no voidable preference action against $NC_1$, because $NC_1$ received only $NC_2$'s property not that of D. Nevertheless, $NC_1$ earlier received "valuable" security interests in the items deposited by D. These security interests are separately prima facie voidable preferences, but, as such, these security interests are protected by the (c)(1) defense. Now, because the (c)(1) defense is soaked up and exhausted, TBC cannot use $NC_1$'s new value to defend its payment. Hence, valuation of the security interest at full value destroys TBC's defense. On top of this, TBC's "intent" would have failed. At best, TBC would have intended that D obtain honest refinancing.[198] As the event intended never occurred, TBC has no right to the (c)(1) defense.

The above discussion assumes that check kiting cases turn on the valuation standard rather than on any earmarking criteria. Case law under § 547(c)(1), however, is generally unclear as to when valuation should occur. Logically, the time of valuation should be the time TBC was paid, because that was the time D transferred a security interest to $NC_1$.[199] Some authorities do permit history to influence valuation.[200] These latter authorities

[195] 98 F.3d 1047 (8th Cir. 1996).

[196] Hence, *Laws* was not an earmarking case. $NC_1$ was really TBC. But the case nevertheless illuminates $NC_1$'s position as a secured or unsecured creditor, when it honors D's checks on provisional credits in light of its knowledge of the kite.

[197] Laws v. United Missouri Bank, 98 F.3d at 1049 ("we will assume [$NC_1$] knew that [D] was likely kiting checks").

[198] If TBC was a coconspirator in D's fraud, then TBC holds the victim's constructive trust property. The bankruptcy trustee loses the voidable preference action, but TBC by no means retains the funds.

[199] *See* Abramson v. St. Regis Paper Co. (*In re* Abramson), 715 F.2d 934, 939 n.9 (5th Cir. 1983) (Brown, J.); Carlson, *supra* note 1, at 283-85.

[200] *See* Gray v. A.I. Credit Corp. (*In re* Paris Indus. Corp.), 130 B.R. 1, 3 (Bankr. D. Me. 1991). One commentator favors deferring the time of valuation. "Otherwise [the secured party], rather than the unsecured creditors, would benefit from the increase in value . . . " Michael Kaye, *Preferences Under the New Bankruptcy Code*, 54 AM. BANKR. L.J. 197, 200-201 (1980). This analysis seems entirely result-oriented. It is based on the popular insight that secured parties should lose and the general creditors should win—an oversimplification of the Bankruptcy Code.

would then make TBC's liability turn on whether the kite was eventually successful or not. But such influence of history is anachronistic and not permitted in valuation.[201]

What then is the effect of declaring that check kites are not eligible for the earmarking defense, conceived as an example of the (c)(1) defense? First, the trustee is largely spared difficult valuation issues in most cases, as checks are typically accorded full face value in the market for clearing items. Second, the result would be that TBC helps to fund an increased dividend for $NC_1$. This can be seen if we imagine the kite as D's one and only asset. Suppose D has no assets and one creditor—TBC, who claims $100. D then kites a check for $100 from $NC_1$. The trustee recovers $100 from TBC, and both TBC and $NC_1$ obtain a 50% dividend in the bankruptcy.[202] If TBC were accorded the defense (because $NC_1$ was "really" an unsecured creditor), TBC, who, if out of the ordinary course of business, has behaved badly in bankruptcy terms, walks away with $100, and $NC_1$ obtains no dividend at all. Thus, TBC and $NC_1$ are made to share the risk of a check kiting scheme. Third, TBC is treated the same in every case, which is appropriate, given TBC's state of mind in intending to cadge a preference.[203]

Our analysis matches most of the current case law on check kiting, but pursuant to far different reasoning. The most straightforward representative of the old school of earmarking is *In re Smith*,[204] where D wrote a check to TBC and honored it on a provisional credit which later failed. Judge Richard Cudahy stated that the case turned on whether D had transferred property to TBC. He found that D "controlled" the provisional credit, because D wrote the check that brought TBC to NC's teller window. NC did not control the proceeds, even though NC elected to honor D's check when it did not have to.[205]

There is a defect in such reasoning. By resting on the factual predicate of debtor control, the court implicitly holds that in *secured* refinancing of unsecured debt, where NC definitely controls the deal, TBC may keep proceeds. Such behavior is preferential and should not be allowed. "Control" therefore should not be the determining factor in secured refinancings.

In fact, NC is in total control (but duped) when checks are kited.[206] D's

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[201] *See* Carlson, *supra* note 1, at 283-85.

[202] We assume, *à la* Coase, that there are no transaction costs.

[203] On the other hand, if TBC is a coconspirator with $NC_1$, $NC_1$ has a constructive trust theory against TBC, which implies that TBC has received debtor property of zero value. Under such circumstances, TBC has not received a preference for the reasons stated *supra* in the text accompanying notes 154-56.

[204] 966 F.2d 1527 (7th Cir. 1992), *cert. dismissed* 506 U.S. 1030 (1992).

[205] *Accord*, McLemore v. Third Nat'l Bank (*In re* Montgomery), 983 F.2d 1389, 1394-95 (6th Cir. 1993).

[206] Thus, in dissent, Judge Joel Flaum thought that the bank did intend to refinance and, for this reason

check, of course, is an order from a principal to its agent (in this case, a bank), directing the agent to pay.[207] If funds exist in the account, the bank is contractually obligated to pay. If the checking account contains only provisional credits, $NC_1$ is not obligated to follow D's orders. Hence, it is just as appropriate to say that $NC_1$ (not the mendicant D) controlled the proceeds. Nevertheless, $NC_1$ decided to pay TBC. This amounted to lending directly to D.[208] In exchange for this loan, NC received apparently valuable collateral. Hence, NC utilizes the (c)(1) defense. This leaves TBC undefended and fully liable for the voidable preference.

*McCuskey v. National Bank (In re Bohlen Enterprises)*[209] is a case in which the same result is reached but on reasoning much different from the classicism on display in *Smith*, or from the (c)(1) reasoning being defended here. The complicated facts of *Bohlen* have already been recounted.[210] In that case, the court abandoned the criterion of control and instead insisted that earmarking required an agreement between $NC_1$ and D that $NC_1$'s loan will take out TBC, plus the execution of that agreement according to its terms.[211] This is similar to our analysis, with the key change that (c)(1) focuses on an agreement between TBC and D—not $NC_1$ and D.

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alone, TBC had received no transfer of debtor property. *See In re* Smith, 966 F.2d at 1537. Agreeing that "control" was the issue, he thought control had two aspects: (1) designating the payee; and (2) actually disbursing the funds:

> My colleagues conclude that the Debtor also had the second aspect, which I henceforth will call dispositive control. They find it difficult, however, to pinpoint precisely when the Debtor obtained such control. It could not have been after the Bank honored the Debtor's check by transferring $121,345.11 to [TBC], who after the transaction enjoyed complete dominion over the disputed funds. . . .
>
> Accordingly, if the Debtor ever had dispositive control over the transferred funds, it had to have been prior to the transfer to [TBC]. At that point in time, the Debtor had a provisional credit of $125,000 based upon its deposit with the Bank of a (bad) check in that amount, as well as final credit of $163.58. Was this provisional credit the Debtor's property? The panel, albeit with some hesitation, suggests no in certain passages . . . This conclusion, absent the hesitation, is surely correct. The Bank was under no legal obligation to make good on any checks written against the provisional credit. It was entitled to wait until the $125,000 check cleared. The Debtor could request, but not direct, the Bank to honor its check to [TBC] because the check was written on insufficient funds. That the Bank complied with the Debtor's request by transferring funds to [TBC] was a matter of grace extended the Debtor by the Bank. This is all a way of saying that the Debtor never had dispositive control over the provisional credit.

*Id.* at 1539 (citations omitted). For a case endorsing this definition of control, see *Tolz v. Barnett Bank (In re Safe-T Brake of S. Fla., Inc.)*, 162 B.R. 359 (Bankr. S.D. Fla. 1993).

[207]*See* Barnhill v. Johnson, 503 U.S. 393, 398 (1992).

[208]*See* Williams v. United States, 458 U.S. 279, 281 n.1 (1982) (stating check kiting scheme uses a bank's credit system to create "an interest-free loan for an extended period of time").

[209]859 F.2d 561 (8th Cir. 1988).

[210]*See supra* notes 161-62 and accompanying text.

[211]859 F.2d at 566.

D. After-Acquired Security Interests and Earmarking

As a final note, one of the classic voidable preference problems involves the attachment of TBC's after-acquired property security interest to the inventory D acquires within the preference period. If TBC is undersecured, the attachment of its security interest to new inventory constitutes a transfer of debtor property only when the debtor obtains rights in the inventory.[212]

The history of regulating the after-acquired property security interest is well known. When the Uniform Commercial Code was promulgated, the after-acquired property security interest became very easy to obtain,[213] but no one knew whether such security interests would survive preference liability. Understanding that she was expected to find a way to uphold these security interests, Judge Shirley Hufstedler, in *DuBay v. Williams*,[214] interpreted the Bankruptcy Act's definition of "transfer" in § 60(a)(2) as occurring when it becomes "so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee."[215] According to Judge Hufstedler, this moment occurred when a secured party filed a financing statement. Hence, filing was the moment of transfer, even if all inventory was later acquired.[216] Later, the great Vern Countryman would scorn this theory as the "Abracadabra" theory, or the doctrine of the "Transfer Occurred Before it Occurred."[217]

The effect of *DuBay v. Williams* was that, so long as the secured party filed a financing statement before the preference period, no security interest in accounts or inventory could ever be a voidable preference. As Grant Gilmore put it, in a memorable remark: "the secured creditor bar (if there is such a thing) is basking happily in the warm glow of Judge Hufstedler's opinion in *DuBay* and, we may assume, has lost any interest it may once have had in reform of the Bankruptcy Act."[218]

Nevertheless, Congress did amend the preference law to strike at such after-acquired property security interests. First, it added § 547(e)(3) to make

[212]*See* 11 U.S.C. § 547(e)(3) (1994); U.C.C. § 9-203(1)(c) (1995).

[213]*See* U.C.C. § 9-204(1) (1995).

[214]417 F.2d 1277 (9th Cir. 1969). It was actually described earlier in *Grain Merchants v. Union Bank & Savings Co.*, 408 F.2d 209, 217 (7th Cir. 1969), but Judge Walter Cummings presented such a large number of validating theories that *DuBay v. Williams* usually gets the credit.

[215]Bankruptcy Act of 1898, § 60(a)(2), *quoted in* 417 F.2d at 1287.

[216]Said Vern Countryman: "If the Ninth Circuit had peered more deeply into state law, it would have found that levying creditors could not reach accounts receivable by garnishing account obligors until the accounts came into existence within the four month period." Vern L. Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 Vand. L. Rev. 713, 792-93 (1985).

[217]*Id.* at 793; Vern L. Countryman, *Code Security Interests in Bankruptcy*, 75 Com. L.J. 269, 277 (1970).

[218]Report of the Committee on Coordination of the Bankruptcy Act and the Uniform Commercial Code, at 207-10 (1970), *reprinted in* 1978 U.S.C.C.A.N. 6164, 6168.

clear that a debtor could never transfer property before the debtor obtained her own rights in it.[219] Under this timing rule, the after-acquired property security interest created on antecedent debt within the preference period was a prima facie preference. To mitigate this fact, Congress created a complicated defense applicable only to those secured creditors who claimed inventory or "receivables." This defense, set forth in § 547(c)(5), defends all security interests on inventory or receivables to the extent TBC did not improve its position over the preference period.[220]

What has generally been overlooked[221] is that, when the debtor buys inventory on open account, the after-acquired property security interest is protected by the earmarking doctrine, both under its current inadequate formulation and under our § 547(c)(1) analysis. In effect, the unsecured supplier of inventory on credit is NC, who remits the inventory directly to TBC. D has no control over this process (once the security agreement is signed). Hence, the unsecured supplier is an NC who secures (i.e., refinances) TBC's claim. In (c)(1) terms, TBC can claim a contemporaneous exchange. Both TBC and D intended that the new value provided by NC be contemporaneous with the transfer of a security interest by D to TBC. On the other hand, if the supplier is secured or paid contemporaneously with providing goods, the supplier soaks up the (c)(1) defense, and TBC is left without a (c)(1) defense for its security interest. Such a security interest must be defended, if at all, under § 547(c)(4)[222] or § 547(c)(5).

The after-acquired property security interest on receivables (as opposed to inventory) is most peculiarly governed by (c)(1) principles. If D sells goods on open account to NC, TBC's after-acquired property security interest on the account is vulnerable. The transfer of the goods to NC constitutes a prima facie voidable preference for the benefit of TBC. But NC can claim that it promised to pay—i.e., NC gave "new value" to D. Hence, NC can defend its receipt of goods under § 547(c)(1), and TBC can rightly say that, though it benefited, the initial transfer is not voidable. The trustee cannot recover the goods or their value from either TBC or NC. But meanwhile TBC has received a security interest from D on the account. TBC cannot claim that the transfer is a (c)(1) exchange. The (c)(1) defense exists, but it has been allocated entirely to NC. So far, security interests on accounts re-

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[219] *See* H.R. Rep. No. 95-595, at 374-75 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6330-31; S. Rep. No. 95-989, at 88-89 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5875; Braunstein v. Karger (*In re* Melon Produce, Inc.), 976 F.2d 71, 76 (1st Cir. 1992).

[220] On this defense, see Carlson, *supra* note 1, at 309-49.

[221] *See, e.g.*, Krafsur v. Scurlock Permian Corp. (*In re* El Paso Refinery, L.P.), 178 B.R. 426, 446 n.20 (Bankr. W.D. Tex. 1995) (suggesting in dictum after-acquired property security interest is void even though supplier of inventory was unsecured), *rev'd*, 171 F.3d 249 (5th Cir. 1999).

[222] That is, TBC shows it advanced new value to D following the challenged voidable preference.

semble security interests on inventory, when D pays the price to NC contemporaneously to receiving rights in the inventory.

But now consider an account arising from provision of services. This time, D conveys no property to NC. Yet NC provides new value to D—the promise to pay for services. The creation of the account is exactly simultaneous with the creation of TBC's security interest, and this is clearly intended by D and TBC. Hence, the security interest on the account deriving from provision of services obtains the (c)(1) defense. But if the account derives from the sale of goods, TBC loses the (c)(1) defense.

The only case we have found that entertains the possibility of an earmarking defense in connection with security interests in accounts is *United States Lines (S.A.), Inc. v. United States (In re McLean Industries, Inc.)*,[223] where Judge Kevin Duffy proclaimed too quickly that TBC's argument for earmarking "borders on frivolity." Judge Duffy ruled that D "controlled" whether the account would come into existence, and hence earmarking could not apply.[224] Once again, a court was able to exploit the content-free criterion of "control" to vindicate a pre-theoretical intuition that TBC had been wrongly preferred. A closer look at the facts, however, would have produced the opposite result.

TBC indeed had a valid (c)(1) defense. In *McLean Industries*, TBC was undersecured and claimed vessels as collateral under a federal ship mortgage. The Ship Mortgage Act preempts any governance of the Uniform Commercial Code on ship mortgages if they fall under the jurisdictional provisions of the Ship Mortgage Act. The Ship Mortgage Act is silent on whether the ship mortgage transfers to proceeds.

In *McLean*, D wished to charter (i.e., rent) a vessel in exchange for charter hire (i.e., a receivable). The problem D faced was that the vessel would be subject to TBC's prior lien. Therefore, D and TBC agreed that, if TBC would subordinate its lien to the charter party (NC), NC would remit payment of charter hire directly to TBC. This arrangement diverted $2 million from D to TBC. TBC then tried to claim that, under the earmarking doctrine, D never "controlled" the payment of charter hire. Hence, TBC received no debtor property, under the illogic of the doctrine as TBC understood it.

In fact, TBC had a valid claim that a contemporaneous exchange took place. In effect, TBC released its valid lien on the vessel for the duration of the charter. In exchange, D gave TBC the charter hire. As it were, TBC received proceeds from the collateral. Receipt of proceeds is always pro-

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[223]162 B.R. 410 (S.D.N.Y. 1993), *rev'd*, 30 F.3d 385 (2d Cir. 1994).

[224]*See id.* at 420-21 ("By contract and in fact, the Debtor had control of the assets, and therefore the earmark doctrine does not apply.").

tected by the (c)(1) defense.[225]

Oddly, on further appeal, the Second Circuit reversed because the statute of limitations of § 546(a) had run.[226] This reversal was based on a very questionable reading of the statute of limitations,[227] and in 1994 Congress amended the Bankruptcy Code to prevent further bad readings of that sort.[228] Nevertheless, TBC gained no satisfaction from its statute of limita-

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[225]For example, suppose TBC has a valid security interest in inventory. D sells it in the ordinary course of business. TBC's security interest disappears. U.C.C. § 9-307 (1990). TBC obtains a new security interest in proceeds. *Id.* § 9-306(2) (1995). The security interest in proceeds is validly defended under § 547(c)(1).

[226]30 F.3d at 385. According to § 546(a), an action under § 547 may be brought within

> (1) two years after the appointment of a trustee under section . . . 1104 . . . ; or
> (2) the time the case is closed or dismissed.

11 U.S.C. § 546(a) (1986) (amended 1994). The court in *McLean* ruled that, since debtors in possession are trustees under § 1107, the statute of limitations starts to run immediately upon the filing of a voluntary chapter 11 petition.

[227]Although the statute of limitations holding is beyond the scope of this Article, it bears pointing out that the matter was wrongly decided. Under § 546(a), the statute begins to run when a trustee is appointed under § 1104—for cause or in the best interests of the creditors. The holding of *McLean* opened wide the door for insider abuse, as when a debtor in possession forgets to sue officers and shareholders for the voidable preferences they have received.

For other cases erroneously holding that the statute of limitations starts to run when the chapter 11 proceeding commences, see *Construction Management Services, Inc. v. Manufacturers Hanover Trust Co. (In re Coastal Group. Inc.)*, 13 F.3d 81, 86 (3d Cir. 1994) and *Zilkha Energy Co. v. Leighton*, 920 F.2d 1520, 1524 (10th Cir. 1990). The Ninth Circuit managed to make the following distinctions: (1) Chapter 11 petition; debtor in possession only; no trustee appointed: statute runs two years from petition. *See* Upgrade Corp. v. Gov't Tech. Servs., Inc. (*In re* Softwaire Ctr. Int'l, Inc.), 994 F.2d 682, 683 (9th Cir. 1993) (per curiam); (2) Chapter 11 petition; chapter 11 trustee appointed; second chapter 7 burial trustee appointed after conversion: two years from appointment of the chapter 11 trustee. *See* Ford v. Union Bank (*In re* San Joaquin Roast Beef), 7 F.3d 1413 (9th Cir. 1993); (3) Chapter 11 petition; no chapter 11 trustee; plan confirmed, appointing a representative to pursue postconfirmation preferences: two years from chapter 11 petition. *See* Liquidation Estate of DeLaurentiis Entertainment Group v. Technicolor, Inc. (*In re* DeLaurentiis Entertainment Group, Inc.), 87 F.3d 1061 (9th Cir. 1996) (Tanner, J.); (4) Chapter 11 petition; no chapter 11 trustee; conversion to chapter 7 and new burial trustee appointed: two years from the chapter 11 petition. *See* Mosier v. Kroger Co. (*In re* IRFM, Inc.), No. 94-55235, 1995 U.S. App. LEXIS 32817 (9th Cir. Sept. 12, 1995); (5) Chapter 11 petition; chapter 11 trustee appointed; no conversion: two years from appointment of chapter 11 trustee. *See* Mitchell v. Steinbrugge (*In re* Hanna), 72 F.3d 114 (9th Cir. 1995).

[228]If the intent was to overrule cases like *McLean Industries*, it may have failed. Prior to 1994, § 546(a) provided that avoidance actions had to be brought no later than the earlier of:

> (1) two years after the appointment of a trustee . . . ; or
> (2) the time the case is closed or dismissed.

Now, § 546(a) requires the action to be brought no later than:

> (1) the later of—
> (A) 2 years after the entry of the order for relief; or
> (B) 1 year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or
> (2) the time the case is closed or dismissed.

tions defense. On remand to the bankruptcy court, Judge Cornelius Blackshear reasoned that, even though the statute of limitations in § 546(a) barred recovery, TBC had still received a voidable preference within the meaning of § 547(b). He then read § 502(d), which holds:

> Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, to 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.[229]

Hence, because TBC held a preference voidable under § 547 but unrecoverable under § 546(a), TBC's secured claim (for $20 million) was not allowable in the bankruptcy. Blackshear then noted § 506(d), which provides:

> To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void unless
>
> > (1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or
> >
> > (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.[230]

Blackshear then put two and two together in a disastrous way. Because TBC had received a $2 million voidable preference, its secured claim for $20 million was disallowed. Because TBC claimed a security interest for a disallowed claim, the security interest was "void" under § 506(d). This amazing result is a valid reading of § 502(d) and § 506(d), as they are currently writ-

This amendment does not clearly contradict the premises of *McLean Industries*. Thus, courts could still hold that all debtors in possession are trustees "appointed" under § 1104, and that the one-year period commences to run in chapter 11 cases as soon as the chapter 11 petition is filed. If a second trustee is "appointed" under § 702 in a converted case, the one-year period does not start to run again. Such a holding, however, would be unfortunate for the reasons described *supra* in note 222. In any case, early returns show that judges are willing to overlook the actual wording of the amendment and to decide statute of limitations cases in a pro-trustee fashion, in spite of the poor draftsmanship. *See* Steege v. Helmsley-Spear, Inc. (*In re* Superior Toy & Mfg. Co.), 175 B.R. 693 (Bankr. N.D. Ill. 1994) (dictum).

[229] 11 U.S.C. § 502(d) (1994).

[230] *Id.* § 506(d).

ten. It is interesting to contemplate, however, that TBC was not liable for the $2 million voidable preference in the first place, because it had a valid earmarking defense.

## CONCLUSION

In this Article, we have made the following points: (1) Under the Bankruptcy Act of 1898 § 60, no "contemporaneous exchange" defense existed. Hence, the courts found within the elements of the prima facie case the notion that a trustee could only recover a preference to the extent the estate was diminished by the transfer. (2) "Diminution of the estate" was used in two contexts—(a) TBC paid some value and extinguished some antecedent debt in exchange for the transfer. The trustee was able to recover only to the extent of the antecedent debt. In short, the diminution requirement substituted for the contemporaneous exchange defense in Bankruptcy Code § 547(c)(1). (b) The diminution doctrine was used in refinancing cases. Thus, unsecured refinancing was upheld because it did not diminish the bankruptcy estate. Secured refinancing of unsecured debt was struck down because of the attendant diminution. (3) The Bankruptcy Code has replaced the need for the diminution doctrine by enacting § 547(c)(1). This subsection renders diminution a defensive matter. Diminution is no longer related to the trustee's prima facie case of voidable preference. (4) Because the refinancing (i.e., earmarking) cases were always litigated on the basis of diminution, courts should recognize that § 547(c)(1) replaces court-made earmarking doctrine. Earmarking is a fiction which, like the "two-transfer" theory denounced in *Deprizio*,[231] must be abandoned. (5) If traditional earmarking doctrine is renounced, results would change in cases involving check overdrafts and draws upon existing lines of credit. In these cases, a defense will exist only if the new credit to refinance old debt is genuinely new, and intended by the parties to accomplish refinancing.

This line of analysis would permit courts to abandon the completely indeterminate notion of "control" as the operative concept in earmarking cases. "Control" has no content, and cannot produce like results in like cases. It should be retired as a primitive relic of the Bankruptcy Act, thankfully repealed when the Bankruptcy Code was enacted.

[231]Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186 (7th Cir. 1989); *see supra* notes 94-96 and accompanying text.

## APPENDIX

11 U.S.C. § 96. Preferred creditors.

(a) (1) A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

(2) For the purposes of subdivisions (a) and (b) of this section, a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee. A transfer of real property shall be deemed to have been made or suffered when it became so far perfected that no subsequent bona fide purchase from the debtor could create rights in such property superior to the rights of the transferee. If any transfer of real property is not so perfected against a bona fide purchase, or if any transfer of other property is not so perfected against such liens by legal or equitable proceedings prior to the filing of a petition initiating a proceeding under this Act, it shall be deemed to have been made immediately before the filing of the petition.

(3) The provisions of paragraph (2) shall apply whether or not there are or were creditors who might have obtained such liens upon the property other than real property transferred and whether or not there are or were persons who might have become bona fide purchasers of such real property.

(4) A lien obtainable by legal or equitable proceedings upon a simple contract within the meaning of paragraph (2) is a lien arising in ordinary course of such proceedings upon the entry or docketing of a judgment or decree, or upon attachment, garnishment, execution, or like process, whether before, upon, or after judgment or decree and whether before or upon levy. It does not include liens

which under applicable law are given a special priority over other liens which are prior in time.

(5) A lien obtainable by legal or equitable proceedings could become superior to the rights of a transferee or a purchase could create rights superior to the rights of a transferee within the meaning of paragraph (2), if such consequences would follow only from the lien or purchase itself, or from such lien or purchase followed by any step wholly within the control of the respective lien holder or purchaser, with or without the aid of ministerial action by public officials. Such a lien could not, however, become so superior and such a purchase could not create such superior rights for the purposes of paragraph (2) through any acts subsequent to the obtaining of such a lien or subsequent to such a purchase which require the agreement or concurrence of any third party or which require any further judicial action, or ruling.

(6) The recognition of equitable liens where available means of perfecting legal liens have not been employed is hereby declared to be contrary to the policy of this section. If a transfer is for security and if (A) applicable law requires a signed and delivered writing, or a delivery of possession, or a filing or recording, or other like overt action as a condition to its full validity against third persons other than a buyer in the ordinary course of trade claiming through or under the transferor and (B) such overt action has not been taken, and (C) such transfer results in the acquisition of only an equitable lien, then such transfer is not perfected within the meaning of paragraph (2). Notwithstanding the first sentence of paragraph (2), it shall not suffice to perfect a transfer which creates an equitable lien such as is described in the first sentence of paragraph (6), that it is made for a valuable consideration and that both parties intend to perfect it and that they take action sufficient to effect a transfer as against liens by legal or equitable proceedings on a simple contract: Provided, however, That where the debtor's own interest is only equitable, he can perfect a transfer thereof by any means appropriate fully to transfer an interest of that character: And provided further, That nothing in paragraph (6) shall be construed to be contrary to the provisions of paragraph (7).

(7) Any provision in this subdivision (a) to the contrary notwithstanding if the applicable law requires a transfer of property other than real property for or on account of a new and contemporaneous consideration to be perfected by recording, delivery, or otherwise, in order that no lien described in paragraph (2) could become superior to the rights of the transferee therein, or if the applicable law requires a transfer of real property for such a consideration to be so perfected in order that no bona fide purchase from the debtor could create rights in such property superior to the rights of the transferee, the time of transfer shall be determined by the following rules:

I. Where (A) the applicable law specifies a stated period of time of not more than twenty-one days after the transfer within which recording, delivery, or some other act is required, and compliance therewith is had within such stated period of time; or where (B) the applicable law specifies no such stated period of time or where such stated period of time is more than twenty-one days, and compliance therewith is had within twenty-one days after the transfer, the transfer shall be deemed to be made or suffered at the time of the transfer.

II. Where compliance with the law applicable to the transfer is not had in accordance with the provisions of subparagraph I, the transfer shall be deemed to be made or suffered at the time of compliance therewith, and if such compliance is not had prior to the filing of the petition initiating a proceeding under this Act, such transfer shall be deemed to have been made or suffered immediately before the filing of such petition.

(8) If no such requirement of applicable law specified in paragraph (7) exists, a transfer wholly or in part, for or on account of a new and contemporaneous consideration shall, to the extent of such consideration and interest thereon and the other obligations of the transferor connected therewith, be deemed to be made or suffered at the time of the transfer. A transfer to secure a future loan, if such a loan is actually made, or a transfer which becomes security for a future loan, shall have the same

effect as a transfer for or on account of a new and contemporaneous consideration.

(b) Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: Provided, however, That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.

(c) If a creditor has been preferred, and afterward in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him.

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