§ 547(a)(2)
§ 547(b)
§ 547(c)
§ 506(a)
§ 553(a)

In re Smith's Home Furnishings, Inc., Case No. 395-35704-elp7
Batlan v. State of Washington, Adv. No. 95-3460

4/1/96 ELP Unpublished

The trustee was granted summary judgment on its claim to recover as a preference the payment of $450,000 made by debtor to the State of Washington pursuant to the settlement of an action for violations of Washington's Consumer Protection Law. The court held that the state was a creditor of debtor no later than the date it commenced its action in state court seeking a money judgment for violation of the Act. The payment was on account of an antecedent debt, because it was made in July pursuant to a March settlement agreement. When debtor and the state entered into the agreement, debtor became legally obligated to pay. Although the settlement agreement itself does not set out a right to payment, the agreement incorporates by reference a draft "findings, conclusions and judgment," which does set out an obligation to pay. The payment on account of a settlement agreement does not, as the state argues, merely extinguish a current obligation. The state did not have any existing encumbrance on debtor's property that it released in return for the payment on the settlement agreement.

The payment enabled the state to receive more than it would have received if the payment had not been made and it received a distribution under Chapter 7. The state was a creditor, and would have participated in the distribution as an unsecured creditor along with the other creditors. The state did not have an offset that made its claim secured under section 506(a). Although a creditor may offset a mutual debt, the state's postpetition obligation to return the preference cannot be set off against debtor's prepetition tax obligation to the state.

There was not issue of fact regarding the state's defenses of contemporaneous exchange or new value. 11 U.S.C. § 547(c)(1), (4). The termination of the state's consumer protection enforcment action did not constitute new value under section 547(a)(2).

There is no exemption from the avoidance powers of section 547(b) for payments that are made to the state as a result of the state's valid exercise of its police power. Unlike the exception for the exercise of police power set out in section 362, section 547 does not include any exception for a governmental entity's exercise of police power. The state is in the same situation as any other unsecured creditor who is seeking debtor's assets. Congress has not provided priority status for debts for civil penalties, restitution and attorney fees.

P96-10(20)

UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF OREGON

In Re: SMITH'S HOME FURNISHINGS, INC., Debtor. ______________________________	)	Case No. 395-35704-elp7
MICHAEL B. BATLAN, Trustee, Plaintiff, v. STATE OF WASHINGTON, Defendant.	)	Adversary No. 95-3460 MEMORANDUM OPINION

This is an action to recover as a preference the payment of $450,000 made by debtor to the State of Washington ("the state") in settlement of an action against debtor for violations of Washington's consumer protection law. This is a core proceeding. 28 U.S.C. § 157(b)(2)(F). For the reasons discussed below, I grant the trustee's motion for summary judgment.

BACKGROUND FACTS

On September 22, 1993, the state filed an action against debtor in state court, alleging that debtor was violating Washington's Unfair Business Practices -- Consumer Protection Act. Revised Code of Washington, Chapter 19.86. The action sought a permanent injunction prohibiting continuation of the unlawful acts and practices alleged, imposition of a civil penalty for past violations of the Consumer Protection Act, and attorney fees and costs. In March 1995, the parties signed a settlement agreement under which debtor agreed to the future entry of a judgment finding violations of the Act, ordering payment of $450,000 to the state, and enjoining future violations of the Act. On July 6, 1995, debtor tendered a check for $450,000 to the state. The state cashed the check on July 10, 1995.

On July 13, 1995, the Washington state court entered a judgment in accordance with the settlement agreement. Among other things, the judgment imposed a civil penalty of $100,000, which was suspended, and ordered debtor to pay the state $235,000 for consumer education and $215,000 for attorney fees and costs. The state filed a partial satisfaction of judgment for $450,000 on July 19, 1995. Debtor filed its petition for relief on August 22, 1995.

SUMMARY JUDGMENT STANDARD

A party is entitled to summary judgment if it has shown that there is no genuine issue of material fact and that it is entitled to summary judgment as a matter of law. Bankruptcy Rule 7056; FRCP 56. In making this determination, the court draws all inferences

from the evidence in favor of the nonmoving party. Jose v. M/V Fir Grove, 765 F Supp 1024, 1028 (D Or 1991).

DISCUSSION

1. Prima facie case.

Under section 547(b), the trustee may avoid any transfer of an interest of the debtor in property

> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made (A) on or within 90 days before the date of the filing of the petition * * *;
>
> (5) that enables such creditor to receive more than such creditor would receive if the case were a case under chapter 7, the transfer had not been made, and the creditor received payment of the debt to the extent provided by the provisions of title 11.

The state does not dispute the trustee's evidence that debtor was insolvent at the time it made the payment, or that the payment was made within 90 days before the petition was filed. It argues that the trustee has not shown that the state was a creditor that had an antecedent debt, or that the payment enabled the state to receive more than it would have under a chapter 7 liquidation.

A. Creditor

"Creditor" is defined as "an entity that has a claim against the debtor that arose at the time of or before the order for relief * * *." 11 U.S.C. § 101(10). A "claim" includes any "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, mature, unmatured,

disputed, undisputed, legal, equitable, secured, or unsecured[.]" 11 U.S.C. § 101(5)(A).

The state argues that it was not a creditor because it was merely exercising its police powers to enjoin unlawful activity. Unlike other creditors, it had not provided debtor any services, goods or other consideration. Contrary to the state's argument, its complaint in state court sought more than an injunction. It sought civil penalties plus the payment of attorney fees and costs. Given the broad definition of "claim" in 11 U.S.C. § 101(5)(A), the state had a claim and therefore became a creditor no later than 1993 when it filed its action to obtain a money judgment,[1] regardless of whether that claim had been reduced to judgment or liquidated.

Even if the commencement of the action in 1993 were not sufficient to constitute a claim, certainly the state had a claim when it entered into the settlement agreement with debtor in March, 1995. At that point, the state had a liquidated right to payment. The state is a creditor.

B. Antecedent debt

A debt is a liability on a claim. 11 U.S.C. § 101(12). Whether a debt is current or antecedent depends on when it was incurred. In re Pan Trading Corp., S.A., 125 BR 869, 875 (Bankr SDNY 1991). "A debt is incurred when the debtor first becomes legally bound to pay." Matter of CHG Intern., Inc., 897 F2d 1479,

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[1] One can argue that the claim arose when the debtor violated the pertinent state statute.

1486 (9th Cir 1990).

The state argues that there was no antecedent debt on account of which the $450,000 payment was made, because there was no debt until the judgment was entered, and the judgment was not entered in state court until after the payment was made.

The problem with the state's argument is that it focuses on the wrong event. According to the settlement agreement and its attached draft judgment, as of the date the agreement was signed, in March 1995, debtor was legally obligated to pay on or before July 1, 1995 the amounts stated in the agreement. The state argues that debtor had no legal obligation to pay until the judgment was entered, because civil penalties and attorney fees and costs are completely discretionary with the court, and are not legally binding until the court determines that violations have occurred and enters a judgment ordering debtor to pay.

Although the state may be correct that there was no legal obligation to pay the judgment before it was entered, in this case it is undisputed that the parties had entered into an agreement settling the case before the judgment was entered. That agreement provided that debtor would pay $450,000 on a future date. The settlement agreement, not the judgment, provides undisputed evidence of the antecedent debt. Further, RCW 19.86.140 provides that any person who violates the consumer protection law "shall forfeit and pay a civil penalty of not more than two thousand dollars for each violation." Under that statute, although the court has discretion as to the amount of the penalty, the court is

required to impose some penalty. Therefore, when debtor admitted to violations of the consumer protection law in the settlement agreement, it became liable for some amount of penalties.

The state attempts to create an issue of fact by arguing that the settlement agreement does not set out a right to payment. It argues that the agreement reflected the parties' intention to perform certain tasks, but that either party could have refused. That argument fails. The agreement incorporates by reference the draft findings, conclusions and judgment. That draft judgment provides that debtor "shall pay the State of Washington, on or before July 1, 1995, the following sums pursuant to ch. 19.86 RCW: $215,000 as costs and attorneys' fees; and $235,000 for [to be specified as future enforcement or consumer education, but not as penalties]." The state does not point to any evidence or cite any legal authority that would raise a question of fact about whether that agreement was enforceable at the time it was made. Although the settlement agreement itself did not set out a right to payment, the incorporated draft judgment did. The state has not shown that there is any question of fact about whether the payment was made on account of an antecedent debt.

The state also contends that the payment was not on account of an antecedent debt, because the payment merely served to extinguish a current obligation. Its theory is that a payment pursuant to a settlement agreement, when no other longstanding debt exists, does not represent payment on an antecedent debt. It relies on Lewis v. Diethorn, 893 F2d 648 (3d Cir), cert denied 498 US 950 (1990), In

re Anthony Sicari, Inc., 144 BR 656 (Bankr SDNY 1992), aff'd 151 BR 60 (SDNY 1993), and Nelson Co. v. Amquip Corp., 128 BR 930 (ED Pa 1991), aff'd 959 F2d 1260 (3d Cir 1992). Its reasoning apparently is that the settlement agreement created the obligation to pay, and that obligation was concurrent with the payment of the agreed amount.

Even assuming the validity of the state's theory, in this case the underpinnings for the theory do not exist. In each of the cases cited by the state, the transfer apparently coincided with the agreement to settle the litigation. There is no indication in any of those cases that there was an agreement to settle the litigation through a payment in the future. In this case, in contrast, the undisputed facts show that the March 1995 settlement agreement called for payment on or before July 1, 1995. The payment in fact was not made until July. Therefore, by the time the payment was made, the obligation to pay had existed for four months. Whatever might be the result had the payment been made at the time the settlement agreement was made, in this case the payment was on account of the debt that preexisted the payment by four months.

Even if the state were correct about the factual underpinning for its theory, I would nonetheless conclude that Lewis and the cases that have relied on it do not apply in this case. In Lewis, a home buyer sued the debtor builder for defective workmanship and filed a *lis pendens* on the title, which was still held by the builder. To remove the *lis pendens*, the builder settled the

dispute by paying the buyers $15,000. The buyers moved from the property. The court found that the settlement agreement was not on account of an antecedent debt and that it constituted a contemporaneous exchange for new value. It based its finding on the fact that the property rose in value due to the removal of the *lis pendens* and therefore the debtor builder received new value for his payment.

That is not the case here. In this case, there is no evidence that the state had any existing encumbrance on any of debtor's property at the time the payment was made, and the payment did not serve to obtain a release of any encumbrance or to increase the value of any of debtor's property. Further, even if the facts were analogous, I would decline to follow Lewis, because it contains no discussion or explanation of its conclusion that there was a current obligation that was extinguished by the payment of the $15,000. See In re Bioplasty, Inc., 155 BR 495 (Bankr D Minn 1993).

The other cases on which the state relies are even less persuasive. In both Sicari and Nelson, the dispositive issue was whether the transfer of the debtor's property had been within the preference period. In both cases the court held that it was not. Each case nonetheless relies on Lewis to conclude in *dicta* that the transfers would not have been on account of an antecedent debt, because they were made as part of settlement agreements. I decline to follow the *dicta* of those cases.

Further, I do not think that the fact that a payment is made

on account of a settlement agreement necessarily makes the payment one on a current as opposed to an antecedent obligation. As the BAP said in In re Upstairs Gallery, Inc., 167 BR 915, 919 (9th Cir BAP 1994):

> "Merely because the parties settled and this settlement resulted in payment to the creditor, it does not follow that the settlement creates a new obligation for which the payment may be deemed outside the scope of § 547(b)(2) and as a 'contemporaneous exchange for new value' under § 547(c)(1). Creation and contemporaneous payment of a new debt in cancellation of an antecedent debt violates both the form and policy against preferences."

Although I recognize that, in Upstairs Gallery, the parties had a preexisting commercial relationship, the rationale stated by the panel applies in this case as well.

C. Chapter 7 distribution

The state also argues that the trustee is not entitled to summary judgment because the state was not required to share in the estate, and therefore the transfer to it did not enable it to receive more than it would have received if the transfer had not been made and if the state had received a distribution under chapter 7. Its argument is based on its assertion that the state is not a creditor because it was acting in its law enforcement capacity. If it was not a creditor, the state argues, it would not have been required to participate in distribution with other creditors.

As I have already explained, the state was a creditor at the time the payment was made. In addition, the state's argument misses the point. No creditor is required to share in the estate

of a bankruptcy debtor. The creditor always has the option of filing a claim against the estate. In this case, if debtor had not made the $450,000 payment, the state would have had the option of pursuing the penalty and attorney fees by filing a claim with this court. Instead, it was paid before the petition was filed. The state was as much a creditor of debtor before the payment was made as it would have been on the date the petition was filed had debtor not made the payment.

The state also argues that the payments did not enable it to receive more than it would have if the payments had not been made and a distribution was made under chapter 7, because the state was entitled to offset those payments against tax liabilities owed by debtor to the state.[2] Debtor responds that a creditor is not entitled to offset a preference against a prepetition claim.

Payment on a fully secured claim does not constitute a preference, because under a chapter 7 liquidation, the fully secured creditor would recover its security. Therefore, the prepetition payment does not enable the fully secured creditor to receive more than it would under a liquidation distribution. A claim of a creditor that is subject to setoff under section 553 is a secured claim to the extent of the amount subject to setoff. 11 U.S.C. § 506(a). Under section 553(a), a creditor may, subject to

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[2] The state raised this argument in its discussion of defenses to the claim. The basis of the defense, however, is that the preferential payment did not enable the creditor to receive more than it would have under a chapter 7 liquidation. Therefore, it is more appropriately addressed in analyzing the trustee's prima facie case.

certain exceptions not relevant here,

> "offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case * * * against a claim of such creditor against the debtor that arose before the commencement of the case * * *."

A creditor who seeks setoff must prove that (1) a debt exists from the creditor to the debtor and the debt arose before the commencement of the case; (2) the creditor has a claim against the debtor that arose prepetition; and (3) the debt and the claim are mutual obligations. Braniff Airways, Inc. v. Exxon Co., U.S.A., 814 F2d 1030, 1035 (5th Cir 1987).

The state has provided evidence that, before debtor filed its bankruptcy petition, debtor owed the state various taxes. Thus, the second element of setoff is met. The state fails, however, to provide evidence that would create a question of fact about the other two elements. As to the first element, that the state owed the debtor a debt prepetition, the state argues that, if the state's consumer protection enforcement action gave rise to an antecedent debt, then a debt exists from the state to debtor, which arose before the commencement of the case. I understand the argument to be that if debtor's payment of $450,000 was a preference, that preference constitutes a prepetition debt of the state to the debtor.

The argument fails. There is no right to recovery of a preference until the petition is filed. Therefore, any obligation on the part of the state to repay that preference did not exist prepetition. Further, there is no mutuality, because the debt

arising from the preference payment is owed to the estate and the tax liability owing to the state was owed prepetition by the debtor.

Collier explains the rule regarding setoff against recovery of a preference:

> "[T]he general rule is that in an action by a trustee to recover money paid or property transferred to a creditor by way of preference, the creditor cannot set off against its liability for the return of the preferential payments or transfer the original debt on which they were to be applied. The reasoning for this rule is that allowing the creditor to set off the amounts owed by the debtor against the preferential payments received would merely continue the preference and render the preference statute useless, because the preferences would not become available for pro rata distribution to all creditors. Moreover, section 502(a) bars the allowance of the claim of a creditor that has received a preference unless the preference is returned."

4 Collier on Bankruptcy ¶ 553.09 (15th ed) (footnotes omitted).

Accordingly, the state would have been an unsecured creditor at the time debtor's petition was filed. The trustee has submitted undisputed evidence that the unsecured creditors will receive less than a 100% distribution under Chapter 7. Therefore, the trustee has established each element of a preference.

2. Defenses.

A. Contemporaneous exchange

The trustee may not avoid a transfer that was intended as a contemporaneous exchange for new value. 11 U.S.C. § 547(c)(1). In order to prevail on this defense, a transferee must show that the transfer (1) was intended by the debtor and the creditor to be a contemporaneous exchange (2) for new value given to the debtor, and (3) the exchange was in fact substantially contemporaneous. 11

U.S.C. § 547(c)(1).

Even assuming that the evidence, viewed in the light most favorable to the state, raises questions of fact regarding the parties' intent and whether the exchange was in fact substantially contemporaneous, the undisputed facts show that any exchange was not for any new value given to the debtor. "New value" is defined in 11 U.S.C. § 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."

The state argues that its termination of its consumer protection enforcement action constituted new value that was exchanged contemporaneously with the transfer of funds. It acknowledges that a creditor's forbearance from enforcing a judgment is not "new value," see In re Riggs, 129 BR 494, 496 (Bankr SD Ohio 1991), but argues that this case is different because, as in Lewis v. Diethorn, 893 F2d 648 (3d Cir), cert denied 498 US 950 (1990), and In re Anthony Sicari, Inc., 144 BR 656 (Bankr SDNY 1992), aff'd 151 BR 60 (SDNY 1993), here the purpose of the transfer was to obtain the state's undertaking not to pursue the litigation.

The state does not explain, and it is not apparent, how the state's termination of its enforcement action meets the definition of "new value." It is not money or money's worth in goods, services, or new credit. Nor is it the release by the transferee (the state) of property previously transferred to the transferee

(the state) in a nonvoidable transaction. In addition, the state's reliance on Lewis and Sicari fails for the same reasons I explained above in the discussion about antecedent debt.

The new value referred to in section 547(c)(1) "must be to the debtor and must replenish the estate for the value removed by the transfers." In re Riggs, 129 BR at 497. In this case, there is no evidence that the state's termination of the litigation enhanced the value of debtor's estate. See In re Thomson McKinnon Securities, Inc., 125 BR 94 (Bankr SDNY 1991). There is no issue of fact regarding the contemporaneous exchange defense.

B. New value

The trustee may not avoid any transfer to a creditor to the extent that, after the transfer, the creditor gave new value to or for the benefit of the debtor. 11 U.S.C. § 547(c)(4). The state argues that, assuming the termination of the litigation is not considered to be a contemporaneous exchange, it fits within the exception set out in section 547(c)(4) for the subsequent giving of new value. This defense fails for the same reason the contemporaneous exchange defense fails: The termination of litigation does not constitute "new value" as defined in section 547(a)(2).

C. Exercise of police powers as exempt from avoidance

The state argues that a payment made to the state as a result of the state's valid exercise of police power should be exempt from the trustee's power to avoid preferences. Although I have no doubt that the state's consumer protection law enforcement action was a

valid exercise of its police power, see In re Charter First Mortg., Inc., 42 BR 380 (Bankr D Or 1984),[3] I cannot add exceptions to the avoidance power to those that Congress itself has created. The fact that the preference statute explicitly excepts certain transfers from avoidance and that payments made on account of a governmental entity's exercise of its police power are not among the exceptions, indicates that Congress has made a policy choice to include those payments in the transfers that are avoidable in bankruptcy.

The state argues that it is different from a commercial creditor, and therefore should be treated differently from other creditors. I disagree with the state's premise. The Washington consumer protection law gives the state a right to injunctive and monetary relief if the statute is violated. RCW 19.86.080; 19.86.140. To the extent the state sought monetary relief from debtor, it is no different from other creditors who sought debtor's assets. The purpose of the preference law is to equalize the distribution of a debtor's assets in the 90 days before bankruptcy by regaining for the estate payments that were made during the time leading up to the date the petition was filed. See In re Perma Pacific Properties, 983 F2d 964 (10th Cir 1992); Matter of Smith,

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[3] The state's reliance on In re Charter First Mortg., Inc., 42 BR 38 (Bankr D Or 1984), is misplaced because it is a case involving the automatic stay, not the preference law. At issue in Charter First Mortg. was a provision in section 362(b)(4) that explicitly excepts from the automatic stay the enforcement by a governmental entity of its police power. There is no analogous exception to the avoidance power of section 547(b).

966 F2d 1527 (7th Cir), cert dismissed 506 US 1030 (1992). After those assets are recovered, all creditors share in the assets according to priorities determined by Congress. See 11 U.S.C. § 507. Congress has not provided priority status for debts for civil penalties, restitution or attorney fees. That is a strong indication that Congress intended governmental units who are seeking monetary relief to be treated the same as all other creditors who are seeking to share in the estate's assets.

I recognize that in In re Nelson, 91 BR 904 (ND Cal 1988), the District Court concluded that principles of federalism mandated a liberal construction of the Bankruptcy Code to minimize federal interference with the state criminal justice system, and therefore held that payments the debtor made on a criminal restitution order within the 90 days before the debtor filed bankruptcy were not avoidable preferences.

That case is not persuasive in this context. First, the payment debtor made in this case was not a result of a criminal prosecution; it was a purely civil enforcement action. Further, even if as a matter of public policy I thought that payments such as debtor made here should be free from avoidance, I do not think that the court is at liberty to add exemptions to those already provided by Congress in section 547(c). Clearly Congress knows how to protect transfers from the avoidance power if it sees fit to do so. As I have already explained, there is no exception in section 547(c) for payments made on account of a debt arising from a state's civil enforcement action. See In re Lacefield, 167 BR 89

(Bankr ED Ky 1994).

I agree with the cases cited by debtor, in which the bankruptcy court required the avoidance of preferential payments that were made on sanctions for civil contempt and for fines for violations of housing laws. See In re Pan Trading Corp., S.A., 125 BR 869 (Bankr SDNY 1991); In re Mantelli, 149 BR 154 (9th Cir BAP 1993). The state's attempts to distinguish those cases are unpersuasive. In this case, $235,000 of the $450,000 paid by debtor was not designated as a penalty but was to be used for funding programs for consumer education. The other $215,000 that debtor paid was to reimburse the state for its attorney fees and costs in pursuing the enforcement action. There is nothing in the Bankruptcy Code that would prevent the trustee from recovering those payments for the benefit of all the creditors.

CONCLUSION

The trustee has established by undisputed facts that he is entitled to avoid the payment of $450,000 made by debtor to the state pursuant to the settlement agreement. The state has not provided any evidence that would raise a genuine issue of material fact regarding any defense to that action. The trustee is entitled to summary judgment on its preference claim.

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This Memorandum Opinion shall constitute Findings of Fact and Conclusions of Law as required by Bankruptcy Rule 7052 and Fed. R. Civ. P. 52, and they shall not be separately stated.

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ELIZABETH L. PERRIS
Bankruptcy Judge

cc: Brad T. Summers
Dina L. Yunker
U. S. Trustee