ACCEPTING THE EARMARKING DOCTRINE: COURTS SHOULD ACCEPT THIS DEFENSE TO PREFERENCE ACTIONS IN CONNECTION WITH CREDIT CARD TRANSFERS

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INTRODUCTION

It is well established that (i) preserving the value of a bankruptcy estate and (ii) providing an equitable distribution of the estate's property among its creditors are two primary goals underlying bankruptcy law in the United States.[1] While solvent debtors have the unequivocal right to payback their creditors in any order they see

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[1] *See* 5 COLLIER ON BANKRUPTCY, ¶ 547.01, at 547-10 (Alan N. Resnick & Henry J Sommer eds., 16th ed. 2009).

fit, insolvent debtors are not allotted that same privilege.[2] Thus, in furtherance of these policy goals, the Bankruptcy Code, through preference actions, allows bankruptcy trustees to avoid[3] and recover[4] certain payments regarding pre-bankruptcy debts made to creditors by insolvent, or soon to be insolvent, debtors.[5] While section 547(b) of the Bankruptcy Code gives a trustee the power to avoid certain pre-bankruptcy transactions, creditors have defenses available to them. One of these defenses is the earmarking doctrine, which is not found in the Bankruptcy

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[2] *See* Kevin M. Baum, Note, *Apparently, "No Good Deed Goes Unpunished": The Earmarking Doctrine, Equitable Subrogation, and Inquiry Notice Are Necessary Protections When Refinancing Consumer Mortgages in an Uncertain Credit Market*, 83 ST. JOHN'S L. REV. 1361, 1364 (2009).

[3] In pertinent part, the Bankruptcy Code states:

> [T]he 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—
> (A) the case were a case under chapter 7 of this title

11 U.S.C. § 547(b) (2012); *see* S. REP. NO. 95-989, at 87 (1978) ("This section is a substantial modification of present law. It modernizes the preference provisions and brings them more into conformity with commercial practice and the Uniform Commercial Code."); *see also* H.R. REP. No. 95-595, at 178 (1977) ("The operation of the preference section to deter 'the race of diligence' of creditors to dismember the debtor before bankruptcy furthers the second goal of the preference section, that of equality of distribution.").

[4] Section 550 of the Bankruptcy Code states:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section . . . 547 . . . of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
> (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550(a); *see* S. REP. NO. 95-989, at 90 (1978) ("Section 550 prescribes the liability of a transferee of an avoided transfer, and enunciates the separation between the concepts of avoiding a transfer and recovering from the transferee. Subsection (a) permits the trustee to recover from the initial transferee of an avoided transfer or from any immediate or mediate transferee of the initial transferee.").

[5] *See* Margot Wickman-Bennett, Note, *Earmarking in the Eighth Circuit*, 79 IOWA L. REV. 965 (1994). In this article, the author explains preferences as follows:

> A preference generally involves a transfer of the debtor's property, made less than ninety days prior to filing the bankruptcy petition, that gives one creditor an advantage over other creditors. A preference occurs only if the creditor receives more money through the preferential transfer than the creditor would have received through a subsequent bankruptcy distribution.

Id. at 968.

Code but instead originates from common law.[6] Essentially, the earmarking doctrine rests on the notion that a transaction is not a preference "[w]hen new funds are provided by [a] new creditor to or for the benefit of [a] debtor for the purpose of paying the obligation owed to the old creditor."[7]

There is little debate today as to the validity of the earmarking doctrine as a defense to preference actions. However, the current trend in the courts is to apply the elements of the earmarking doctrine strictly and narrowly. Consequently, this limits the ability of creditors to use the earmarking doctrine as a defense when a debtor uses credit from a new lender to pay-off an antecedent credit card debt from another company. In fact, every circuit faced with the issue, has rejected the earmarking doctrine in cases involving credit card transfers.[8]

The majority approach towards the earmarking doctrine has the potential to negatively impact credit markets and ultimately affect the economy. Access to credit is a central component to a well-functioning modernized economy.[9] Consequently, credit cards have become indispensable in today's modern economy,[10] and Americans have become increasingly reliant on them.[11] The use of

[6] *See* Baum, *supra* note 2, at 1367 (explaining that earmarking doctrine is one of three common law defenses to preference actions).

[7] McCuskey v. Nat'l Bank of Waterloo (*In re* Bohlen Enters., Ltd.), 859 F.2d 561, 565 (8th Cir. 1988); *see In re* Flannery, 513 B.R. 1, 5 (Bankr. D. Mass. 2014) (indicating earmarking doctrine applies "where a third party lends money to the debtor for the specific purpose of paying a selected creditor"); Wickman-Bennett, *supra* note 5, at 967 (providing "the 'earmarking' doctrine can frustrate the efforts of the trustee by protecting payments or transfers to an old creditor made directly by a third party serving as a new creditor").

[8] *See, e.g.*, Yoppolo v. MBNA Am. Bank (*In re* Dillworth), 560 F.3d 562, 565 (6th Cir. 2009) (affirming bankruptcy court's holding that earmarking doctrine did not apply because it was debtor, not lender, who decided which creditor would receive funds); MBNA Am. Bank v. Meoli (*In re* Wells), 561 F.3d 633, 635 (6th Cir. 2009) (noting because lender credit card company did not restrict use of funds to particular purpose, earmarking doctrine was inapplicable); Parks v. FIA Card Servs. (*In re* Marshall), 550 F.3d 1251, 1257 (10th Cir. 2008) (finding earmarking doctrine inapplicable because lender credit card company did not place any condition on debtor's use of funds); Montgomery v. McLemore (*In re* Montgomery), 983 F.2d 1389, 1396 (6th Cir. 1996) (determining that because assets in control of debtor, earmarking doctrine did not apply); *see also* Bank of Am. v. Mukamai (*In re* Egidi), 571 F.3d 1156, 1162 (11th Cir. 2009) (declining to apply earmarking doctrine because it was debtor that decided who would receive designated funds). The Eleventh Circuit has never "expressly applied the earmarking doctrine." *Id.* at 1162.

[9] *See* Ronald J. Mann, *Optimizing Consumer Credit Markets and Bankruptcy Policy*, 7 THEORETICAL INQUIRIES L. 395, 400 (2006) ("In modern economies . . . credit cards now have a pervasive influence over most consumer lending and payment transactions."). In this article, the author analyzes the relationship between the consumer credit market and bankruptcy policy. Mr. Mann explains the economic theory behind encouraging a more open consumer credit market. He writes that "a dominating motivation for opening consumer credit markets is the hope that an increase in consumer credit will jump-start consumer spending and thus lead to overall growth of the economy." *Id.*; *see also id.* at 430 n.12 (citing report by U.S. Department of Commerce, which states that in 2005 consumer spending made up approximately 70% of the GDP in the United States); *World Development Indicators: Structure of demand*, Table 4.8, WORLD BANK (Apr. 11, 2016), http://wdi.worldbank.org/table/4.8 (reporting that as of 2014, household final consumption equals about 69% of GDP, up 3% from 2000).

[10] *See* Mann, *supra* note 9, at 397–98. Here, Mann explains how credit cards have changed the way Americans buy products. He writes that credit cards "introduce substantial cost savings by shifting consumers from paper-based payments and closed-end bank loans to card-based payments and borrowing transactions." *Id.* Furthermore, Mann explains that credit cards have become an important tool for providing credit to entrepreneurs when "conventional bank lending is not [available]." *Id.* at 398.

credit cards by Americans has not only precipitated an increase in consumer spending but has, at the same time, created a rise in consumer debt.[12] In fact, the Federal Reserve estimated that as of January 1, 2015, outstanding consumer debt in the United States exceeded $3 trillion dollars.[13] Of that amount, it was also estimated that more than $880 billion was comprised of revolving debt, which is predominantly made up of credit card purchases.[14] Thus, it is of the utmost importance that the courts do not apply equitable bankruptcy doctrines in a manner that could disrupt the flow of consumer credit.

This Note argues that the majority opinion is misguided, and that courts should apply a more liberal standard when applying the earmarking doctrine. To make this point, this Note compares the earmarking doctrine with the constructive trust doctrine, which courts have acknowledged should not be applied rigidly. Further, this Note argues that the earmarking doctrine is desirable and necessary because, first, it will not deter companies from providing consumers with credit. And second, if creditors are not deterred from providing rollover agreements for credit cards, then consumers could potentially be able to use the rollover agreement's favorable terms to lower their debt, and maybe even avoid filing for bankruptcy.

Part I of this Note gives a brief overview of preference actions and the policies behind them. Part II discusses the earmarking doctrine generally. Part II also provides a brief historical overview of the earmarking doctrine. Furthermore, Part II examines the current state of the law and how the majority of circuits have stopped short of extending the earmarking doctrine to rollover credit card agreements. Part III analyzes the current state of the law as it pertains to the constructive trust doctrine. Part IV proposes a new, more liberal, standard for the courts to implement in cases involving the earmarking doctrine. Finally, Part V advocates for the proposed liberalized standard suggested. Furthermore, Part V

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[11] *See id.* at 397–98 (asserting that "[i]n modern economies, credit cards are the instrument for discretionary and entrepreneurial spending; indeed credit cards now have a pervasive influence over most consumer lending and payment transactions").

[12] *See id.* at 398 (commenting that credit cards "blur the lines between conventional payment and borrowing decisions, and, in doing so, they are associated with substantial increases in consumer spending and borrowing levels").

[13] *See G.19 Consumer Credit February 2015*, FEDERAL RESERVE, (Apr. 7, 2015), http://www.federalreserve.gov/releases/g19/20150407/g19.pdf (stating outstanding debt is $3,327,800,000,000).

[14] *See* Yasmin Ghahremani, Tamara E. Holmes & CreditCards.com, *Credit Card Debt Statistics*, NASDAQ.COM (Sept. 23, 2014, 1:00 AM), http://www.nasdaq.com/article/credit-card-debt-statistics-cm393820 (reporting that in second quarter of fiscal year 2014, average credit card debt in United States was $5,234 per person). Furthermore, it is estimated that in 2012, the average credit card debt for low and middle-income families was $7,145 per household. *Id.*; *see also* Art Swift, *Americans Rely Less on Credit Cards Than in Previous Years*, GALLUP.COM (Apr. 25, 2014), http://www.gallup.com/poll/168668/americans-rely-less-credit-cards-previous-years.aspx. This article reports that, although Americans seemingly have decreased their reliance on credit cards, people still have an average of 2.6 credit cards. *Id.* It is clear that access to credit cards has had a monumental impact on the economy, and it is thus crucial that the courts, when dealing with bankruptcies, do not discourages lenders from continuing to provide consumers with access to credit.

discusses the benefits a more liberal application of the earmarking doctrine will have for both creditors and debtors.

I. OVERVIEW OF PREFERENCE ACTIONS

Simply put, a preference action can be explained as follows. Suppose you are about to file for bankruptcy and you only have ten dollars left in your bank account. Now, assume you owed that same amount to both your mother and your banker, who would you pay back? Although one might be surprised at how often someone would pay their banker back first, this is certainly not an easy choice to make. Ultimately, section 547(b) of the Bankruptcy Code seeks to avoid having debtors make these sorts of decisions.[15] Essentially, a preference action permits a trustee representing a bankruptcy estate to avoid pre-bankruptcy transfers of the debtor's property that would result in preferential treatment of favored creditors.[16]

Pursuant to 11 U.S.C. section 547(b), for a transaction to qualify as a preference within the meaning of the Bankruptcy Code, five specific conditions must be met.[17] First, there must be a transfer of the estate's assets to a creditor.[18] Second, the transfer must be made in connection with an antecedent debt.[19] Third, the transfer must have occurred once the debtor was no longer solvent and thus unable to honor his or her obligations to creditors.[20] Fourth, the transfer in question must have either been made within one year if the creditor is an insider or within 90 days if the creditor is not an insider.[21] And finally, the creditor cannot be left better off than it would have under chapter 7 liquidation proceedings.[22]

Furthermore, to successfully assert a preference claim, the Bankruptcy Code explicitly places the burden of proving each of these five elements strictly on the

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[15] *See* 11 U.S.C. § 547(b) (2012) (providing ways for trustee to avoid transferring an interest of debtor in property under certain circumstances).

[16] 5 COLLIER ON BANKRUPTCY, *supra* note 1, ¶ 547.01, at 547-10; *see* Baum, *supra* note 2, at 1366 ("Traditionally, preferential transfers were viewed as transfers from a debtor to a favored or powerful creditor."); *see also* David M. Holiday, *Cause of Action in Bankruptcy Case for Avoidance of Preferential Transfer Under 11 U.S.C.A. § 547*, 43 CAUSES OF ACTION SERIES 2d 219 (suggesting "the creditor's good faith in dealing with the debtor is not a factor to be considered under the preference statute").

[17] *See generally* 11 U.S.C. § 547; *see also* 5 COLLIER ON BANKRUPTCY, *supra* note 1, ¶ 547.01, at 547-10.

[18] 11 U.S.C. § 547(b)(1).

[19] *Id.* § 547(b)(2).

[20] *Id.* § 547(b)(3).

[21] *Id.* § 547(b)(4). In pertinent part, section 101(31)(A) provides that:

> The term "insider" includes—
> (A) if the debtor is an individual—
> (i) relative of the debtor or of a general partner of the debtor;
> (ii) partnership in which the debtor is a general partner;
> (iii) general partner of the debtor; or
> (iv) corporation of which the debtor is a director, officer, or person in control.

See generally id. § 101(31)(A).

[22] *Id.* § 547(b)(5).

bankruptcy trustee.[23] Additionally, it is important to realize that determining whether a preferential transfer has occurred is a mechanical and rather straightforward analysis, which in no way relies on courts interpreting the intentions behind the transaction in question. Consequently, "[a] debtor's or creditor's motives for making the preferential transfer are of no importance in bankruptcy."[24]

With the two goals of bankruptcy law mentioned above, preference actions accomplish two crucial objectives.[25] First, they prevent creditors from undercutting each other and picking apart a financially distressed estate in an attempt to protect their loans.[26] Thus, by disallowing preferential transfers, the Bankruptcy Code effectively preserves and maximizes the value of bankruptcy estates because "creditors are discouraged from racing to the courthouse to dismember the debtor during the debtor's slide into bankruptcy."[27] Consequently, this allows for an orderly and transparent process to assess the value of a bankruptcy estate's assets. Ultimately, a preference action allows for a distribution of assets to be done in a manner that does not diminish the value of a bankruptcy estate's assets.[28] As a close

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[23] *Id.* § 547(g) (section 547 of the Bankruptcy Code states that: "[f]or the purposes of this section, the trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section").

[24] Baum, *supra* note 2, at 1366 ("Although preferential transfers are voidable by the trustee, this power of avoidance is not based on fault."); *see* Barash v. Pub. Fin. Corp., 658 F.2d 504, 505 (7th Cir. 1981). In this case, the Eighth Circuit was faced with an issue over whether voluntary payments made by debtors to their creditors constituted voidable preferential transfers within the meaning of section 547(b). *Id.* As part of their defense, the creditors argued, "they had no way of knowing that the debtors were having financial difficulties." *Id.* at 510. In response, the court first acknowledged that the transactions in question "did not result from unusual action by either the debtors or creditors. Rather, they were made in the ordinary course as they came due." *Id.* Consequently, the *Barash* court held:

> [T]he creditor's knowledge or state of mind is no longer relevant. Under the predecessor to s[ection] 547 (s[ection] 60 of the Bankruptcy Act of 1898), the Trustee had to establish that the creditor had "reasonable cause to believe" that a debtor was insolvent before a transfer could be avoided. Congress eliminated this requirement in favor of the objective criteria under the new Code.

Id. *See* Vern Countryman, *The Concept of A Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 748 (1985) ("The function of the preference concept is to avoid prebankruptcy transfers that distort the bankruptcy policy of distribution. Transfers that do distort this policy do so without regard to the state of mind of either the debtor or the preferred creditor."); *see also* 5 COLLIER ON BANKRUPTCY, *supra* note 1, ¶ 547.01, at 547-10 ("The debtor's intent or motive is not material in the consideration of an alleged preference under section 547. It is the *effect* of the transaction, rather than the debtor's or creditor's *intent*, that is controlling.").

[25] *See generally* H.R. REP. NO. 95-595, at 177 (1977); *see also* Gulf Oil Corp. v. Fuel Oil Supply & Terminaling, Inc., (*In re* Fuel Oil Supply & Terminaling, Inc.), 837 F.2d 224, 227 (5th Cir. 1988) ("The preference under this section serves two congressional goals.").

[26] *See In re Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d at 227 (explaining that "by bringing back into the debtor's estate certain transfers made shortly before the filing of the bankruptcy petition, [a preference action] creates a disincentive for creditors to attack a financially unstable debtor"); Baum, *supra* note 2, at 1366; *see also* 5 COLLIER ON BANKRUPTCY, *supra* note 1, ¶ 547.01, at 547-10; Wickman-Bennet, *supra* note 5, at 969.

[27] 5 COLLIER ON BANKRUPTCY, *supra* note 1, ¶ 547.01, at 547-10.

[28] *See* H.R. REP. NO. 95-595, at 177 (1977) (concluding that "[t]he protections, thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his

corollary to the first objective, preference actions also serve to ensure an equitable distribution of the bankruptcy estate's assets among all similarly situated creditors[29] because "[a]ny creditor that received a greater payment than others of its class may be required to disgorge the payment so that all may share equally."[30]

Section 547(c) of the Bankruptcy Code provides creditors with an affirmative defense to preference actions.[31] However, in addition to the statutory defense, courts have developed the earmarking doctrine for creditors facing a preference action.

II. THE EARMARKING DOCTRINE

Strictly a product of judicial construction,[32] courts widely consider the earmarking doctrine to be a valid defense to preference actions.[33] Essentially, the

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creditors"); *see also* Morrison v. Champion Credit Corp. (*In re* Barefoot), 952 F.2d 795, 798 (4th Cir. 1991). In this case, a debtor bounced a check to a creditor. To rectify this, within 90 days of filing for bankruptcy, the debtor wrote the creditor a check for the outstanding loan. Ultimately, the Fourth Circuit held that the transaction in question constituted a preference within the meaning of the Bankruptcy Code. When discussing the purpose of preference actions, the Fourth Circuit explained that "the avoidance power discourages creditors from attempting to outmaneuver each other in an effort to carve up a financially unstable debtor and offers a concurrent opportunity for the debtor to work out its financial difficulties in an atmosphere conducive to cooperation." *Id.* at 798; *In re* Peterson Distrib., Inc., 197 B.R. 919, 926 (D. Utah 1996) (explaining that a primary reason behind preference actions is to "discourage unusual collection activity by creditors and unusual payment activity by a debtor which favors certain creditors over others and may precipitate bankruptcy"); Holiday, *supra* note 16 (citing generally to cases where the goals of preference actions were discussed).

[29] H.R. REP. NO. 95-595, at 178 (1977). In their report, Congress makes it clear that the two objectives behind preference actions are interrelated and the success of one is dependent on the other being achieved. To illustrate this, Congress wrote: "The operation of the preference section to deter 'the race of diligence' of creditor to dismember the debtor before bankruptcy furthers the second goal of the preference section—that of equality of distribution." *Id.*

[30] *Id.*; *see In re Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d at 227 (explaining that a preference action "promotes equity among unsecured creditors by forcing these creditors to share with other creditors on a pro rata basis"); Yellowhouse Mach. Co. v. Hughes Constr. Co. (*In re* Hughes), 704 F.2d 820 (5th Cir. 1983) (stating that "[t]he nature of the preference avoiding powers granted by section 547 of the Bankruptcy Code is intended to promote the common good of *all* of an estate's creditors" when explaining necessity for preference actions); Bethaney J. Vazzana*, Trustee Recovery of Indirect Benefits Under Section 547(b) Bankruptcy Code*, 6 BANKR. DEV. J. 403, 405 (1989) (remarking "[u]sually, a preferential transfer is inequitable because that transfer takes away funds that would otherwise be shared by similarly situated creditors"); Countryman, *supra* note 24, at 748 (acknowledging "[t]he function of the preference concept is to avoid prebankruptcy transfers that distort the bankruptcy policy of distribution"); *see generally* 5 COLLIER ON BANKRUPTCY, *supra* note 1, ¶ 547.01, at 547-10.

[31] In pertinent part, section 547(c) of the Bankruptcy Code states:

> (c) The trustee may not avoid under this section a transfer—
> (1) to the extent that such transfer was—
> (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
> (B) in fact a substantially contemporaneous exchange

11 U.S.C. § 547(c)(1) (2012).

earmarking doctrine posits that "funds provided by a third party to a debtor to pay a specific debt to a designated creditor will not be avoided as a preferential payment under 11 U.S.C. § 547(b)."[34] Further, the earmarking doctrine can apply regardless of whether the funds to pay an old lender come from the debtor personally or the new lender, so long as the funds in question are specifically designated to satisfy the antecedent debt.[35] Moreover, in its most traditional form, the earmarking doctrine only applied to cases where the new creditor is either a co-debtor or guarantor. That

[32] *See* McCuskey v. Nat'l Bank of Waterloo (*In re* Bohlen Enters., Ltd.), 859 F.2d 561, 565 (8th Cir. 1988) ("The earmarking doctrine is entirely a court-made interpretation of the statutory requirement that a voidable preference must involve a 'transfer of an interest of the debtor in property.' Equivalent language has existed in the Bankruptcy Act for many decades."); *In re* Flannery, 513 B.R. 1, 5 (Bankr. D. Mass. 2014) ("The earmarking doctrine applies 'Where a third party lends money to the debtor for the specific purpose of paying a selected creditor.'"); Baum, *supra* note 2, at 1374–75 (explaining "courts have created a common law preference action defense, beyond the statutory protections of § 547, for third parties who refinance an antecedent debt owed by the debtor"); Hon. Laurel M. Isicoff & Terry Ryan, *Credit Cad Transfers, Preferences or Protected: Survey of a Failed Challenge*, 5 FIU L. REV. 123, 129 (2009) ("Most courts and commentators have held the view that the earmarking doctrine is essentially a 'judicial creation.'"); *but see* David G. Carlson & William H. Widen, *The Earmarking Defense to Voidable Preference Liability: A Reconceptualization*, 73 AM. BANKR. L.J. 591, 592 (1999) (rejecting idea that earmarking doctrine is an "extra-statutory, judge created exception to [section] 547(b) liability"); *id.* (arguing that earmarking doctrine is a version of "contemporaneous exchange" defense now codified under Bankruptcy Code [section] 547(c)(1), therefore abolishing earmarking and any other doctrine related to diminution of the estate).

[33] *See* Metcalf v. Golden (*In re* Adbox, Inc.), 488 F.3d 836, 841 (9th Cir. 2007). Here, the bankruptcy trustee argued that, by failing to plead the earmarking doctrine in their answer to the preference action complaint, they forfeited their right to use it as a defense. The Ninth Circuit held:

> Earmarking is not one of the affirmative defenses enumerated in Rule 8, and we decline to construe it as such under Rule 8's residuary clause for "any other matter constituting an avoidance or affirmative defense." Properly understood, the earmarking doctrine is not an affirmative defense under Rule 8, but rather a challenge to the trustee's claim that particular funds are part of the bankruptcy estate under 11 U.S.C. § 547. Thus, the [lenders] did not waive their earmarking defense by failing to plead it in their answer in the preference action.

Id. at 842. *See* Barry E. Adler, *Accelerated Resolution of Financial Distress*, 76 WASH. U. L.Q. 1169, 1183 (1998) (noting "the earmarking doctrine is fortuitously acceptable").

[34] Isicoff & Ryan, *supra* note 32, at 130; *see In re Bohlen Enters., Ltd.*, 859 F.2d at 565 ("In every earmarking situation there are three necessary dramatis personae. They are the 'old creditor,' (the pre-existing creditor who is paid off within the 90-day period prior to bankruptcy), the 'new creditor' or 'new lender' who supplies the funds to pay off the old creditor, and the debtor."); Adler, *supra* note 33, at 1180 ("The facts of an earmarked loan case are simple. A new lender repays or directs the repayment of a debtor's outstanding loan. The new lender may, as a mere convenience for the debtor, pay the loan directly."); Lisa G. Beckerman & Robert J. Stark, *Structuring Workout Settlements Premised on the "Earmarking" Doctrine*, 26 CAL. BANKR. J. 105, 112 ("The [earmarking] 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.'"); 5 COLLIER ON BANKRUPTCY, *supra* note 1, ¶ 547.03, at 547-10 (indicating "when a third person makes a loan to a debtor specifically to enable that debtor to satisfy the claim of a designated creditor, the proceeds never become part of the debtor's assets, and therefore no preference is created").

[35] 4 COLLIER ON BANKRUPTCY, *supra* note 1, ¶ 547.25, at 547 ("[The earmarking doctrine] is the same regardless of whether the proceeds of the loan are transferred directly by the lender to the creditor or are paid to the debtor with the understanding that they will be paid to the creditor in satisfaction of the creditor's claim, so long as the proceeds are clearly 'earmarked.'").

is to say, the earmarking doctrine, when strictly applied, was traditionally only successfully asserted in "cases in which the lender who provides the funds to the debtor to pay off the creditor was also obligated to the creditor either as a guarantor or surety."[36]

A. History of the Earmarking Doctrine

Before continuing with an analysis of the earmarking doctrine, it is helpful to understand its history and the context in which it was originally created. Although not formally referred to as "earmarking" until 1940,[37] courts dating as far back as 1912 have employed the principles behind the earmarking doctrine.[38] For example, in *National Bank of Newport v. National Herkimer County Bank*,[39] the Supreme Court explained, "unless [a] creditor takes by virtue of a disposition by the insolvent debtor of his property for the creditor's benefit, so that the estate of the debtor is thereby diminished, the creditor cannot be charged with receiving a preference by transfer."[40] Thus, this case serves as an important precursor to the earmarking doctrine because it was, for the first time, acknowledged that if an estate is not diminished then a preference does not exist. As discussed below, this is a central aspect of a modern analysis of the earmarking doctrine.[41]

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[36] Parks v. FIA Card Servs. (*In re* Marshall), 550 F.3d 1251, 1257 n.5 (10th Cir. 2008); *see In re Bohlen Enters., Ltd.*, 859 F.2d at 565 (explaining "[t]he earliest enunciation of the doctrine occurred in cases where the new creditor providing new funds to pay off the old creditor, was himself also obligated to pay that prior debt. In other words, the new creditor was a guarantor of the debtor's obligation").

[37] *See* Smyth v. Kaufman (*In re* J.B. Koplik & Co.), 114 F.2d 40, 43 (2d. Cir. 1940) (stating it is not a preference when debtor borrows funds from new lender to pay an antecedent debt because "the payments were earmarked by the lender and that consequently never became part of the bankrupt's free assets"); *see also* Carlson & Widen, *supra* note 32, at 648 n.107 (noting "[t]he actual phrase 'earmarking,' however, was coined by cousin Augustus Hand" in *Smyth v. Kaufman*).

[38] *See* Nat'l Bank of Newport v. Nat'l Herkimer Cnty. Bank, 225 U.S. 178 (1912). This is the first known case to invoke the principles behind the earmarking doctrine, although they were not expressed as such. *See also* Isicoff & Ryan, *supra* note 32, at 648.

[39] 225 U.S. at 178.

[40] *Id.* at 184. In this case, a knitting company gave their supplier a note in order to purchase machinery and other supplies on credit from their supplier. *Id.* at 181. Subsequently, the debtor endorsed the note in question to a third party bank, which eventually secured the note with the supplier's assets, including those sold on credit to the knitting company. *Id.* at 182. Some time later, the supplier directly paid the third party bank the amount of the outstanding loan. *Id.* As a part of the transaction, the supplier assumed the note as well as the associated security interest in the assets previously mentioned. *Id.* Then, within the preference period, the knitting company filed for bankruptcy. *Id.* at 181. The bankruptcy trustee challenged the transaction arguing that "'the bankrupt parted with property to the amount of the note, and the bank received it and was benefited to that amount,' of the detriment of the other creditors." *Id.* at 182. However, the Supreme Court held that "the payment to the [third party] bank did not proceed from the [knitting company]." *Id.* at 185. On the contrary, the Court explained that the supplier "took up the note with its own funds and received back the security. Neither directly nor indirectly was this payment to the bank made by . . . [the] Knitting Company, and the property of that company was not thereby depleted." *Id.*

[41] *See* Adler, *supra* note 33, at 1180 (explaining "[t]his dual consideration, of property and of diminution, while redundant in the guarantor case, has proven significant in another setting, that of the earmarked loan from a nonguarantor").

The ideas behind the earmarking doctrine were further developed in *Grub v. General Contract Corp*.[42] There, the Second Circuit held that, regardless of whether the debtor technically had control over how to use the funds in question, the earmarking doctrine, although not explicitly referred to as such, was still applicable.[43] The Second Circuit reasoned that the facts indicated the funds were *only* made available by a bank so that the debtor could payback the specific antecedent debt in question.[44] In fact, Judge Learned Hand, who wrote the majority opinion on behalf of the Second Circuit, explained "if [the bank] once made it clear that [the debtor] could use it only in one way, that was the only way that he could use it, and it never enriched the estate."[45]

This is a significant precedent because Judge Hand demonstrated that when applying the earmarking doctrine it is important to look at the totality of the circumstances, and not merely apply the newly created doctrine in a rigid manner.[46] Furthermore, like in the *National Bank of Newport* case, Judge Hand acknowledged that a preference does not exist in these sorts of transactions because they do not in any way diminish the bankruptcy estate.[47]

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[42] 94 F.2d 70 (2d Cir. 1938). In this case, a debtor, unable to meet his financial obligations, was in debt by more than $12,000. *Id.* at 72. After telling bank officials that he was "in a jam," the debtor obtained a $6,000 credit line from the bank, which was secured with collateral owned by the debtor. *Id.* However, it is important to note, that there were no explicit or formal restrictions on how the $6,000 was to be used. *Id.* Having already secured the rest of the amount owed from other sources, the debtor immediately wrote a check to satisfy the antecedent debt, and shortly thereafter filed for bankruptcy. *Id.* Consequently, the trustee filed a preference action against the holder of the now paid off antecedent debt. *Id.*

[43] *Id.*

[44] *Id.* First, the *Grubb* court acknowledged that, at least at first glance, it appeared as though the bank merely made the funds available to the debtor to use at his discretion. However, upon closer examination, the *Grubb* court concluded that the loan was given to the debtor for the sole purpose of paying back a particular antecedent debt. The court noted that for the earmarking doctrine to apply, it must be proven that the bank "did not mean to give [the debtor] full control over the proceeds of the loan." *Id.* The court felt that this burden was met. Ultimately, the court held that:

> [o]bviously, it was not an ordinary loan—the kind of accommodation that a bank of discount expects to give to its depositors; it was 'to tide him over an emergency'; especial motives controlled it. Besides, [the debtor] showed that he meant to use the credit to pay the defendant at the very moment he became entitled to [the amount of the loan].

Id.

[45] *Compare id.*, *with* Smyth v. Kaufman (*In re* J.B. Koplik & Co.), 114 F.2d 40 (2d. Cir. 1940). In *In re J.B. Koplik & Co.*, a debtor notified his initial creditors that he did not have sufficient capital to them back. 114 F.2d at 42. Consequently, the debtor was able to borrow the necessary funds from his landlord to honor his financial obligations to the initial lender. *Id.* However, the court here held that the earmarking doctrine was inapplicable because there was "nothing indicating that [the landlord] loaned [the necessary funds] on condition that it should be applied to this particular creditor. *Id.* While [the landlord] apparently knew that it would be used for this purpose . . . he made the loan generally." *Id.*

[46] *See supra* text accompanying note 44. It is clear that Judge Hand did not simply look at the mechanical aspects of the transaction, but instead considered all the relevant facts of the case to determine that the earmarking was an appropriate defense.

[47] *See Grubb*, 94 F.2d at 72 (citing Nat'l Bank of Newport v. Nat'l Herkimer Cnty. Bank, 225 U.S. 178 (1912)).

B. The Two Tests to Determine the Validity of the Earmarking Doctrine

Effectively, the earmarking doctrine rests on the premise that when a new lender provides a debtor with funds to pay a particular antecedent debt, a preference cannot exist. The reasoning behind this is two-fold. First, pursuant to section 547(b), a "trustee may avoid any transfer of an interest of the debtor in property."[48] Thus, it is believed that in circumstances where the earmarking doctrine applies, the debtor does not have an interest in the property in question. Second, it is argued that these sorts of transactions cause no diminution to bankruptcy estates. This is because the funds in question were used for the sole purpose of paying antecedent debts and thus merely "pass[ed] through the debtor's hands."[49] Simply put, "courts view the funds as transferred by the guarantor to the creditor through, *but not by,* the debtor."[50]

When determining whether the earmarking doctrine applies to a particular preference action, courts will generally apply one of two tests: (i) the *Bohlen* test or (ii) the control test.[51] The *Bohlen* test was developed in *McClusky v. National Bank* (*In re Bohlen*) by the Eighth Circuit,[52] which stipulated that three conditions must be satisfied before the earmarking doctrine may be invoked successfully.[53] Essentially, use of the earmarking doctrine is dependent on a new creditor proving that: (i) there was an agreement between the new lender and the debtor stipulating that the new funds be used to pay a specific antecedent debt; (ii) the agreement was actually fulfilled according to its terms; and (iii) the transaction, when viewed in its entirety, did not diminish the bankruptcy estate.[54] The Eighth and Third Circuits have adopted the *Bohlen* test.[55]

Alternatively, courts have used the control test when determining the applicability of the earmarking doctrine. Under this test, two elements must be

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[48] 11 U.S.C. § 547(b) (2012).

[49] Collins v. Greater Atl. Mortg. Corp. (*In re* Lazarus), 478 F.3d 12, 15 (1st Cir. 2007) ("[T]he earmarking doctrine relies on a conceptual view that the payment passing through the debtor's hands is not his and that he is merely a kind of bailee.").

[50] *Id.* ("If the earmarked funds were treated as those of the debtor, the guarantor's payment could often be recaptured from the original creditor as an avoidable preference and the guarantor would then have to pay twice."); *see* McCuskey v. Nat'l. Bank of Waterloo (*In re* Bohlen Enters., Ltd.), 859 F.2d 561, 561 (8th Cir. 1988) (rationalizing validity of earmarking doctrine on premise that "no diminution of the debtor's estate had occurred since the new funds and new debt were equal to the preexisting debt and the amount available for general creditors thus remained the same as it was before the payment was made").

[51] *See* Beckerman & Stark, *supra* note 34, at 114 (delineating the two tests used when analyzing earmarking doctrine).

[52] 859 F.2d at 566.

[53] *Id.* The *Bohlen* court held that this requirement was not met because "the debtor did not perform that agreement. It used the funds to pay a different antecedent debt which happened to be owed to the same creditor, and of which the new lender was completely unaware." *Id.* at 567.

[54] *Id.* (highlighting three conditions that must be satisfied before earmarking doctrine may be invoked).

[55] *See* Reigle v. Mahajan (*In re* Kumar Bavishi & Assocs.), 906 F.2d 942 (3d Cir. 1997) (rejecting earmarking doctrine because the transaction did not involve an agreement between new lender and debtor as is required by the *Bohlen* test); Beckerman & Stark, *supra* note 34, at 114 ("The Third Circuit Court of Appeals approvingly cited *Bohlen* in a case tangentially involving the earmarking doctrine.").

satisfied. First, there must be an "absence of control by the debtor over the disposition of funds."[56] Second, the transfer must not create a diminution of the bankruptcy estate.[57] Although similar, aside from looking to whether the transaction in question diminished the bankruptcy estate, this test focuses its attention on the level of control the debtor has over how the acquired funds are actually used by the debtor.[58] The control aspect of this test, similar to the first two elements of the *Bohlen* test, is primarily used to determine whether "the debtor has . . . 'an interest' . . . in the property such that its transfer may be avoided under [section] 547(b)."[59] However, courts adopting this test still consider whether the three elements of the first test are satisfied.[60] The Sixth Circuit has adopted this test.[61]

C. The Current Application of the Earmarking Doctrine

Regardless of which test is used, the vast majority of courts have held that the earmarking doctrine is not applicable in cases involving rollover credit card agreements. For example, in *Meoli v. MBNA American Bank, N.A.* (*In re Wells*),[62] the Bankruptcy Appellate Panel for the Sixth Circuit held the earmarking could not be used in a case involving a convenience check obtained from one creditor in order to pay off another lender.[63] In that case, a debtor sought to reduce the balance owed on a credit card account with MBNA.[64] To do so, the debtor acquired two convenience checks from her credit card account with Chase Bank USA ("Chase").[65] However, within 90 days of paying MBNA, the debtor filed for bankruptcy, and the trustee for the bankruptcy estate filed a preference action to challenge the transaction.[66]

The *Wells* court ruled in favor of the bankruptcy trustee and determined that the transaction in question was not subject to the earmarking doctrine, and thus constituted an avoidable preference.[67] Applying the control test, the Sixth Circuit held that the debtor did in fact have an interest in the funds used to pay Chase.[68] To

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56 Beckerman & Stark, *supra* note 34, at 115 (quoting Gray v. Travelers Ins. Co. (*In re* Neponset River Paper Co.), 231 B.R. 829, 834–35 (1st Cir. 1999)).

57 *Id.*

58 *Id.* at 115–16 (noting that, just like in the *Bohlen* test, some "courts have held that the third-party lender must stipulate, as a condition of the loan, that the proceeds be used to pay [a particular] pre-existing debt").

59 MBNA Am. Bank v. Meoli (*In re* Wells), 561 F.3d 633, 635 (6th Cir. 2009).

60 *In re* Neponset River Paper Co., 231 B.R. at 835. Although adopting the control test, the court here acknowledged that the three elements of the *Bohlen* test are "[f]actors to be considered when determining whether a transfer satisfies the earmarking doctrine." *Id.*

61 *See* Beckerman & Stark, *supra* note 34, at 115 ("This test has been embraced by the Sixth Circuit Court of Appeals.").

62 561 F.3d 633 (6th Cir. 2009).

63 *Id.* at 635.

64 *Id.* at 634.

65 *Id.*

66 *Id.*

67 *Id.*

68 *Id.* at 635.

come to this conclusion, the *Wells* court reasoned that the debtor was, in actuality, free to use the convenience checks in any manner she saw fit.[69] The *Wells* courts effectively held that the debtor failed the control test, thus prohibiting MBNA from invoking the earmarking doctrine.[70]

Similarly, in *Bank of America v. Mukamai* (*In re Egidi*), the Eleventh Circuit rejected the earmarking doctrine in a case where the debtor used one credit card to pay-off another.[71] In this case, when deciding to consolidate all of her credit card debts, the debtor obtained a convenience check from Capital One and made a series of payments to MBNA.[72] However, within 90 days of the transaction, the debtor filed for bankruptcy. Subsequently, the trustee filed a preference action against Bank of America.[73]

As a preliminary matter, the Eleventh Circuit held that the earmarking doctrine was inapplicable because "[the debtor], not the lender, designated the recipient of the transferred funds."[74] Thus, the *Egidi* court essentially held that a preferential transfer existed since the debtor had an interest in the funds because she had discretion over how to use the convenience check made available to her. Furthermore, the *Egidi* court was not persuaded by the argument that the transaction was merely a "bank to bank transfer" that did not cause a diminution of the estate.[75] The court reasoned that the estate was diminished because the debtor could have used the check to either pay off different creditors or to even purchase new assets that would have become part of the estate, and thus available to satisfy creditor claims.[76] However, "[b]ecause the [debtor] chose to pay MBNA from the lines of credit, the other creditors were denied payment or an opportunity for payment."[77] Thus the Eleventh Circuit essentially determined that the transaction in question failed the control test.

Moreover, just like in *Egidi* and *Wells*, the Tenth Circuit in *Marshall v. FIA Card Services* (*In re Marshall*) held that the earmarking doctrine could not be used in a case where debtors directed one bank to use their credit card to pay off a credit card balance with another bank.[78] Here, through a balance transfer with their Capital One credit card, the debtors directed Capital One to pay off another credit card

[69] *Id.* (holding debtor "exercised complete control over the funds drawn, in which she had an ownership interest").
[70] *Id.*
[71] 571 F.3d 1156, 1162 (11th Cir. 2009).
[72] *Id.* at 1158.
[73] *Id.* The transaction in question occurred in August of 2006 and the debtor filed for bankruptcy on October 28, 2006. *Id.*
[74] *Id.* at 1162.
[75] *Id.* at 1163–64.
[76] *Id.* at 1161 (explaining that a diminution of the estate occurred because "[o]nce the credit card companies extended the lines of credit to [the debtor], she could have paid other creditors or purchased other assets that would have become part of the estate and have been available to other creditors").
[77] *Id.*
[78] 550 F.3d 1251, 1253 (10th Cir. 2008).

balance owed to MBNA.[79] However, shortly thereafter, the debtor filed for bankruptcy and the bankruptcy trustee challenged the transaction.[80]

The Tenth Circuit held that the earmarking doctrine "only applies when the lender requires the funds to be used to pay a specific debt."[81] However, the *Marshall* court explained that this requirement was not met because "Capital One placed no conditions on Debtors' use of the funds, it only honored their instructions."[82] Thus, it was determined that the transaction in question was not subject to the earmarking doctrine because "the debtor, even if never in actual possession of the loaned proceeds, exercises dominion or control over them as evidenced by an ability to direct their distribution."[83] Furthermore, the court also determined that these sorts of transactions "deplete the bankruptcy estate [because] when a debtor converts an offer of credit into loan proceeds and uses those proceeds to pay another creditor, the debtor deprives the bankruptcy estate of those proceeds."[84] Thus, while acknowledging that the "net value of the estate did not change,"[85] the Marshall court concluded that "[t]he Capital One loan proceeds were an asset of the estate for at least an instant before they were preferentially transferred to MBNA."[86]

D. Summarizing the Current State of the Law

As the case law above demonstrates, the earmarking doctrine, although recognized as a valid defense to preference actions, is currently being construed narrowly in cases involving debtors using one credit card to pay off another. Indeed, courts are taking a strict approach when analyzing the level of control the debtor has over the funds in question.[87] Additionally, the cases outlined above make it clear that courts will deem an estate to be diminished when, because of his or her control over the allotted funds, the debtor chooses to pay back a particular creditor instead of allowing them to be available to all lenders for distribution during bankruptcy proceedings.[88]

However, the general consensus by the courts to apply the earmarking doctrine in a rigid manner is misguided. As is demonstrated below, the constructive trust

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[79] *Id.*
[80] *Id.*
[81] *Id.* at 1257.
[82] *Id.*
[83] *Id.* at 1256.
[84] *Id.*
[85] *Id.* at 1258 (explaining that although "the Capital One infusion of loan proceeds was totally offset by additional debt to Capital One . . . that [was] not the relevant test").
[86] *Id.*
[87] *See* Isicoff & Ryan, *supra* note 32, at 134 (indicating that "[t]his concept of debtor control appears central in most courts' analysis of the applicability of the earmarking defense").
[88] *See* Bruce S. Nathan & Scott Cargill, *Courts Remain Split Over Whether a Debtor's Credit Card Payment is an Avoidable Preference*, 27 AM. BANKR. INST. J. 22, 75 (2008) ("Courts that consider a debtor's credit card line to be property that can be used by the debtor to pay creditors will likely find a credit card payment to be a preference, assuming satisfaction of all of the other elements of [section] 547(b).").

doctrine, another equitable remedy developed by the courts, is liberally applied, and it would be beneficial for both creditors and debtors for the courts to apply that same standard to the earmarking doctrine.

III. THE CONSTRUCTIVE TRUST DOCTRINE

As a preliminary matter, this Note does not discuss whether the constructive trust doctrine should be widely available in the bankruptcy context. Rather, it deals with how the courts determine whether a trust exists. This Note argues the same liberal standard should be applied in earmarking cases. The constructive trust doctrine, like the earmarking doctrine, is an equitable remedy that does not originate from a statute, but instead finds its genesis in the courts.[89]

The earmarking doctrine and the constructive trust doctrine focus on similar aspects of a challenged transaction. As explained above, the earmarking doctrine concerns itself over whether the debtor has, within the meaning of section 547(b), an interest in the transferred funds. Similarly, the constructive trust doctrine is focused on determining if the debtor has an equitable interest in the property in question such that it qualifies as property of the estate within the meaning of section 541(a) of the Bankruptcy Code.[90]

A. The Constructive Trust Doctrine Generally and Its Liberal Standard

In general, the constructive trust doctrine is, like the earmarking doctrine, an equitable device and it is primarily invoked to "compel one who unfairly holds a property interest to convey that interest to another to whom it justly belongs."[91] In its most basic form, the constructive trust doctrine effectively serves as a mechanism to prevent unjust enrichment in cases where a defendant "[is] under an

[89] *See* Caryl A. Yzenbaard et al., *The Law of Trusts and Trustees § 471*, BOGERT'S TRUSTS AND TRUSTEES (George Bogert et al., 2014) (noting constructive trusts are "court-created trusts[s]").

[90] *See generally* 11 U.S.C. § 541(a) (2012). In pertinent part, section 541(a) of the Bankruptcy Code stipulates that:

> (a) The commencement of a case under section 301, 302 or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
>
> (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

Id. § 541(a)(1); *see* Begier v. Internal Revenue Serv., 496 U.S. 53 (1990) (explaining that when "a debtor does not own an equitable interest in property he holds in trust for another, that interest is not 'property of the estate' and, likewise, not 'property of the debtor'").

[91] Yzenbaard, *supra* note 89; *see* Richard Lieb & Siu Lan Chan, *The Constructive Trust Remedy in Bankruptcy Cases*, 1996 ANN. SURV. BANKR. L. 2 (1996) (explaining "the obligation to convey the property stems from the *equitable duty* to transfer it to the plaintiff").

equitable duty to convey" the property in question to a complaining party.[92] Furthermore, a constructive trust, otherwise known as an implied trust, is created by the courts and differs from a regular trust because neither of the parties in these cases has ever "expressed an intent to have a trust."[93] Also, unlike an ordinary trust, a constructive trust "is not meant to continue for any significant amount of time after its imposition."[94]

Within the bankruptcy context, the constructive trust doctrine has the potential to significantly impact the assets available to satisfy creditor claims during bankruptcy proceedings.[95] Essentially, once a court deems property to be held in a constructive trust, it no longer qualifies as "property of the estate" within the meaning of section 541(a) of the Bankruptcy Code.[96] Consequently, when finding that a constructive trust exists in a bankruptcy case, a court essentially "allocates specific property the beneficiary of the constructive trust, to the exclusion of all other creditors of the debtor estate."[97]

Most pertinent to the analysis of this Note, is the liberal standard that courts have adopted when determining whether a constructive trust exists in a particular instance. Unlike the earmarking doctrine, the constructive trust doctrine has not been applied in an inflexible manner. While different circuit and state courts have established their own tests for determining whether a constructive trust exists, it is generally well accepted that, because the constructive trust doctrine is an equitable measure, any potential "requisite elements are not rigid, but are flexible considerations for the court to apply."[98]

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[92] Lieb & Chan, *supra* note 91 (providing "the object [of the constructive trust doctrine] is to avoid unjust enrichment that would result if the property were not impressed with the trust and conveyed to the plaintiff").

[93] Yzenbaard, *supra* note 89.

[94] *Id.*

[95] *See* Lieb & Chan, *supra* note 91 ("By imposing a constructive trust, a bankruptcy court, as a court of equity, allocates specific property to the beneficiary of the constructive trust, to the exclusion of all other creditors of the debtor estate.").

[96] *Id.* ("The *res* of a constructive trust, once the trust is created by a court, generally does not constitute 'property of the estate' within the meaning of Bankruptcy Code [section] 541(a) . . . . The result would be that the property would not be included within the estate, and thus not be available for the benefit of creditors.").

[97] *Id.* ("The imposition of a constructive trust in a bankruptcy case has the effect of either excluding or removing the property impressed with the constructive trust from the debtor estate. The ownership of the property held in constructive trust is transferred to the constructive beneficiary."). *See* Begier v. Internal Revenue Serv., 496 U.S. 53 (1990) (stating "if [a] debtor transfers property that would not have been available for distribution to his creditors in a bankruptcy proceeding, the policy behind the avoidance power is not implicated. The reach of [section] 547(b)'s avoidance power is therefore limited to transfers of 'property of the debtor'").

[98] Mark S. Dennison, *Constructive Trust Formed Because of Abuse of Confidential Relationship Between Transferee and Transferor of Property*, 79 AM. JUR. PROOF OF FACTS 3D 269 (2015). *See, e.g.*, Koreag, Controle et Revision v. REFCO F/X Assoc., Inc. (*In re* Koreag, Controle et Revision), 961 F.2d 341, 352 (2d Cir. 1992). In this case, the Second Circuit acknowledged that pursuant to New York law, four factors must be met for a constructive trust to exist. These are: "(i) a confidential or fiduciary relationship; (ii) a promise, express or implied; (iii) a transfer made in reliance on that promise; and (iv) unjust enrichment." *Id.* However, the Second Circuit also made a point of asserting that "[a]lthough these factors provide important

B. Begier v. Internal Revenue Service: *The Constructive Trust Doctrine's Liberal Application at Work and the Standard Set by the Supreme Court*

In *Begier v. Internal Revenue Service*,[99] the Supreme Court held that a constructive trust existed in a case where a trustee for a bankrupt debtor sought to avoid tax payments to the Internal Revenue Service ("IRS").[100] Because the bankrupt debtor in this case was an employer and a commercial airliner, it was required to collect federal taxes from its employees as well as excise taxes from its customers for payment to the IRS.[101] Consequently, under 26 U.S.C. section 7501, the amount collected by the airliner was "held to be a special fund in trust for the United States."[102] However, the commercial airliner fell behind on its payments to the IRS.[103] Subsequently, the commercial airliner was ordered to create a separate bank account for the taxes it collected from its customers and employees.[104]

While the commercial airliner complied with this order, it did not have sufficient funds to cover the entire amount due to the IRS.[105] Thus, the airliner paid the IRS $695,000 from the separate account and $946,434 from its general operating funds.[106] Within 90 days of these payments, the commercial airliner filed for bankruptcy, and a preference action was brought against the IRS.[107] Thus, the issue before the Supreme Court was "whether the particular dollars that [the commercial airliner] paid to the IRS from its general operating accounts were 'property of the debtor.'"[108]

In coming to its conclusion, the Supreme Court first rejected the argument that a trust for the IRS did not exist because the commercial airliner did not segregate

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guideposts, the constructive trust doctrine is equitable in nature and should not be 'rigidly limited.'" *Id.* (quoting Simonds v. Simonds, 45 N.Y.2d 233, 241 (1978)).

[99] 496 U.S. 53 (1990).

[100] *Id.* at 67.

[101] *Id.* at 57; *see generally* 26 U.S.C. § 3402(a) (2012). In pertinent part, this statute states, "[e]xcept as otherwise provided in this section, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary." *Id.* §§ 3402(a)(1), 4291. This statute declares that "[e]xcept as otherwise provided in section 4263(a) every person receiving any payment for facilities or services on which a tax is imposed upon the payor thereof under this chapter shall collect the amount of the tax from the person making such payment." *Id.* § 4291.

[102] *Begier*, 496 U.S. at 60; *see generally* 26 U.S.C. § 7501 (stipulating "[w]henever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States").

[103] *Begier*, 496 U.S. at 56.

[104] *Id.*

[105] *Id.*

[106] *Id.*

[107] *Id.* The payments in question took play in June 1984, and only about a month later, on July 1984, the commercial airline filed for bankruptcy under chapter 11 of the Bankruptcy Code. *Id.*

[108] *Id.* at 62.

the taxes it collected from its customers and employees.[109] The Supreme Court noted that the relevant statute did not require a company to create a separate account for collected taxes. Second, the Supreme Court reasoned that if it mandated such a requirement, it "would mean that an employer could avoid the creation of a trust simply by refusing to segregate [the taxes it collected]."[110]

Next, and more relevant to the analysis of this Note, the Supreme Court had to determine whether the specific funds used in the operating expenses to actually pay the IRS were held in a constructive trust.[111] To resolve this issue, the Supreme Court held that "the IRS has to show *some* connection between the [section] 7501 trust and the assets sought to be applied to a debtor's trust-fund tax obligations."[112]

However, when deciding whether a nexus exists, the Supreme Court did not apply a rigid standard, but was instead flexible, as is appropriate when dealing with an equitable doctrine. The Supreme Court justified this standard by quoting Representative Edwards' remarks in the legislative history. These remarks stated that, "[t]he courts should permit the use of reasonable assumptions under which the Internal Revenue Service, and other tax authorities, can demonstrate that amounts of withheld taxes are still in the possession of the debtor at the commencement of the case."[113] Thus, the Supreme Court ruled that a debtor merely "voluntarily paying its trust-fund obligation . . . is alone sufficient to establish the required nexus between the 'amount' held in trust and the funds paid."[114]

This case is significant because instead of employing a narrow standard, the Supreme Court appropriately considered the substance of the facts at hand. Thus, while preserving the policies behind preference actions, the Supreme Court also did not create an overly burdensome standard for defendants to meet when trying to establish the existence of a constructive trust. Like the constructive trust doctrine, the earmarking doctrine is an equitable remedy, and therefore, when faced with an earmarking case, courts should follow the Supreme Court's lead and apply a liberal standard.

IV. PROPOSING THE LIBERALIZED STANDARD THAT SHOULD BE USED BY THE COURTS WHEN ANALYZING THE EARMARKING DOCTRINE

The rigid manner in which the courts are currently applying the earmarking doctrine has the potential to entirely eliminate the doctrine as a defense to preference actions,[115] which, as discussed below, will negatively impact creditors as

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[109] *Id.* at 61.
[110] *Id.*
[111] *Id.* at 62.
[112] *Id.* at 65–66.
[113] *Id.* at 65.
[114] *Id.* at 66–67.
[115] *See* Dan Schechter, *Payoff Old Creditor by New Creditor is Preferential When Debtor Controls Payment, Even if Money Never Passes Through Debtor's Hands [In re Marshall (10th Cir.)]*, 2009 COMM. FIN. NEWS. 04 (2009) (explaining "[i]f the court's narrow view of the 'earmarking' doctrine is widely followed, it would greatly reduce the number of cases in which earmarking could be successfully invoked").

well as debtors. Thus, with the goal of making the earmarking doctrine more available to defendants in preference actions, this Section proposes a modified standard for determining whether the earmarking doctrine is an appropriate defense.

A. Expanding the Scenarios for When the Earmarking Doctrine May be Applied

Courts must be willing to extend the earmarking doctrine such that it is not only applied in cases where the new lender is either a guarantor or co-debtor. Although some courts have accepted this premise, many have refused to do so.[116] While this will not guarantee a positive outcome for lenders, extending the earmarking doctrine past its traditional applications will, at the very least, make the doctrine more widely available as a defense to creditors when faced with a preference action over a credit card transfer.

B. A New Standard for Control

While the level of control a debtor has over the dispersed funds must remain a central component to an earmarking analysis, it should be considered in light of the facts of a case in a more holistic manner. Currently, the majority of courts analyze the control element of the earmarking doctrine in a mechanical and rigid manner. This is particularly evident in *In re Marshall*, where the Tenth Circuit rejected the earmarking doctrine in a case involving a credit card transfer on the basis that the debtors had too much control over the funds in question.[117] When explaining why the *Marshall* debtors had too much control over the funds in question, the Tenth Circuit wrote:

> Technology masks the processes involved here. Separating them into constituent elements reveals a sequence of events, not just one: Debtors drew on their Capital One line of credit; that draw converted available credit into a loan; Debtors directed Capital One to use the loan proceeds to pay MBNA; and Capital One complied. It is essentially the same as if Debtors had drawn on their Capital One line of credit, deposited the proceeds into an account within their control, and then wrote a check to MBNA. The latter is clearly a preference.[118]

[116] *See, e.g.*, McCuskey v. Nat'l Bank of Waterloo (*In re* Bohlen Enters., Ltd.), 859 F.2d 561, 566 (8th Cir. 1988) (explaining earmarking should not be extended to scenarios outside original context of co-debtor and guarantor cases because "[t]he equities in favor of a guarantor or surety, the risk of his having to pay twice if the first payment is held to be a voidable preference, are not present where the new lender is not a guarantor himself").

[117] Parks v. FIA Card Servs. (*In re* Marshall), 550 F.3d 1251, 1253 (10th Cir. 2012).

[118] *Id.* at 1256.

Essentially, the Tenth Circuit reasoned that the debtors had control over the funds because they voluntarily chose to complete each of the independent steps outlined above. However, the Tenth Circuit's analysis is misguided. As courts of equity, bankruptcy courts have long been expected to examine particular transactions in their totality.[119] Thus, "[c]ourts in bankruptcy proceedings have a history of elevating 'substance over form.'"[120]

Therefore, when deciding preference actions involving credit card transfers, courts should apply a standard similar to the one employed by the Eighth Circuit in cases involving late-perfected mortgages granted in connection with home loan refinancing. Essentially, the Eight Circuit accepted the earmarking doctrine under the premise that refinancing a home loan should be considered a "single [unitary] transaction, consisting of multiple steps" instead of a process consisting of multiple distinct transactions.[121] The Eighth Circuit approach is desirable because it properly considers the reality behind home loan refinancing. In reality, an average consumer is most likely to consider the two components of refinancing a mortgage as simply being various steps taken to complete *one* transaction.

This reasoning can certainly be applied to preference actions revolving around credit card transfers. Contrary to the Tenth Circuit's opinion, most consumers likely do not view the process of using one credit card to pay off another as a series of transactions actively taken. Rather, a consumer involved in a credit card transfer, in all probability, believes that they are engaged in a single transaction for the purpose of attaining more favorable credit card terms from a new lender.

In the same way the Supreme Court in *Begier* permitted the IRS to "use . . . reasonable assumptions" to prove the existence of a constructive trust,[122] the courts should consider a debtor's reasonable intentions when looking at the earmarking doctrine within the context of credit card transfers. Therefore, the earmarking doctrine should not be precluded as a defense in preference action based on the mere fact that a debtor has the ability to direct to whom the funds in question are being dispersed. For example, in the *Marshall* case, the debtors specifically directed Capital One to pay off their credit card with MBNA.[123] Thus, the facts of

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[119] *See* Baum, *supra* note 2, at 1384 (noting "[b]ankruptcy courts are courts of equity").

[120] *Id.* at 1384 (explaining how "[t]hrough their substance/form analysis, the courts will examine a transaction to see what its true purpose was, not just focus on how it formally operates").

[121] *Id.* at 1377; *see* Kaler v. Cmty. First Nat'l Bank (*In re* Heitkamp), 137 F.3d 1087 (8th Cir. 1998). In this case, a couple incurred a mechanics lien because of their inability to pay an outstanding debt of $40,000 to subcontractors. *Id.* at 1088. Consequently the debtors in this case obtained a loan, which was secured by granting the bank a second mortgage on their home. *Id.* However, in this case, the bank directly gave the borrowed funds to the subcontractors. *Id.* Moreover, as part of the agreement, the subcontractors agreed to waive their lien against the couple. *Id.* However, the bank failed to record the mortgage until the preference period. *Id.* Because the Eighth Circuit view that a home loan refinancing is considered one unitary transaction, the bank held that no preferential transaction occurred. Essentially, the court here held no transfer of property existed because all that occurred was the couple exchanging one security interest for another of the same value. *Id.* at 1089.

[122] Begier v. Internal Revenue Serv., 496 U.S. 53, 65 (1990).

[123] *See* Parks v. Card Servs. (*In re* Marshall), No. 05-18216, 2008 WL 544452, at *7 (D. Kan. Feb. 27, 2008) (hereinafter *In re* Marshall II), *rev'd*, 550 F.3d 1251 (10th Cir. 2008) (reasoning that debtors did not

that case clearly show that the debtors intended for the funds in question to be "earmarked" in order to pay off an antecedent credit card debt.[124] By prioritizing form over substance, the Tenth Circuit's rigid interpretation failed to recognize this.

The standard suggested here is more in line with the manner in which credit card transfers actually occur, and thus will make the earmarking doctrine more applicable to these sorts of cases. This is because the reality today is that, "usually, [a] debtor is actively involved in structuring the [credit card transfer]. [Thus] [i]f [a] debtor's involvement is enough to destroy the earmarking defense, then this defense will rarely succeed."[125]

C. There is Still No Diminution to the Bankruptcy Estate

Should the courts adopt the control standard laid out above, a bankruptcy estate would not suffer any diminution. Black's Law Dictionary defines the verb "diminution" as "the act or process of decreasing, lessening or taking away."[126] With this definition in mind, the standard for whether an estate has been diminished should not be based on the level of control a debtor has over the credit card transfer, but should, instead, focus on whether an estate's assets and net obligation remains unchanged after the transaction.[127] In virtually all of the cases discussed in Part II of this Note, the financial state of the bankruptcy estates, at the very least, remained unchanged.

D. The Liberal Standard Fulfills the Three Requirements of the Bohlen *Test*

Analyzing the earmarking doctrine in a manner consistent with the suggestions laid out above would still satisfy the three elements laid out in the *Bohlen* test. First, an agreement between a new lender and a debtor to pay an antecedent debt would exist. The entire reason behind credit card transfers is precisely to use one credit card to pay off another.

It is true that in many instances a rollover agreement does not specify the particular debtor that will be paid. However, the fact that a debtor would request

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have control over funds in question because they "were specifically directed to a specific creditor. Only MBNA, or its successor, could retrieve the payment by Capital One").

[124] *Id.* at 6 (explaining that "an ability to direct where the funds go does not in itself give rise to a property interest. As long as the funds were advanced for the purpose of paying a specific creditor, the debtor does not exercise 'control' for the purposes of earmarking") (quoting Adams v. Anderson (*In re* Superior Stamp & Coin Co.), 223 F.3d 1004, 1010 (9th Cir. 2000)).

[125] Schechter, *supra* note 115.

[126] *Diminution*, BLACK'S LAW DICTIONARY (10th ed. 2014).

[127] *See* Baum, *supra* note 2, at 1383 (explaining that "'[f]rom a holistic standpoint,' an estate cannot have been diminished when its 'assets and net obligations remained the same'"). *See, e.g.*, *In re Marshall II*, 2008 WL 544452, at *8. Unlike the appellate court, the district court held that the credit card transfer in question did not diminish the estate. The court reasoned "[t]he cash value of the estate was not effected by the transfer . . . in likelihood all that substantively occurred was the debtors' line of credit was decreased with Capital One, while equally increasing available credit from MBNA." *Id.*

for a specific amount to be made available would surely indicate which lender the debtor was intending to pay with the transfer. Thus, using the holistic approach suggested above would surely satisfy the first element of the *Bohlen* test.

Next, once the agreed upon transfer actually occurred, the second element of the *Bohlen* test would be satisfied. And finally, should courts accept the diminution standard above, the third element of the *Bohlen* test would also be met because the net worth of the estate remains the same.

V. THE EARMARKING DOCTRINE IS BENEFICIAL FOR CREDITORS AS WELL AS DEBTORS

The standard suggested above does not contradict the two policies behind preference actions. First, accepting the earmarking doctrine to defend credit card transfers does not in any way encourage creditors from "racing to the courthouse to dismember [a] debtor."[128] Credit card transfers are transactions initiated by a debtor in an attempt to attain more favorable terms for their debt. Moreover, in these cases a debtor is not choosing to pay off one creditor in lieu of another. Instead, without altering the value of their estate's assets and net obligations, debtors are merely changing credit card companies. Thus, with the net value of the estate remaining the same, no similarly situated creditor should expect to receive a lesser amount on their claim should the earmarking doctrine be interpreted more broadly.

The rigid approach currently used to analyze the earmarking doctrine has the potential to negatively impact consumer credit markets. Without this doctrine, credit card companies that transfer funds to an antecedent credit card account end up with a losing investment. Essentially, funds that were intended to be earmarked become part of the estate, thus increasing its value. This means that a new lender does not recover the funds made available; instead, he is forced to file a claim in bankruptcy, where he can only hope to recover a certain portion of the loan on a pro rata basis vis-à-vis the other creditors. Thus, from a credit card company's perspective, forbidding the earmarking doctrine would only serve to discourage them from participating in credit card transfers, and ultimately exclude debtors from the favorable terms attached with such transactions.

It is important that credit card companies are not deterred from providing consumers with rollover credit card agreements. The lower interest rates found in rollover agreements can provide consumers with necessary monetary assistance in times of financial strife.[129] Because of their lower interest rates, rollover agreements

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[128] 5 COLLIER ON BANKRUPTCY, *supra* note 1, ¶ 547.01, at 547-10.

[129] *Balance Transfer Credit Cards*, CREDITCARDS.COM, http://www.creditcards.com/balance-transfer.php (last visited Apr. 22, 2015). This website features a number of credit card transfer agreements and explains their provisions. A common theme among all the transfer agreements featured here is that they offer a 0% interest rate on transfers and purchases for as short as 6 months and as long as 21 months. This low interest rate can prove to be particularly useful for a debtor struggling to keep up with his or her credit card payments. Although these 0% interest rates are temporary, they have the potential to provide enough relief such that a debtor has a chance to catch up on his or her credit card payments.

have the potential to allow distressed debtors to pay off their credit card loans without even having to enter bankruptcy.[130] Consequently, with access to these agreements, debtors are more likely to lift themselves from financial distress and once again become active consumers. This will in turn benefit the U.S. economy as a whole due to the fact that consumer spending makes up more than two-thirds of GDP in the United States.[131] Furthermore, should a debtor file for bankruptcy after completing a credit card transfer, the favorable terms of rollover agreements mean that a debtor will pay less interest on his credit card debts, thus increasing the amount of money available in the estate to satisfy creditor claims.

Finally, because the earmarking doctrine is demonstrably an important defense to preference actions, Congress should take it upon itself to amend section 547(c) of the Bankruptcy Code such that it includes a flexible interpretation of the earmarking doctrine. In doing so, courts would no longer be able to deny creditors access to this defense when faced with a preference action over a credit card transfer. And as this Note adamantly argues, this will benefit credit card companies as well as the consuming public.

VI. CONCLUSION

The policies behind preference actions are important and must be preserved. However, as this Note argues, the earmarking doctrine when used in connection with credit card transfers poses no threat to the policies underlying the Bankruptcy Code's opposition to preferential transfers. On the contrary, the earmarking doctrine benefits creditors and debtors alike. However, the current rigid interpretation of the earmarking doctrine excludes this defense from being used in preference actions involving credit card transfers. Therefore, courts, just like what is done in cases dealing with the constructive trust doctrine, must adopt a more flexible test for the earmarking doctrine—one that considers the realities of modern day credit card transfers.

[130] *See* Baum, *supra* note 2, at 1390 (arguing "bankruptcy courts should adopt a policy that helps keep people out of their courtrooms").

[131] *See supra* text accompanying note 14; *see also* James Livingston, *It's Consumer Spending, Stupid*, N.Y. TIMES (Oct. 25, 2011), http://www.nytimes.com/2011/10/26/opinion/its-consumer-spending-stupid.html?_r=0 (arguing "[c]onsumer spending is not only the key to economic recovery in the short term; it's also necessary for balanced growth in the long term").