

11 USC § 547(b) (1)
11 USC § 547(C)
Earmarking Doctrine

O'Connell & Goyak v. Watson BAP No. OR-91-2259-JAsR
Adv. No. 90-3131-S
In re Cox Bk No. 389-33596-S7

8/21/92 BAP aff'g DDS Unpublished

The BAP affirmed a judgment against the debtor's attorneys for recovery of a preferential transfer. The debtor's employer paid the lawyer's bill the day before the bankruptcy petition was filed. The panel analyzed the transaction and determined that the earmarking doctrine did not apply as argued by the defendant, because the debtor transferred collateral to secure the loan from his employer to pay the bill. Substitution of a secured debt for an unsecured debt does not fall within the earmarking doctrine because the transfer diminished the value of the estate.

The defendant did not meet its burden of proof that the transfer was made in the ordinary course of business.

Affirmed by Ninth Circuit--unpublished Memorandum attached.

P92-18 (9)

NOT FOR PUBLICATION

U.S. BANKRUPTCY COURT
DISTRICT OF OREGON
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OF THE NINTH CIRCUIT

BY _____
UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT

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6 In re:) BAP No. OR-91-2259-JAsR
7 David M. Cox,)
8 Debtor.) BK. No. 389-33596-S7
9 _____) Adv. No. 90-3131
10 O'CONNELL & GOYAK, A)
11 PARTNERSHIP LAW FIRM,)
12 Appellant,)
13 v.) M E M O R A N D U M
14 RONALD A. WATSON, TRUSTEE OF)
15 THE ESTATE OF DAVID M. COX,)
16 Appellee.)
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Argued and Submitted on
July 24, 1992 at Portland, Oregon

Filed- AUG 21 1992

Appeal from the United States Bankruptcy Court
for the District of Oregon

Honorable Donald D. Sullivan, Presiding

Before: Jones, Ashland, and Russell, Bankruptcy Judges.

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BACKGROUND

On August 1, 1988, debtor David Cox ("Cox") received a \$20,602.27 loan from Oregon First Investment Corp. ("OFIC") to pay a creditor, Dale Lewis. OFIC is owned by Cox's employer, Alan Nyman ("Nyman"). In return for the loan, Cox promised to transfer six (6) beach lots to OFIC. Cox failed to transfer the lots to OFIC, transferring them instead to his son, Timothy Cox. Timothy recorded the deed for the lots on May 5, 1989.

A year later, Nyman advised Cox to seek legal representation in an unrelated matter. Cox did so, incurring approximately \$26,000.00 in legal fees. On August 6, 1989, Cox entered an agreement with his employer Northwest Fruit Marketing ("NFM") through Nyman, its owner. The agreement provided that in return for Cox's interest in contingent income tax refunds and for his interest in the previously mentioned beach lots, NFM would pay the legal fees. Because Cox was a signatory on NFM's account, Nyman gave him a blank check and told him to pay the legal fees with it. Cox did so, writing the check to O'Connell & Goyak ("O'Connell") for \$25,931.69.

The next day, August 7, 1989, Cox filed a petition under Chapter 11 of the Bankruptcy Code.¹ O'Connell represented Cox in the bankruptcy case which was later converted to a Chapter 7 case. Appellee, the Chapter 7 bankruptcy trustee ("Trustee"), filed an adversary proceeding against O'Connell to avoid the

¹ Unless otherwise indicated, all references to chapters and sections are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330.

1 \$25,931.69 transfer as preferential. The trial court ruled for
2 the trustee, ordering O'Connell to pay the funds to the Trustee.
3 O'Connell appeals. We affirm.

4 ISSUES

5 I. Whether the trial court properly held that the
6 earmarking doctrine does not apply to this transaction.

7 II. Whether the lower court properly held that O'Connell
8 failed to establish ordinary course of business as a defense to
9 the preference.

10 STANDARD OF REVIEW

11 Findings of fact are reviewed for clear error. Bankruptcy
12 Rule 8013. In re Moreggia & Sons, Inc., 852 F.2d 1179, 1181
13 (9th Cir. 1988). Conclusions of law are reviewed de novo. In
14 re Pizza of Hawaii, Inc., 761 F.2d 1374, 1377 (9th Cir. 1985).

15 DISCUSSION

16 I. THE EARMARKING DOCTRINE

17 A. PREFERENTIAL TRANSFER DEFINED

18 The trustee may avoid and recover transfers under several
19 sections of the Bankruptcy Code. 11 U.S.C. § 550(a)(1). The
20 requirements for a trustee's avoidance of a preferential
21 transfer are found in 11 U.S.C. § 547. They are:

- 22 (1) A transfer by the debtor of an interest of the debtor in
property;
- 23 (2) to or for the benefit of the creditor,
- 24 (3) for or on account of an antecedent debt,
- 25 (4) made while the debtor was insolvent,
- 26 (5) made on or within 90 days before the date of the filing of
the petition, and
- (6) is one that enables the creditor to receive more than the
creditor would receive in a Chapter 7 liquidation if the
transfer had not been made.

1 11 U.S.C. § 547(b). In order to prevail, the trustee must prove
2 all of the above elements. 11 U.S.C. § 547(g). The parties do
3 not dispute that the second through fifth elements are satisfied
4 here. However, the same cannot be said for either the first or
5 sixth elements.

6 With regard to the first argument, O'Connell contends that
7 under the earmarking doctrine, the loan proceeds never became
8 property of the debtor because the check was payable directly to
9 O'Connell. The trial court disagreed. Because the parties have
10 fully briefed the issue, we will analyze their respective
11 positions. However, the better analysis may be to focus on the
12 transfer of the debtor's interest in the tax refunds and the
13 beach lots to NFM. That transfer was clearly made "for the
14 benefit of" O'Connell, a creditor on an antecedent debt, even
15 though the transfer was not made directly to O'Connell. See 11
16 U.S.C. § 547(b)(1). Under such an analysis, the earmarking
17 doctrine is irrelevant.

18 **B. THE EARMARKING DOCTRINE DEFINED**

19 The earmarking doctrine is a judicially created
20 interpretation of the first element of a preference--that the
21 transfer involve "an interest of the debtor in property." In re
22 Bohlen Enter., Ltd., 859 F.2d 561, 565 (8th Cir. 1988). Under
23 the doctrine, when a third party advances or loans funds to the
24 debtor for the specific purpose of paying another creditor, the
25 funds never enter the estate or become property of the debtor.
26 In re Sierra Steel, Inc., 96 B.R. 271, 274 (9th Cir. BAP 1989).

Under the earmarking doctrine, a transfer is not

1 preferential because transferring earmarked funds does not harm
2 other creditors. One creditor is simply traded for another.
3 See Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d
4 1351, 1362 (5th Cir. 1986). In order for the earmarking
5 doctrine to apply to a transaction, the transfer must satisfy
6 three requirements:

- 7 (1) the existence of an agreement between the new
8 lender and the debtor that the new funds will be
9 used to pay a specific antecedent debt,
- 10 (2) a performance of that agreement according to its
11 terms, and
- 12 (3) the transaction viewed as a whole (including the
13 transfer in of the new funds and the transfer out
14 of the old creditor) does not result in any
15 diminution of the estate.

16 Bohlen, 859 F.2d at 566 (footnote omitted).

17 **C. APPLICATION TO THE CASE AT BAR**

18 **1. Agreement to Pay Antecedent Debt**

19 In the case at bar, Cox entered an agreement with
20 NFM on August 6, 1989, pursuant to which: (1) NFM agreed to
21 loan Cox \$25,931.69 to pay off O'Connell; (2) NFM agreed to
22 assume Cox's miscellaneous personal debts totalling
23 approximately \$15,000.00; (3) Cox agreed to transfer to NFM his
24 interest in tax refunds arising from a 1988 operating loss
25 carryback of approximately \$30,000.00; and (4) Cox agreed to
26 transfer to NFM, his rights to the six aforementioned beach
lots². Thus, the first prong of the Bohlen test is satisfied
in the instant case.

² Cox had previously transferred the same lots to his son, Timothy Cox on April 29, 1989 by quitclaim, for "love and affection." The deed was recorded on May 5, 1989.

1 2. Performance of the Agreement

2 The second prong requires performance of the agreement
3 according to its terms. In other words, the question becomes
4 whether Cox used the funds as prescribed in the agreement. In
5 re Van Huffel Tube Corp., 74 B.R. 579, 585 (Bankr. N.D. Ohio
6 1987). Cox paid O'Connell in accordance with the agreement.
7 Therefore, this element is satisfied.

8 3. Diminution of the Estate

9 It appears that the third Bohlen element is not satisfied,
10 however, because the estate suffered a diminution as a result of
11 the August 6th transfer. The Trustee claims that because Cox
12 was a signatory on NFM's account, and because he personally
13 signed the check which was used to pay O'Connell, he controlled
14 the transaction. The Trustee cites In re Hartley, 825 F.2d
15 1067, 1068, 1071 (6th Cir. 1987), for the proposition that if a
16 debtor controls the payment from a new creditor to an old
17 creditor, the funds become part of debtor's property. The
18 Trustee submits that under this reasoning the funds at issue
19 became the property of the estate. The Trustee points to Cox's
20 admission that he was issued a blank check that he could have
21 written to anyone.

22 The fortuity of Cox's signatory status, however, and the
23 fact that he was given a blank check to sign does not seem
24 paramount. These funds were transferred in accordance with the
25 August 6th agreement. If the new creditor prescribes one method
26 of payment (in this case, that Cox would sign the check over to
O'Connell), and the debtor performs the agreement as prescribed,

1 the money never enters the estate. Van Huffel, 74 B.R. at 585.
2 See also Grubb v. Gen. Contract Purchase Corp., 94 F.2d 70, 73
3 (2d Cir. 1938).

4 The Trustee is correct, however, in arguing that the
5 security offered for the August 6th loan resulted in a
6 diminution of the estate. To quote the trial court: "I decline
7 to see any difference, other than metaphysical, between paying
8 money directly to the firm or funneling it through a creditor
9 who took estate property as security for the loan made to pay
10 the law firm." The trial court correctly held that Cox
11 controlled the transaction. Although neither party argued such,
12 the key issue concerning diminution of the estate is the fact
13 that the new loans were secured. The earmarking doctrine does
14 not apply when an unsecured loan is paid through a secured
15 guarantor. E.g., Van Huffel, 74 B.R. at 586. The debt owed to
16 O'Connell was unsecured prior to the transfer. Moreover, Cox's
17 admitted purpose in assigning the lots and the tax refund was to
18 secure the debt with what little liquidity was available to him.

19 O'Connell argues that there was no diminution of the estate
20 because Cox had already transferred the beach property to his
21 son. However, as a result of an adversary proceeding filed
22 against the son, the trustee gained a monetary judgment along
23 with the remaining unsold lots from the younger Cox, having
24 proven a fraudulent transfer. Viewing this, beneficial
25 ownership of the lots and the money re-entered the estate and
26 were thus transferrable to NFM as per the agreement. Therefore,

1 the transfer of lots to NFM reduced the estate as found by the
2 trial court.

3 Moreover, Cox gave his right to the tax refund as security
4 for the loan. The only evidence before the court regarding its
5 value was the August 6th agreement which put the value at
6 \$30,000. While it is true that Cox had yet received the refund,
7 this fact does not affect a finding regarding value.³ Because
8 the tax refund was offered and accepted as security, it
9 possesses some value if only speculative.

10 Both the beach lots and the tax refund had value which was
11 offered as security and/or consideration for the loan. The
12 estate was diminished because Cox gave security for the
13 agreement which satisfied an unsecured creditor. We therefore
14 conclude that the earmarking doctrine does not apply in the
15 instant case.

16 **II. ORDINARY COURSE OF BUSINESS**

17 O'Connell asserts that even if a prima facie case for
18 preferential transfer is proven, the ordinary course of business
19 exception applies here. The exception provides that the trustee
20 may not avoid a transfer when the defendant shows that it was

- 21 (A) in payment of a debt incurred by the debtor in
22 the ordinary course of business or financial
23 affairs of the debtor and the transferee;
24 (B) made in the ordinary course of business or
25 financial affairs of the debtor and the
26 transferee; and
(C) made according to ordinary business terms[.]

³ Counsel for the Trustee indicated at oral argument that the refund had been received.

1 11 U.S.C. § 547(c)(2). The purpose of the defense is to protect
2 recurring, customary credit transactions that are incurred and
3 paid in the ordinary course of business. Van Huffel, 74 B.R. at
4 588, citing H.R.Rep. No. 95-595, 95th Cong., 1st Sess., 373-374
5 (1977), U.S. Code Cong. & Admin. News 1978, pp. 5787, 6329,
6 6330. The case at bar does not display the type of business
7 transaction envisioned by the framers of the Code because Cox
8 had no prior dealings with O'Connell which would establish their
9 ordinary course.

10 There is some authority for O'Connell's proposition that a
11 history of prior dealings between themselves and Cox is not
12 necessary. See In re Morren Meat & Poultry Co., Inc., 92 B.R.
13 737, 740 (Bankr. W.D. Mich. 1988). Although prior history would
14 help establish the ordinary course, the absence of such does not
15 preclude the court from determining the ordinary course. Id.
16 However, this gloss on the ordinary course exception should not
17 be applied here because the instant transaction is highly
18 suspect. Cox paid his debt to O'Connell without ever having
19 received a billing, or without knowing the amount owed.
20 Further, O'Connell made no effort to show that this type of
21 payment is ordinary to either their business or the industry, as
22 required. We are not convinced that this type of payment
23 satisfies the ordinary business terms requirement of 11 U.S.C. §
24 547(c)(2)(C). The trial court found that O'Connell failed to
25 show the payment was made according to ordinary business. We
26 agree and AFFIRM.

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United States Bankruptcy Appellate Panel
of the Ninth Circuit

NOTICE OF ENTRY OF JUDGMENT

A separate Judgment was entered in this case on AUG 21 1992.

Motions for Rehearing

A motion for rehearing may be filed within 10 days after entry of the judgment. (Bankruptcy Rule 8015).

The motion shall be submitted on 8½ by 11 inch paper, shall not exceed 15 pages in length, and shall comply with rules governing service and signature. An original and three copies shall be filed.

A motion for rehearing may toll the time for filing a notice of appeal to the Court of Appeals. See Bankruptcy Rule 8015.

Bill of Costs

Bankruptcy Rule 8014 provides that costs on appeal shall be taxed by the Clerk of the Bankruptcy Court. Cost bills should be filed with the Clerk of the Bankruptcy Court from which the appeal was taken. Also see, Federal Rules of Appellate Procedure 39.

Issuance of the Mandate

The mandate, a certified copy of the judgment addressed to the Clerk of the Bankruptcy Court from which the appeal was taken, will be issued 21 days after entry of the judgment unless otherwise ordered by the Panel. A timely motion for rehearing will stay issuance of the mandate until 7 days after disposition of the motion, unless otherwise ordered. See Bankruptcy Rule 8017 and Federal Rules of Appellate Procedure 41.

Appeal to Court of Appeals

An appeal to the Ninth Circuit Court of Appeals is initiated by filing a notice of appeal with the Clerk of this Panel. The Notice of Appeal should be accompanied by payment of the \$100 filing fee. Checks may be made payable to the U.S. Court of Appeals For The Ninth Circuit. See Federal Rules of Appellate Procedure 4 and the corresponding Rules of the United States Court of Appeals for the Ninth Circuit for specific time requirements.

(Cite as: 2 F.3d 1156, 1993 WL 302115 (9th Cir.))

NOTICE: THIS IS AN UNPUBLISHED
OPINION.

(The Court's decision is referenced in a "Table of
Decisions Without Reported Opinions" appearing in
the Federal Reporter. Use FI CTA9 Rule 36-3 for
rules regarding the citation of unpublished opinions.)

United States Court of Appeals, Ninth Circuit.

In re David M. COX, Debtor.
O'CONNELL & GOYAK, Appellant,
v.
Ronald A. WATSON, Appellee.

No. 92-36859.

Argued and Submitted July 14, 1993.
Decided Aug. 9, 1993.

Appeal from the Ninth Circuit Bankruptcy
Appellate Panel, No. OR-91-2259- JAsR; Jones,

Ashland and Rusell, Bankruptcy Judges.

Bkrctcy.App. 9

AFFIRMED.

Before: GOODWIN, FARRIS and THOMPSON,
Circuit Judges.

MEMORANDUM [FN*]

**1 The judgment of the United States Bankruptcy
Appellate Panel is affirmed for the reasons stated by
that panel in its Memorandum Disposition filed
August 21, 1992.

FN* This disposition is not appropriate for
publication and may not be cited to or by the courts
of this circuit except as provided by 9th Cir.R.
36-3.

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