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Structuring Workout Settlements Premised On The "Earmarking" Doctrine

by

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Introduction

Unsecured creditors sometimes approach "workout" negotiations[1] as a blitzkrieg assault on the debtor. They fear that, if the debtor does not make a quick transfer, all available value will be lost to competing creditors or wasted by the debtor.[2] Accordingly, creditors engaged in such negotiations tend to pursue a one-dimensioned strategy, pressing for the prompt turnover of as much value as possible.

These parties may, nevertheless, be served by temporarily focusing away from *how much value* they are to receive, focusing instead on *how the value will be transferred*. In other words, creditors involved in workout negotiations should sometimes adroitly exercise restraint in their quest for more and more value, using some of their leverage instead to secure a more beneficial deal structure.

The problem stems from the fact that a troubled debtor, even after it achieves a settlement of claims asserted by key creditors, may still need bankruptcy protection. This is especially true if the debtor suffers negative cash flow from operations or if it is compelled to shoulder too heavy a burden under the workout settlement.[3] If the debtor subsequently files for bankruptcy, creditors that receive pre-petition transfers as part of a workout may, depending on the deal structure, face preference and/or fraudulent conveyance exposure.

Preference and fraudulent conveyance exposure may, however, be reduced by structuring a workout settlement based on the "earmarking" doctrine. The doctrine holds that a pre-bankruptcy transfer will not be avoided as a preference or fraudulent conveyance if the payment was supplied and "earmarked" for the creditor by a non-debtor third party.[4] Provided that the requirements of the doctrine are satisfied and that there is a non-debtor source of funding – such as a new loan facility, funds from the capital markets, and/or contributions from an insider/affiliate with a stronger balance sheet – creditors may receive pre-petition payments as part of a workout settlement with reduced preference and fraudulent conveyance risks.

This article examines the earmarking doctrine as a basis for structuring workout settlements. Section I describes the preference and fraudulent conveyance causes of actions. Section II examines the earmarking doctrine as a defense to such claims. Section III suggests points that should be considered when structuring a workout settlement so that a creditor, relying on the earmarking doctrine, may reduce preference and fraudulent conveyance risks.

The Causes Of Action

Preferences

Fundamental policies underlying the Bankruptcy Code[5] include: (a) equality of treatment among creditors of the same type; and (b) disincentivizing creditors from dismembering a financially pressed debtor prior to bankruptcy.[6] In furtherance of these policies, the Bankruptcy Code affords the trustee (or Chapter 11 debtor-in-possession)[7] the power to avoid a transfer made shortly before a Chapter 11 filing that gives the recipient an unfair advantage over other similarly situated creditors.[8]

In particular, Bankruptcy Code § 547(b) provides that a trustee may avoid a transfer of its property:[9] (1) made to a creditor;[10] (2) on account of an antecedent debt;[11] (3) while the debtor was insolvent;[12] (4) within one year of the filing of a bankruptcy petition if made to an insider, or within ninety days if made to an entity that is not an insider;[13] and (5) that left the creditor better off than it would have been if the transfer had not been made and it had asserted its claim in a Chapter 7 liquidation case (*i.e.*, absent the transfer, the recipient would have only a general unsecured claim against a hypothetical liquidating estate and would have received less value from such estate).[14] The trustee bears the burden of proof respecting all of the elements of a preference claim.[15]

It has been argued that a transfer made to a creditor as part of a pre-petition compromise that is less than the full amount of the outstanding debt may not be avoided as a preference. The argument is premised on Bankruptcy Code § 547(c)(1), which provides that a transfer is not avoidable if it was intended by the parties to be, and was in fact, a substantially contemporaneous exchange of "new value".[16] Creditors have argued that, by agreeing to accept less than full payment on its claim as part of a consensual arrangement, they have provided new value to the debtor in the form of debt forgiveness and litigation forbearance. Bankruptcy Code Section 547(a)(2), however, defines "new value" narrowly to include only "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."[17] In light of the Bankruptcy Code's narrow definition of "new value," courts have held that a compromise of an outstanding debt does not qualify as new value for purposes of the § 547(c)(1).[18]

Creditors that enter into a workout agreement, therefore, must find another way to shield settlement payments from subsequent preference attack.

Fraudulent Conveyances

The Bankruptcy Code provides a trustee with two mechanisms for attacking fraudulent conveyances: (1) Bankruptcy Code § 548 affords the trustee direct powers to avoid fraudulent transfers; and (2) Bankruptcy Code § 544 enables the trustee to use state law to avoid fraudulent transfers. [19] The primary difference between actions brought pursuant to §§ 548 and 544 relates to the applicable statute of limitations.[20]

First, Bankruptcy Code § 548(a)(1)(B) provides that the trustee may avoid any conveyance of the debtor's property if the debtor received less than "reasonably equivalent value" in exchange for the conveyance[21] and (i) the debtor was insolvent on the date the conveyance was made or obligation was incurred, or became insolvent as a result of the transfer;[22] (ii) the debtor was engaged or was about to engage in business or a transaction for which any property remaining with the debtor was of unreasonably small capital;[23] or (iii) the debtor intended to incur, or believed it would incur, debts beyond the debtor's ability to pay as they matured.[24]

Second, Bankruptcy Code § 544(b)(1) affords the trustee any right established by state law of any unsecured creditor to avoid a pre-petition transfer of the debtor's property.[25] Many states have adopted the Uniform Fraudulent Conveyance Act[26] or the Uniform Fraudulent Transfer Act,[27] each of which provides for the avoidance of fraudulent transfers by creditors outside the bankruptcy context. The elements of the cause of action under both the UFCA and the UFTA are essentially the same as under Bankruptcy Code Section 548,[28] except that, under the UFCA, the plaintiff must establish that the debtor did not receive "fair consideration"[29] in exchange for the transfer.[30]

If, as part of a workout agreement, creditors receive settlement payments from an affiliate of the debtor, which affiliate subsequently seeks bankruptcy protection, the creditors may face substantial risk that the settlement payment will be avoided as a fraudulent conveyance. They must, therefore, find a way to shield such payments from subsequent fraudulent conveyance attack.

Potential Defendants

Bankruptcy Code § 550 provides that an avoided transfer may be recovered from: (a) the initial transferee of the transfer; (b) any entity for whose benefit such transfer was made; or (c) any immediate or mediate transferee of such initial transfer.[31] The trustee may recover the actual property transferred or, if the Bankruptcy Court so orders, the value of such property.[32] If the defendant must provide the value of the property transfer, the property is valued as of the date of the transfer by the debtor.[33]

Thus, any participant in a workout that receives a preferential or fraudulent transfer can be compelled to disgorge it or its original value to the debtor's estate. [34] That is true even if the recipient transferred the property onward to another or the property, since the transfer, has substantially eroded in value. Accordingly, creditors engaged in workout negotiations have tremendous economic incentive to settle on terms that obviate the preference and fraudulent conveyance risks.

The Earmarking Doctrine

Courts have held that, where a third-party provides necessary funds to retire a specific obligation a debtor owes to an existing creditor, the payment to the existing creditor was not a transfer involving the debtor's property and, therefore, cannot be avoided.[35] This rule is often referred to as the "earmarking" doctrine. The doctrine is premised on the theory that, where a third-party "earmarks" funds to pay a pre-existing creditor, the transfer does not harm the debtor's bankruptcy estate because the third-party "merely steps into the shoes of an old creditor."[36]

As described below, the earmarking doctrine may serve as the foundation for a workout agreement that shields settlement payments from preference and fraudulent conveyance attacks.

Scope Of The Doctrine

Concept With Broad Application

Historically, earmarking doctrine cases involved a third-party paying an obligation of the debtor that the third-party itself was also obligated to pay, as a surety, subsequent endorser, or guarantor.[37] The courts refused to permit the trustee to avoid payments made by a guarantor to satisfy the debtor's obligations, reasoning that it is inequitable to force the guarantor to satisfy the debtor's obligations a second time if the guarantor's first payment is avoided and turned over to the debtor's estate.[38] Such inequity does not arise where the third-party is not contractually obligated to pay the debt. Certain modern courts have, consequently, questioned whether the doctrine should apply where the third-party is not contractually obligated to pay the debt.[39]

Nevertheless, the prevailing view is that the doctrine has been extended "'to encompass any situation where a subsequent loan was made on the condition that it be used to repay an existing loan,'"[40] including situations wherein the third-party was not contractually obligated to pay the debtor's debt.[41] Indeed, one court has stated that the notion that the earmarking doctrine is limited to cases wherein the third-party was contractually obligated to pay the debtor's debt "ignores the march of history."[42]

Application To Fraudulent Conveyance Actions

As noted above,[43] the earmarking doctrine is typically considered a defense to preference actions. The doctrine may, however, have application to fraudulent conveyance actions.[44] Specifically, the doctrine may apply where the payment is initially transferred by the third-party to an entity that forwards the payment on to the creditors and then files for bankruptcy protection.[45]

Those are the facts of *Nordberg v. Sanchez* (*In re* Chase & Sanborn Corp.).[46] In that case, an insider of the debtor funneled borrowed moneys through the debtor's bank account, onward to a friend to repay an antecedent debt owed by the insider.[47] The debtor's trustee sued the friend, seeking disgorgement of the transfer as a fraudulent conveyance.[48] The court dismissed the action, holding that the funds never became property of the debtor and, therefore, could not be disgorged under a fraudulent conveyance theory.[49] Reaching this conclusion, the court focused heavily on the fact that the debtor never had control of the funds.[50]

Thus, *Nordberg* supports the proposition that the earmarking doctrine will prevent a fraudulent conveyance action where the debtor made a transfer of value provided by a third-party and "earmarked" for the payment of another.

Tests For Invocation Of The Doctrine

There are two widely recognized tests for determining whether the earmarking doctrine is applicable under a given set of circumstances.[51] One test was first articulated by the Eighth Circuit Court of Appeals in the case *McClusky v. Nat'l Bank* (*In re Bohlen Enter., Ltd.*).[52] Under *Bohlen*, the earmarking doctrine will defeat a preference or fraudulent conveyance claim, provided that: (1) there exists an agreement between a new lender and the debtor that new funds will be used to pay a specified antecedent debt; (2) there has been performance of that agreement according to its terms; and (3) the transaction viewed as a whole (including the transfer in of the new funds and the transfer out to the old creditor) does not result in any diminution of the estate.[53] The Third Circuit Court of Appeals approvingly cited *Bohlen* in a case tangentially involving the earmarking doctrine.[54] Trial courts outside of the third and eighth circuits have also embraced the *Bohlen* test.[55]

The other test focuses on two elements: "(1) the absence of control by the debtor over the disposition of the funds, and (2) no diminution of the debtor's estate as a result of the transfer."[56] This test has been embraced by the Sixth Circuit Court of Appeals and a variety of lower courts.[57] To show "the absence of control by the debtor over the disposition of the funds," courts have held that the third-party lender must stipulate, as a condition of the loan, that the proceeds be used to pay the pre-existing debt.[58]

Courts determine whether a transfer diminishes the bankruptcy estate by using balance sheet accounting: "[d]iminution of the estate occurs where the transfer reduces the pool of funds available to all, so that creditors in the same class do not receive as great a percentage as the preferred creditor."[59] Nevertheless, where the transfer results in diminution of the estate, the transfer is avoidable only to the extent that the transfer reduced the value of the estate, not necessarily the full amount of the transfer.[60]

A First Circuit Bankruptcy Appellate Panel and two bankruptcy courts have combined both the *Bohlen* and the "control" tests to determine whether the earmarking doctrine will shield a particular transfer from avoidance attack.[61] Combining both tests may not, however, seem to make intuitive sense since the first two elements of the *Bohlen* test (that there be an agreement to use the funds to pay a pre-existing creditor and performance of the agreement) essentially equate with the element of the second test that the debtor lacks control of the funds transferred to the pre-existing creditor.

Provided that the elements of the *Bohlen* or the "control" test (depending on the jurisdiction) are satisfied, the third-party need not transfer the funds directly to the pre-existing creditor and may transfer the funds to the debtor as intermediary for subsequent transfer to the pre-existing creditor.[62]

Burden Of Proof

There appears to be a split of authority as to which party bears the burden of proof respecting the earmarking doctrine.[63] The better view is that the trustee bears the burden of proving that the earmarking doctrine does not apply because, under Bankruptcy Code § 547(g), the trustee bears the burden of proving all elements of the preference claim, including proof that the transfer involved the debtor's property.[64] This reasoning is also supported by § 547(c), which lists affirmative defenses for preferences actions, because the earmarking doctrine is not included in such list of defenses.[65] There is, nevertheless, authority holding that the earmarking doctrine is an affirmative defense that must be proven by the defendant.[66]

Prospective Invocation Of The Earmarking Doctrine

In light of the above, a creditor engaged in workout negotiations should, if possible, structure a settlement with a view towards reducing preference and fraudulent conveyance risks. In order to avail itself of the "earmarking" defense regardless of where the debtor's bankruptcy case might be filed, the creditor should ensure that the structure of the settlement satisfies both the *Bohlen* and the "control" tests. Accordingly, the creditor should retain substantial evidence proving: (1) that there exists an agreement between a new lender and the debtor that new funds will be used specifically to pay the creditor's antecedent debt; (2) that, pursuant to the agreement, the debtor does not have any control over the disposition of the settlement funds; (3) that there has been performance of that agreement according to its terms; and (4) that the transaction viewed as a whole (including the transfer in of the new funds and the transfer out to the old creditor) does not result in any diminution of the estate.

Evidencing An Agreement

There are many ways to document an agreement between a new lender and the debtor providing that new funds will be used to retire the creditor's antecedent debt. Almost axiomatic, the creditor can compel the debtor, as a condition precedent to consummating an out-of-court settlement, to enter into a detailed agreement with the new lender that specifically provides for the payment of the creditor's outstanding claim. Such an agreement should make clear, in the "Whereas" clauses for example, that the new loan is linked to the workout settlement and that all parties intend for the settlement to be premised on the earmarking doctrine. It should be clear to all parties that the pre-existing creditor is intended to be a third-party beneficiary of the agreement. The agreement should be in a form reasonably acceptable to and, perhaps, signed by the creditor whose claim is to be retired.

If circumstances are such that a formal agreement is not feasible, a simple letter agreement may suffice. Again, the letter agreement should make clear that all parties are seeking to effectuate an "earmarking" settlement. Even if the letter agreement is not signed by all of the parties, they should endeavor, by the trail of correspondence, to form the terms of the lending agreement. If, after the terms of the arrangement have been outlined in correspondence, it is not entirely clear that the parties predicate the settlement and lending agreement on the earmarking doctrine, the creditor should contribute to the flurry of correspondence, making its intentions abundantly clear. The creditor should thereafter have the debtor and the new lender acknowledge the creditor's intentions by separate correspondence.

The creditor may ultimately help its cause by ensuring public disclosure of the agreement. If the debtor is a public reporting company, the creditor should compel the debtor to make prompt and full disclosure of the settlement, detailing how the lending arrangement is part and parcel of the settlement and intended to avail the creditor of an "earmarking" defense. If a formal lending agreement was executed, the debtor should attach a copy of the agreement to a statement filed with the Securities and Exchange Commission. Even if the debtor is not a reporting company, public disclosure may be effectuated through a clearly worded press release.

Furthermore, if it is anticipated that the capital markets will be the source of settlement funding, the prospectus should plainly disclose that the debtor intends to retire specific antecedent debt with the cash generated by the issuance of securities. Again, the prospectus should make clear that the debtor intends to effectuate an "earmarking" settlement with the use of these funds.

If creditors structuring a workout settlement ensure that the closing documents clearly note that the transfer is intended to pay the creditor's antecedent debt and/or full public disclosure of this intent is made by the debtor, the first requirement of the earmarking doctrine should be satisfied.

Evidencing Lack Of Control

It should also be a relatively simple matter proving that the debtor is entirely deprived of control over the disposition of the settlement funds. As noted above, this element is satisfied if the third-party lender stipulates, as a condition of the loan, that the proceeds be used to pay the pre-existing debt. Accordingly, final documentation respecting the new lending arrangement should specifically incorporate such a term.

The defense is strengthened if the lending agreement also provides for the direct payment of loan proceeds to the antecedent creditor in satisfaction of the outstanding debt claim. If circumstances contemplate a time lag between funding and the payment of the antecedent debt, the funds may be placed in escrow pending satisfaction of all conditions precedent for payment to the creditor. Final documentation in this regard should clearly exclude the debtor from any rights effecting consummation of the transfer. The debtor should not even be afforded the right to waive conditions precedent to consummation of the transfer.

To further evidence lack of control, the debtor and the third-party might establish a "lock box" account with a lending institution. The purpose of the account would be the deposit of the settlement funds into the account, to be released to only the antecedent creditor. The terms of the "lock box" agreement should prevent the debtor from ever having access to the funds in the account.

As indicated above, the "earmarking" defense is not necessarily destroyed if the debtor is temporarily vested with custody of the settlement funds. This, however, should be avoided because custody over the settlement funds may suggest that the debtor, in fact, had some power to control disposition of the settlement funds. If circumstances require that the settlement funds are to be vested with the debtor for a period of time, the creditor should ensure that: (1) the holding period is as brief as possible; (2) the funds are accounted for separately by the debtor, held in a segregated account and not commingled with funds from other sources; (3) the funds are held by a banking institution of some size and repute; and (4) the debtor's access to the funds is limited only to transferring same to the creditor. The creditor should write to the banking institution holding the settlement funds advising the bank that it has an interest in the funds and that it intends to hold the bank liable if the funds are inappropriately released to the debtor. Moreover, the creditor should, if possible, compel regularized reporting as to the location and amount of the settlement funds.

If creditors structuring a workout settlement ensure that the debtor never actually obtains access to the settlement funds or, if it does, such access is limited and the funds are held in a segregated account, the second requirement of the earmarking doctrine should be satisfied.

Evidencing Performance

To establish the full performance of the agreement according to its terms, the creditor should create a detailed paper trail of the transaction. The creditor should obtain and retain documents fully tracing the flow of the settlement funds, from their origin, ultimately to the creditor. The creditor should, if possible, obtain and retain receipts or transfer statements from all intermediate parties. The creditor should also, if possible, obtain and retain detailed acknowledgements from all involved parties that they complied with all applicable terms of the lending arrangement and that they did not deviate from the terms of the agreement in any respect. If the debtor is a public reporting company, the creditor should ensure that the debtor promptly and accurately reports in a filing with the Securities and Exchange Commission that the transaction was successfully consummated entirely in accordance with its terms.

If the creditors ensure that the agreement is performed entirely in accordance with its terms and keep meticulous records establishing same, the third requirement of the earmarking doctrine should be satisfied.

Evidencing No Diminution Of The Estate

A more difficult evidentiary issue for the recipient of the settlement proceeds may be establishing that the transaction viewed as a whole does not result in any diminution of the estate. If the new source of funding is willing to lend on an unsecured basis, the issue is relatively easy: a new unsecured creditor replaces the pre-existing unsecured creditor (*i.e.*, the funder "merely steps into the shoes of an old creditor") without any material change to the liability side of the debtor's balance sheet. If, however, there is any additional complexity stemming from the new lending arrangement – such as the provision of collateral, a modification to a guarantee-relationship, differing lending terms, or more stringent covenants – it could be argued persuasively that the pre-existing obligation was replaced by a more onerous obligation. Quantifying the extent to which the new lending arrangement is more onerous may be an issue sufficiently vague that it may lead the parties to vigorous litigation or a favorable settlement.

That is because the earmarking doctrine holds that, where the transfer results in diminution of the estate, the transfer is avoidable only to the extent that the transfer reduced the value of the estate, not necessarily the full amount of the transfer.

Accordingly, creditors structuring a workout settlement should try to keep the transaction as simple as possible. Preferably, the source of funding should not receive any rights that are in addition to the rights that the settling creditors could have exercised. If, however, the source of funding demands additional protections or improved rights, the creditors should look for creative ways to structure the transaction to minimize a claim that the workout settlement resulted in a diminished bankruptcy estate. This factor is, in any event, case specific and, therefore, does not lend itself to any particular guidelines.

Conclusion

In juxtaposition to the process of restructuring debt obligations before a bankruptcy court, creditors involved in workout negotiations do not vet the settlement through a judicial process. Thus, creditors continue to bear risks even after a settlement payment has been made on outstanding claims. Such risks include preference and fraudulent conveyance attack if the debtor shortly after consummating a settlement finds itself the subject of a bankruptcy proceeding. A creditor that structures its settlement payment so as to avail itself of an "earmarking" defense may obviate a significant threat of a subsequent avoidance action. Indeed, if the settling creditor ensures that all elements of the earmarking doctrine can be established under the circumstances, it may effectively neutralize avoidance risks lingering long after the settlement payment is made.

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1 Meaning, "an out-of-court negotiation with creditors whereby a debtor enters into an agreement with a creditor or creditors for a payment or plan to discharge the debtor's debt(s)." BLACK'S LAW DICTIONARY 1606 (6th ed. 1990); *see, generally,* Tex. Comm. Bank. v. Licht (*In re* Pengo Indus, Inc.), 962 F.2d 543, 546-48 (5th Cir. 1992)(describing the process of out-of-court restructuring); Official Comm. of Unsecured Creditors v. Valley Fid. Bank & Trust Co. (*In re* Chateaugay Corp.), 961 F.2d 378, 381 (2d Cir. 1992)(same); Richard E. Mendales, *We Can Work it Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context*, 46 RUTGERS L. REV. 1213, 1220-21 (1994)(same)[hereinafter *Workout Context*].

2 "In most cases, a workout results from a breakdown of creditor confidence that the debtor can continue to meet its obligations on a timely basis. The debtor's business may be unable to generate sufficient cash flow to meet the debtor's current obligations; or the danger of such failure in the short-term future may have passed certain trigger points,

putting the debtor in default under certain of its loan covenants, or compelling the debtor to begin talks with its creditors to forestall such default." *Workout Context*, 46 RUTGERS L. REV. at 1220.

3 For an example of how staunch creditor posturing during workout negotiations led ultimately to the debtor's bankruptcy filing, *see In re* Southland Corp., 124 B.R. 211 (Bankr. N.D. Tex. 1991); *see also Workout Context*, 46 RUTGERS L. REV. at 1223-1244 (describing certain business and legal problems arising in workout scenarios that may ultimately lead to the debtor's bankruptcy filing).

4 As discussed in Part II.A.2. of this article, the earmarking doctrine has primary applicability to preference actions and its use as a defense to fraudulent conveyance actions is limited.

5 Title 11 of the United States Code is referred to as the "Bankruptcy Code".

6 Union Bank v. Wolas, 502 U.S. 151, 161-62 (1991); Morrison v. Champion Credit Corp. (*In re* Barefoot), 952 F.2d 795, 797-98 (4th Cir. 1991); Rabin v. B&M Realty Corp. (*In re* Plecharty), 201 B.R. 486, 493 (Bankr. N.D. Ohio 1997).

7 11 U.S.C. § 1107(a)(providing that a debtor-in-possession in a Chapter 11 case has substantially the same rights and responsibilities of a trustee).

8 *Id.* § 547(b); *see* 5 Collier on Bankruptcy ¶ 547.01 (15th ed. rev. 1996).

9 The Supreme Court has stated that "'property of the debtor subject to the preferential transfer provision is best understood as that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings." Begier v. I.R.S., 496 U.S. 53, 58 (1990). Thus, a pre-petition transfer of a security interest in property of the debtor may constitute a preference. Amer. Bank of Martin County v. Leasing Serv. Corp. (*In re* Air Conditioning, Inc. of Stuart), 845 F.2d 293 (11th Cir.), *cert. denied*, 488 U.S. 993 (1988). Nevertheless, there is authority holding that a debtor's transfer of newly issued stock is neither a transfer of its property nor, consequently, a transfer of property of its bankruptcy estate. *See, e.g.,* Trinity Gas Corp. v. I.R.S. (*In re* Trinity Gas Corp.), 242 B.R. 344, 352 (Bankr. N.D. Tex. 1999); *In re* CPT Corp., 1992 WL 237359 (Bankr. D. Minn. 1992); Intramerican Oil & Minerals, Inc. v. Mid-America Petroleum, Inc. (*In re* Mid-America Petroleum, Inc.), 71 B.R. 140, 141 (Bankr. N.D. Tex. 1987); *see also* Nat'l Can Corp. v. U.S., 520 F. Supp. 567, 578 (N.D. Ill. 1981). It therefore follows that a transfer by the debtor of newly issued shares as part of a workout may not be avoidable as a preference.

10 11 U.S.C. § 547(b)(1).

11 11 U.S.C. § 547(b)(2). A transfer is deemed made "on account of antecedent debt" if the debt is incurred prior to the relevant transfer. Intercontinental Publ'ns, Inc. v. Perry (*In re* Intercontinental Publ'ns, Inc.), 131 B.R. 544, 549 (Bankr. D. Conn. 1991); Ledford v.

Fort Hamilton Hughes Memorial Hosp. (*In re* Mobey), 15 B.R. 573 (Bankr. S.D. Ohio 1981).

12 11 U.S.C. § 547(b)(3). A transfer is "made while the debtor was insolvent" if, at the time of the transfer, the "fair value" of the debtor's assets is less than the sum of the debtor's debts. *Id.* § 101(32). The "fair value" of the debtor's assets is determined on a "going concern" basis, provided that bankruptcy was not clearly imminent on the date of the transfer. *See* Travelers Int'l AG v. Trans World Airlines, Inc. (*In re* Trans World Airlines, Inc.), 134 F.3d 188, 194 (3d Cir. 1998). In this regard, the debtor is aided by a presumption of insolvency during the 90-day period immediately preceding the date on which the bankruptcy petition is filed. 11 U.S.C. § 547(f).

13 11 U.S.C. § 547(b)(4). Bankruptcy Code § 101(31)(B) defines "insider" to include a "person in control of the debtor". *Id.* §101(31)(B)(iii). Pursuant to the legislative history, an insider is "one who has a sufficiently close relationship with a debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor." *In re* Schuman, 81 B.R. 583, 586 (9th Cir. BAP 1987) (citing H.R. Rep. No. 95-595, 95th Cong., 2nd Sess. 312 (1977), *reprinted in* U.S. Code Cong. and Admin News 1978, p. 5787). The tests developed by the courts to determine whether a party is an insider "focus on the closeness of the parties and the degree to which the transferee is able to exert control or influence over the debtor." *Id.* at 586. A transferee is an insider if "he exercises such control or influence over the debtor to render their transaction not arms length." *In re* Lamansky, 56 B.R. 981, 983 (Bankr. W.D. Wis. 1986). The control such person exercises need not be legal or absolute. *See* Norton Bankr. L. & Proc. § 57:31 (2d. ed. 2000). In fact, the existence of the ability to keep the debtor from acting is just as much control as the ability to cause the debtor to act and "heavy consideration is to be given to the power or potential power to influence and control the activities of a person, as opposed to the actual exercise of that power." *In re* Colesville Medical Center Limited P'ship, 20 B.R. 87, 90 (Bankr. D.M.D. 1982). Creditors employing aggressive strategies during workout negotiations to compel the turnover of the debtor's property may face substantial risk that they will be deemed "insiders" and, consequently, that a one-year preference period will apply.

14 11 U.S.C. § 547(b)(5).

15 11 U.S.C. § 547(g).

16 11 U.S.C. § 547(c)(1).

17 11 U.S.C. § 547(a)(2).

18 *See, e.g.,* Energy Coop., Inc. v. SOCAP Intern., Ltd. (*In re* Energy Coop., Inc.), 832 F.2d 997, 1003 (7th Cir. 1987)("[The debtor] paid [the preference defendant] $1.6 million to settle a breach of contract claim that arose more than a month before [the debtor] paid [defendant]; in other words, [the debtor] paid off an antecedent debt. [The defendant's] release (or the "goodwill") makes no difference."); *In re* Olson, 66 B.R. 687, 694 (Bankr.

D. Minn. 1986)(court held that the waiver of future child support payments is not new value because the waiver was not new value within the § 547(a)(2) definition).

19 There are two general forms of the fraudulent conveyance claim: (a) an "actual" fraudulent conveyance, wherein the debtor makes a transfer with actual intent to hinder, delay or defraud creditors; and (b) a "constructive" fraudulent conveyance, which is described in this article. *See* 11 U.S.C. § 548. This article focuses only on "constructive" fraudulent conveyances because, in the workout context, debtors do not tend to make transfers with actual intent to hinder, delay or defraud creditors; rather, they are compelled to make the transfers in light of substantial leverage asserted by creditors.

20 Under § 548, there is a one-year reach-back period. *Id.* § 548(a)(1). State fraudulent conveyance statutes (as invoked by § 544) often incorporate longer reach-back periods. *See, e.g.,* Unif. Fraud. Trans. Act § 9(b) (establishing a four year reach-back period for constructive fraudulent conveyances).

21 11 U.S.C. § 548(a)(1)(B)(i). Bankruptcy Code Section 548(d)(2) (A) defines "value" to mean "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor." *Id.* Whether a transfer constitutes "reasonably equivalent value" is largely a question of fact and considerable latitude is afforded the trier of fact. Nordberg v. Arab Banking Corp. (*In re* Chase & Sandborn Corp.), 904 F.2d 588, 593 (11th Cir. 1990); Jacoway v. Anderson (*In re* Ozark Restaurant Equip. Co.), 850 F.2d 342, 344 (8th Cir. 1988).

22 11 U.S.C. § 548(a)(1)(B)(i)(I); *see supra* note 13.

23 11 U.S.C. § 548(a)(1)(B)(i)(II). Whether the debtor is adequately capitalized at the time of a transfer is a question of fact in which industry customs and other industry-specific factors may be relevant. Barrett v. Continental Ill. Nat'l Bank and Trust Co., 882 F.2d 1 (1st Cir. 1989), *cert. denied*, 494 U.S. 1028 (1990). Some courts have focused on the amount by which the debtor's assets exceeded liabilities. *See, e.g.,* Credit Managers Assoc. of S. Cal. v. Fed. Co., 629 F. Supp. 175 (C.D. Cal. 1986). This has been referred to as the "balance sheet test." 5 COLLIER ON BANKRUPTCY ¶ 548.05[3] at 548-51 (15th ed. rev. 1996). Other courts focus on whether the debtor was reasonably likely, under the circumstances, to pay its debts as they subsequently became due. *See, e.g.,* Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056 (3d Cir. 1992).

24 11 U.S.C. § 548(a)(1)(B)(i)(III). To establish this element, there must be evidence proving that the transfer occurred at the same time that the debtor had the intent or belief that it would not be able to pay other creditors as their claims subsequently became due. Loeb v. Dante (*In re* Dante), 1 B.R. 547 (Bankr. N.D. Ga. 1979); *see* 5 Collier on Bankruptcy ¶ 548.05[5][a] at 548-52.1 (15th ed. rev. 1996).

25 *See* 11 U.S.C. § 544(b)(1). A trustee asserting § 544(b)(1) rights and, thereby, stepping into the shoes of one of the debtor's unsecured creditors, does not avoid the transfer only

for the benefit of that certain creditor. Rather, the avoided transfer benefits all general unsecured creditors, like an action under § 548. Moore v. Bay, 284 U.S. 4 (1931).

26 The Uniform Fraudulent Conveyance Act is referred to as the "UFCA". The following states have enacted the UFCA or a modified form of the UFCA: Maryland, New York, Tennessee, Virgin Islands, and Wyoming. Unif. Fraud. Conv. Act, 7A U.L.A. 2 (1999 & Supp. 2000).

27 The Uniform Fraudulent Transfer Act is referred to as the "UFTA". The following states have enacted the UFTA or a modified form of the UFTA: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Texas, Utah, Vermont, Washington, West Virginia, and Wisconsin. Unif. Fraud. Trans. Act, 7A U.L.A. 266.

28 *Compare* 11 U.S.C. § 548 *with* Unif. Fraud. Conv. Act §§ 4, 5, 6 *and* Unif. Fraud. Trans. Act §§ 4, 5.

29 Unif. Fraud. Conv. Act §§ 4, 5, 6. Conceptually, "fair consideration" and "reasonably equivalent value" are not materially different, although "fair consideration" includes a good faith requirement. Cohen v. Sutherland, 257 F.2d 737, 742 (2d Cir. 1958); Bearden v. Baugh (*In re* Baugh), 60 B.R. 102, 105 (Bankr. E.D. Ark. 1986).

30 Like Bankruptcy Code § 548, the plaintiff prosecuting a claim under the UFTA must establish that the debtor did not receive "reasonably equivalent value" in exchange for the transfer. *See* Unif. Fraud. Trans. Act §§ 4, 5.

31 11 U.S.C. § 550.

32 *Id.*

33 Drewes v. FM Da-Sota Elevator Co. (*In re* Da-Sota Elevator Co.), 939 F.2d 654 (8th Cir. 1991); *see* 5 COLLIER ON BANKRUPTCY ¶ 550.02[3][a] at 550-8 (15th ed. rev. 1996).

34 Bankruptcy Code § 550(b) prohibits the trustee from recovering from a transferee that takes for value, in good faith and without knowledge of the voidability of the transfer or any immediate or mediate good faith transferee of such transferee. It is highly unlikely that creditors participating in workout negotiations will qualify for this exemption.

35 *See, e.g.,* Kaler v. Community First Nat'l Bank (*In re* Heitkamp), 137 F.3d 1087 (8th Cir. 1998); Mandross v. Peoples Banking Co. (*In re* Hartley), 825 F.2d 1067 (6th Cir. 1987); Coral Petro. Inc. v. Banque Paribas-London, 797 F.2d 1351 (5th Cir. 1986); Herzog v. Sunarhauserman (*In re* Network 90 Degree, Inc.), 126 B.R. 990 (Bankr. N.D. Ill. 1991); Tolz v. Barnett Bank of South Florida (*In re* Safe-T-Brake), 162 B.R. 359 (Bankr. S.D. Fla. 1993); Steelvest, Inc. v. Messer & Sons Constr. Co. (*In re* Steelvest, Inc.), 112 B.R.

852 (Bankr. W.D. Ky. 1990); Ledford v. First Nat'l Bank (*In re* Belme), 79 B.R. 355 (Bankr. S.D. Ohio 1987).

36 *Heitkamp*, 137 F.3d at 1089; *see* 5 COLLIER ON BANKRUPTCY ¶ 547.03[2] at 547-20; JOSEPH F. RIGA & DAVID A. SCHOLL, *Preferences,* in CHAPTER 11 THEORY & PRACTICE § 35.04 at 35:16-21 (1997)[hereinafter *Riga & Scholl*].

37 McClusky v. Nat'l Bank (*In re* Bohlen Enter., Ltd.), 859 F.2d 561, 565 (8th Cir. 1988); Bank v. Phalen, 62 F.2d 21 (7th Cir. 1932); *In re* Reusch & Co., 44 F. Supp. 677, 680 (D.N.J. 1942)); *see* Grubb v. General Contract Purchase Corp., 94 F.2d 70 (2d Cir. 1938).

38 *See Bohlen*, 859 F.2d at 566.

39 *See, e.g., Id.* ("The courts have extended the doctrine beyond the guarantor situation and have applied it to situations where the new creditor is not a guarantor but merely loans to the debtor for the purpose of enabling the debtor to pay the old creditor . . .. As a matter of first impression, it would seem that the doctrine should not have been so extended."); Geremia v. Fordson Assoc. (*In re* Int'l Club Enterps., Inc.), 109 B.R. 562, 566 (Bankr. D.R.I. 1990)(holding that the earmarking doctrine does not apply where the third-party was not contractually obligated to pay the debtor's debt).

40 Growe v. AT&T Universal Card Servs. (*In re* Adams), 240 B.R. 807, 810 (Bankr. D. Me. 1999)(quoting Yoppolo v. Greenwood Trust Co. (*In re* Spitler), 213 B.R. 995, 998 (Bankr. N.D. Ohio 1997)(emphasis added)).

41 *See, e.g., Heitkamp*, 137 F.3d 1087 (court held that the earmarking doctrine applied, even though the third-party was not contractually obligated to pay the debt); *Hartley*, 825 F.2d 1067 (same).

42 *Safe-T-Brake*, 162 B.R. at 364.

43 *See supra* note 5.

44 See, e.g., Beim v. Alix (*In re* Sanders), 1998 U.S. App. LEXIS 28398 (6th Cir. November 9, 1998)(earmarking defense raised in fraudulent conveyance action; defense rejected, not as a matter of law, but, rather, as a factual matter because the transfers involved property of the debtor); Perrino v. Salem, Inc. (*In re* Mainely Payroll, Inc.), 233 B.R. 591, 599 (Bankr. D. Me. 1999)(earmarking defense applicable to fraudulent conveyance action); Brandt v. Hicks, Muse & Co., Inc. (*In re* Healthco Int'l, Inc.), 195 B.R. 971, 982 (Bankr. D. Mass. 1996)("The courts reason that a party who exercises no control over the transferred property and claims no beneficial interest in it should not be held responsible for having received a fraudulent transfer."); Mirror Group Newspapers, PLC v. Maxwell Newspapers, Inc. (*In re* Maxwell Newspapers, Inc.), 164 B.R. 858, 866 (Bankr. S.D.N.Y. 1994)("If, however, the Maxwells' conduct can be imputed to Maxwell Newspapers, I then must consider several other issues raised by Maxwell Newspapers; specifically . . . whether to borrow the concepts of 'mere conduit' and 'earmarking' from preference and fraudulent transfer law to insulate Maxwell Newspapers from MGN's claims."); *see also*

Kenneth P. Coleman, *Conduits, Good Faith, and the Recovery of Preferences and Fraudulent Transfers Under Bankruptcy Code Section 550*, 114 BANKING L. J. 375 (1997)(noting applicability of the earmarking defense to fraudulent conveyance claims).

45 Although such a fact pattern may appear esoteric, it is not necessarily unusual in the workout context. For example, if the debtor engaged in workout negotiations is a holding company, value transferred to the creditors pursuant to a settlement may originally come from, flow through and ultimately be transferred by different companies affiliated with the debtor.

46 813 F.2d 1177 (11th Cir. 1987).

47 *Id.* at 1179.

48 *Id.* at 1178.

49 *Id.* at 1181-82.

50 *Id.* at 1181.

51 *Adams*, 240 B.R. at 810.

52 859 F.2d 561 (8th Cir. 1988).

53 Id. at 566.

54 *See* Reigle v. Mahajan (*In re* Kumar Bavishi & Assoc.), 906 F.2d 942, 944 (3d Cir. 1990); *see also In re* Datesman, 1999 Bankr. LEXIS 994, at *11 (Bankr. E.D. Pa. Aug. 9, 1999)(lower court in the third circuit adopted Bohlen test); Maggio v. Mfr. Hanover Trust Co. (*In re* Oliver's Stores), 112 B.R. 671, 677 (Bankr. D.N.J. 1989)(same), *aff'd*, 1990 U.S. Dist. LEXIS 15417 (D.N.J. June 5, 1970).

55 *See, e.g.,* Official Comm. of Unsecured Creditors of Crystal Med. Prods., Inc. v. Pederson & Houpt (*In re* Crystal Medical Prods., Inc.), 240 B.R. 290 (Bankr. N.D. Ill. 1999); Adams, 240 B.R. 807; Hovis v. Powers Constr. Co. (*In re* Hoffman Assoc.), 194 B.R. 943 (Bankr. D.S.C. 1995); Wasserman v. Village Assoc. (*In re* Freestate Mgmt. Servs., Inc.), 153 B.R. 972 (Bankr. D. Md. 1993).

56 Gray v. Travelers Ins. Co. (*In re* Neponset River Paper Co.), 231 B.R. 829, 834-35 (1st Cir. BAP 1999).

57 *See In re* Montgomery, 983 F.2d 1389, 1395 (6th Cir. 1993)("The real question here is whether the Debtor was actually able to exercise sufficient dominion and control over the funds to demonstrate an interest in the property."); New York City Shoes, Inc. v. Best Shoe Corp., 106 B.R. 58, 60-61 (E.D. Pa. 1989)("The fundamental inquiry in a case, such as this, is whether the transfer diminished or depleted the debtor's estate . . .. For funds to be 'earmarked' the third party lender must exercise strict control over the distribution

of the funds which it advances to the debtor."); Musso v. Brooklyn Navy Yard Dev. Corp. (*In re* Westchester Tank Fabric., Ltd.), 207 B.R. 391, 398 (Bankr. E.D.N.Y. 1997)("A determination that the $100,000.00 transferred by the Queens Plaza Check was earmarked is contingent upon whether the Debtor had such control over the use of these funds so as to make evident an interest in property and, concomitantly, whether the disbursement diminished the pool of assets which would otherwise be available to creditors."); Groupe v. Pacini (*In re* Some Other Place, Inc.), 1995 Bankr. LEXIS 473, at *11 (Bankr. N.D. Ill. April 13, 1995)("The inquiries therefore become (1) whether Debtor exercised sufficient dominion and control over the funds to demonstrate an interest in property, and (2) whether transfer to Pacini somehow depleted or diminished the value of the Debtor's estate."); *Safe-T-Brake*, 162 B.R. at 364 ("Under this analysis, the new money, although in possession of the debtor, never becomes property of the debtor because the debtor has no control over how the funds are ultimately distributed, and thus no avoidable preference results."); *Network 90 Degree*, 126 B.R. at 994 ("The foundation of the earmarking doctrine lies . . . in the debtor's control (or lack of control) over the assets which were transferred."); *see also Riga & Scholl*, at 35:18 ("control is the operative issue.").

58 *See, e.g.,* Hansen v. MacDonald Meat Co. (*In re* Kemp Pac. Fisheries, Inc.), 16 F.3d 313, 317 (9th Cir. 1994)(rejecting the earmarking defense, finding no indication that the new lender stipulated the payee to the debtor); *Montgomery*, 983 F.2d at 1395 ("[W]here the borrowed funds have been specifically earmarked by the lender for payment to a designated creditor, there is held to be no transfer of property of the debtor."); *In re* Smith, 966 F.2d 1527 (7th Cir.), *cert. dismissed*, 506 U.S. 1030 (1992); *Adams*, 240 B.R. at 811; *Spitler*, 213 B.R. at 998; *see also Smith*, 966 F.2d at 1539 (Flaum J. dissenting)("I suggest that control has two components: first, the power to designate which party will receive the funds; and, second, the power to actually disburse the funds at issue to that party."); *Safe-T-Brake*, 162 B.R. at 365 ("[T]he court finds the reasoning in Judge Flaum's dissent . . . persuasive."); *see also Riga & Scholl*, at 35:19-21 (explaining the cases addressing the control issue).

59 *Neponset*, 231 B.R. at 835; *see Hansen*, 16 F.3d at 316 ("'Essentially, the transfer must diminish directly or indirectly the fund to which creditors of the same class can legally resort for the payment of their debts, to such an extent that it is impossible for other creditors of the same class to obtain as great a percentage as the favored one.'" (quoting 4 COLLIER ON BANKRUPTCY ¶ 547.03, at 547-26 (15th ed. 1993)); *Hartley*, 825 F.2d at 1070 ("If the transfer diminishes the estate, the other creditors are injured because less remains for them to share.").

60 *See, e.g.,* Taunt v. Fidelity Bank (*In re* Royal Golf Prods. Corp.), 908 F.2d 91 (6th Cir. 1990)(where debtor granted third-party security interest in exchange for third-party's payment to a pre-existing creditor, the transfer to the pre-existing creditor was avoidable only to the extent of the value of the security interest); *Hartley*, 825 F.2d at 1071 ("Even where the debtor transfers a security interest in return for the loan, the payment is only a voidable preference to the extent the transaction depleted the debtor's estate."); Va. Nat'l Bank v. Woodson (*In re* Decker), 329 F.2d 836, 840 (4th Cir. 1964)("The fact that there

was a preference which involved a depletion of the bankrupt's estate to some undisclosed extent does not necessarily require that the preferred creditor shall return all that he has received unless the amount of depletion is at least equal to the amount so received. The test is not what the creditor receives but what the bankrupt's estate has lost."); *In re* O'Neill Enter., Inc., 359 F. Supp. 940, 943 (W.D. Va. 1973)("To the extent that an estate is depleted as the result of a transfer, where the other elements of a voidable preference are present, that transfer is preferential."); DeRosa v. Buildex Inc. (*In re* F&S Cent. Mfg., Corp.), 53 B.R. 842, 847 (Bankr. E.D.N.Y. 1985)("[W]here a debtor surrenders or encumbers its property in order to obtain a loan, the transfer does diminish the debtor's assets and the transaction is not exempt. [Citation omitted] The trustee may recover an amount equal to the value of the assets surrendered or encumbered.").

61 *See Neponset*, 231 B.R. at 834-35; *Crystal*, 240 B.R. at 296; Ragsdale v. Bank South, N.A. (*In re* Whitacre Sunbelt, Inc.), 206 B.R. 1010, 1020-21 (Bankr. N.D. Ga. 1997).

62 *See Montgomery*, 983 F.2d at 1395 ("[W]here the borrowed funds have been specifically earmarked by the lender for payment to a designated creditor, there is held to be no transfer of property of the debtor even if the funds pass through the debtor's hands in getting to the selected creditor."); *Bohlen*, 859 F.2d at 565 ("The courts have said that even when the guarantor's new funds are placed in the debtor's possession before payment to the old creditor, they are not within the debtor's control."); *Safe-T-Brake*, 162 B.R. at 364 ("modern caselaw has come to recognize that the earmarking doctrine may apply both in those situations where the lender of new funds pays the prior creditor directly or where the funds are entrusted to the debtor with the understanding that the debtor is to use the money only to pay the debtor's obligation to a specific creditor designated by the source of the funds."); Jensen v. Pen Air Conditioning, Inc. (*In re* Winsco Builders, Inc.), 156 B.R. 98, 101 (Bankr. M.D. Fla. 1993)("The fact that the check which was made payable jointly to the Debtor and another was deposited in the Debtor's account who, in turn, issued his own check payable to the creditor who was a jointly-named payee, is of no consequence."); *see also Riga & Scholl*, at 35:17 ("[In circumstances wherein] the new creditor pays [funds] to the debtor who is instructed to pay them to the old creditor … the court will not unravel the transfer, even if it occurred within the 90 days prior to the debtor's bankruptcy filing, as long as the preference defendant can show the funds were used as the new creditor intended and the debtor did not exert any other dominion or control over the funds inconsistent with the new creditor's intention or otherwise indicative of the debtor's unfettered ownership.").

63 *Ragsdale*, 206 B.R. at 1020 n.3.

64 *See, e.g.,* Brown v. First Nat'l Bank (*In re* Ark-La Materials, Inc.), 748 F.2d 490, 491 (8th Cir. BAP 1984); Stingley v. AlliedSignal, Inc. (*In re* Libby Int'l, Inc.), 247 B.R. 463, 467 (8th Cir. BAP 2000); Krigel v. Sterling Nat'l Bank (*In re* Ward), 230 B.R. 115, 118 (8th Cir. B.A.P. 1990); Int'l Ventures, Inc. v. Block Props. VII (*In re* Int'l Ventures, Inc.), 214 B.R. 590, 595 (Bankr. E.D. Ark. 1997); *Safe-T-Brake*, 162 B.R. at 365; *Oliver's Stores*, 112 B.R. at 677; Titan Energy Corp. v. Cent. Oilfield Supply Co. (*In re* Titan Energy Corp.), 82 B.R. 907, 909 (Bankr. S.D. Ohio 1988); *see also Riga & Scholl*, at 35:17 n.47

("[A]rguably the trustee should bear the burden of proving the earmarking doctrine does *not* apply." (emphasis in the original)).

65 *See* 11 U.S.C. § 547(c).

66 *See, e.g.,* American Honda Fin. Corp. v. A. Angelle, Inc. (*In re* A. Angelle, Inc.), 230 B.R. 287, 298 (Bankr. W.D. La. 1998); *Freestate*, 153 B.R. at 982-83; *EUA Power Corp.*, 147 B.R. at 644; *Network 90 Degrees*, 126 B.R. at 993.