

VEILING SUBSTANCE IN SEMANTICS: THE KNOTTY STATE OF THE EARMARKING DOCTRINE

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ABSTRACT

Conflicting social philosophies with their infinite variations will inevitably influence law making and law interpretation. Consciously or unconsciously, social and political attitudes affect even those concerned with such an apparently technical matter as the definition of preferential transfer in bankruptcy. As it evolved over time from its English law antecedents, the law of preferential transfers in the United States gradually shifted its concern from the culpability of commercial actors to the effect of the transfer on distributive equality goals, culminating in our current law of preferences as codified in the federal Bankruptcy Code. While crafted in a highly technical and formalistic fashion, the black-letter law is simply incapable of capturing all of the nuances of behavior in the credit marketplace. Therefore, the need has remained for the bankruptcy courts to put their gloss on the statute to ensure it serves its intended purposes in any given case and also as a system. One prominent example of this judicial explication is what's known as the earmarking doctrine, a court-made equitable invention intended to assure that the transfer under scrutiny truly involves property of the debtor, as opposed to circumstances where the debtor serves merely as a conduit to move funds from one creditor to another. Although its existence has been recognized almost without exception, courts, and for that matter commentators, disagree sharply over the circumstances when it is appropriate for the doctrine to be invoked and, even when there is agreement about those circumstances, similar disagreement over the standard to apply in determining if the transfer at issue is actually protected under the earmarking exception. This Article attempts to address both of these questions by proposing a fluid approach to defining the scope of the earmarking doctrine that conforms its application to what is asserted to be the foundational purpose of the preference law; namely, ratable distribution among creditors with similar rights.

*“The worst form of inequality is to try to make unequal things equal.”***

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** This is an oft-cited paraphrase for Aristotle's statement that “For instance, it is thought that justice is equality, and so it is, though not for everybody but only for those who are equals; and it is thought that inequality is just, for so indeed it is, though not for everybody, but for those who are unequal” in ARISTOTLE, POLITICS, bk. III., at V. 8 (H. Rackham

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I. INTRODUCTION

One of the core policies underlying the federal bankruptcy law¹ is “equality of distribution” among similarly-positioned creditors;² the

trans., Harvard Univ. Press rev. ed. 1932) (c. 400-300 B.C.E.). Obviously, no believer in equality among people not of equal status, Aristotle’s sentiment translates nicely to the bankruptcy law’s emphasis of equal treatment among common claimants.

1. References in this Article to the “Code” or the “Bankruptcy Code” are to the current law of bankruptcy, which is found in Title 11 of the United States Code. 11 U.S.C. §§ 101–1532 (2012). It was enacted on Nov. 6, 1978, as the Bankruptcy Reform Act of 1978. See Pub. L. No. 95–598, 92 Stat. 2549, (the “1978 Act”), and governs all cases filed on or after Oct. 1, 1979.

2. See generally *Slobodian v. U.S. ex rel. I.R.S.*, 533 B.R. 126 (M.D. Pa. 2015) (describing equality of distribution as a central policy of the Bankruptcy Code) (citing *In re Kiwi Int’l Air Lines, Inc.*, 344 F.3d 311, 316 (3d Cir. 2003)). See also Howard C. Buschman III, *Benefits and Burdens: Post-Petition Performance of Unassumed Executory Contracts*, 5 BANKR. DEV. J. 341, 341 (1988) (describing the similar treatment of like creditors as a fundamental tenet of bankruptcy law); David G. Epstein, Casey Ariail & David M. Smith, *Not Just Anna Nicole*

concept is frequently captured in the adage equity is equality.”³ Its influence can be observed in several provisions of the federal Bankruptcy Code.⁴ This objective is most prominently featured in the Code’s scheme for defining voidable preferences.⁵ Although the

Smith: Cleavage in Bankruptcy, 31 EMORY BANKR. DEV. J. 15, 15 (2014) (criticizing the favored treatment given to vendors and lessors as inconsistent with the key policy of equality of distribution among similarly-situated creditors); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain*, 91 YALE L. J. 857, 857 (1982) (noting that while bankruptcy is usually thought of as a procedure for providing relief to an overburdened debtor, in fact, most of the bankruptcy process is concerned with creditor-distribution questions); *Nathanson v. NLRB*, 344 U.S. 25, 29 (1952) (describing equality of distribution as the theme of the former bankruptcy law).

3. See, e.g., *Centergas, Inc. v. Conoco, Inc.*, 172 B.R. 844, 853–54 (Bankr. N.D. Tex. 1994) (noting that prior bankruptcy law and the Code codified this maxim, which derives from Roman Law); see also Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. 1399, 1454 (2012) (noting that bankruptcy policy is built around the distributional norm that “similar creditors should have similar recoveries”); Lawrence Ponoroff, *Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time*, 1993 WIS. L. REV. 1439, 1447 (1993) (hereinafter “Evil Intentions”) (“Bankruptcy law must regulate preferences precisely because preferential transfers belie the bankruptcy maxim that ‘equality is equity.’”); Kenneth N. Klee, *Tithing and Bankruptcy*, 75 AM. BANKR. L.J. 157, 157 (2001) (“If the Bankruptcy Code were a Country and Western song, its refrain would be ‘Equity is Equality.’ At its core, the bankruptcy system embodies the principle that creditors with similar rights are treated equally.”).

4. See, e.g., 11 U.S.C. § 726(b) (2012) (providing that, the rights of secured creditors and priority creditors aside, all general creditors of the debtor take *pari passu*); 11 U.S.C. §§ 547–51 (2012) (collecting trustee’s avoiding powers); 11 U.S.C. §§ 1122(a), 1123(a)(4) (2012) (grouping “substantially similar” claims for similar treatment in Chapter 11 plans); 11 U.S.C. § 1322(a)(3), (b)(1) (2012) (requiring that a Chapter 13 plan that classifies claims must provide equal treatment for each claim within the class and may not discriminate unfairly against or among any class or classes). Of course, bankruptcy policy must be reconciled with other social policies with which it competes. See *infra* note 243 and accompanying text. The vindication of those other policies will, from time-to-time, result in unequal treatment among like claims. A prime example of this disparate treatment can be found in the Code’s scheme for awarding priority to certain unsecured claims in order, in each case, to advance a competing policy interest. See 11 U.S.C. § 507(a) (2012). Correspondingly, § 510(c) gives the bankruptcy courts license to demote an otherwise equal claim when necessary to redress inequitable conduct. See generally Alec P. Ostrow, *The Animal Farm of Administrative Insolvency*, 11 AM. BANKR. INST. L. REV. 339 (2003) (detailing various contexts in which the Code elevates the priority of certain claims).

5. The definition of a preference can be found in § 547(b) of the Code. See *infra* notes 53–55 and accompanying text. The fear is that “[i]f preference law fails to preserve absolute equality in liquidation, those creditors who are aware of this failure will compete for position during insolvency rather than cooperating fully in an attempt to maximize the value of the firm.” Note, *Preferential Transfers and the Value of the Insolvent Firm*, 87 YALE L.J. 1449, 1455 (1978); see also *Ramco/Fitzsimmons Steel Co., Inc. v. Raritan River Steel Co.*, 95 B.R. 299, 301 (Bankr. W.D.N.Y. 1988) (“The laws relating to preferences were intended to avoid payments . . . to creditors on the eve of bankruptcy on antecedent debt, which payments or transfers have the effect of preferring those creditors over other creditors similarly situated but unpaid. They have been described as deterrents to grab law tactics and have as their purpose promoting the policy of equality of distribution among creditors of insolvent debtors.”); JAMES ANGELL MACLACHLAN, *HANDBOOK OF THE LAW OF BANKRUPTCY* 283 (1956) (observing that “[t]he law of preference is the most significant contribution of bankruptcy to commercial law...”).

legislative history of the Code suggests there are two principal justifications for the preference statute,⁶ I have argued in other contexts that the deterrence explanation for the preference law is chimerical, and equality should be the predominant purposive object driving the interpretation and application of contemporary preference law.⁷

6. The House Committee Report that accompanied the Bankruptcy Reform Act of 1978, provided as follows:

The purpose of the preference section is two-fold. First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. . . . 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.

H.R. REP. NO. 95-595, at 177-78 (1977).

7. See Lawrence Ponoroff, *Bankruptcy Preferences: Recalcitrant Passengers Aboard the Flight From Equality*, 90 AM. BANKR. L.J. 329, 368 (2016) (hereinafter “*Flight From Equality*”); Ponoroff, *Evil Intentions*, *supra* note 3, at 1439. That said, I am not the only one, and certainly not the first, to champion equality as the dominant policy to be served by the preference law. See generally Lissa L. Broome, *Payments on Long-Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendments*, 1987 DUKE L.J. 78, 115 (1987) (identifying preservation of equality as the main goal of the preference law since 1978, with deterrence playing only an incidental role); David Gray Carlson, *Security Interests in the Crucible of Voidable Preferential Law*, 1995 U. ILL. L. REV. 211, 215-18 (1995) (identifying several reasons that raise serious doubt over whether deterrence is the principal purpose of voidable preference law); Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 748 (1985) (suggesting that, despite the legislative history discussing the aim of “detering creditors from scrambling for advantage, it seems ridiculous to expect [the preference law to produce] deterrence. . . .”); Rafael I. Pardo, *On Proof of Preferential Effect*, 55 ALA. L. REV. 281, 282 (2004) (opining that while Congress identified deterrence and the equality principle as the twin purposes of the preference provision, the latter should be viewed as primary); Charles Jordan Tabb, *Rethinking Preferences*, 43 S.C. L. REV. 981, 1029 (1992); Note, *supra* note 5, at 1459 (proposing the hegemony of equality in enforcement of the preference law). Cf. Brook E. Gotberg, *Conflicting Preferences in Business Bankruptcy: The Need for Different Rules in Different Cases*, 100 IOWA L. REV. 51, 59, 65 (2014) (noting that the policy of deterrence conflicts with the policy of equal distribution.); John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 262-64 (1981) (identifying several reasons that raise serious doubt over whether deterrence is the principal purpose of voidable preference law, but also questioning whether there are sufficient preference recaptures to warrant the assertion that preference law actually ameliorates distributional equalities). See also *infra* text accompanying notes 63-65.

It should also be noted that, in significant measure, the exceptions to preference liability in § 547(c) (see *infra* note 11), highlight the fact that the normative justification for the preference law remains in some measure about “deterrence” as well as equality. See *infra* note 8. This is particularly true of the all-important ordinary course of business exception in subsection (c)(2). See Tabb, *supra* note 7, at 1016-27 (describing section 547(c)(2) as irreconcilably at odds with proper basis for preference liability and advocating for its repeal). Professor Countryman was of the same mind. Countryman, *supra* note 7, at 817-18; see also Ponoroff, *Evil Intentions*, *supra* note 3, at 1481 n.119 and accompanying text (noting that “[i]t would

Operating from that foundational premise,⁸ the restrictive approach taken by some courts⁹ as to the minimum factual circumstances under which the earmarking doctrine might be wielded as a mechanism for sidestepping preference liability is a disturbing one in that it elevates form over substance in a manner not compelled by the letter of the statute and in stark transgression with legislative purpose. Even among courts that accord the doctrine a more expansive interpretation, there is considerable confusion and disagreement over the standard that should be employed in deciding if a sufficient showing has been made to warrant application of the earmarking doctrine as a valid defense to a trustee's preference challenge.¹⁰

Although not one of the prescribed statutory defenses to preference liability,¹¹ the earmarking doctrine has long been recognized as a judicially-created exception to what otherwise would technically qualify preference.¹² It derives from a pragmatic interpretation of the perambulatory language in § 547(b) that the transfer must be of “an interest of the debtor in property” in order for preference liability to

be difficult and perhaps unfair to disassociate completely the scheme of preference exceptions in section 547(c) from the sentiment that these transactions do not involve the sort [of] deliberate ‘eve of bankruptcy’ grab which colored earlier preference law” and identifying section 547(c)(2) as the most direct expression of that sentiment.).

8. In fairness, it should be observed that not all agree with dubbing “equality” as the dominant policy consideration animating the preference law. *E.g.*, Daniel J. Bussel, *The Problem with Preferences*, 100 IOWA L. REV. BULL. 11, 14 (2014) (“[T]he interest in ratable distribution alone is insufficient to warrant avoidance in at least some situations involving innocent transferees.”); THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 125–28 (1986) (adopting the position that the justifications for the preference law are to prevent dismantling of the bankruptcy estate and in order to assure that no creditor is able to unilaterally opt-out of the hypothetical creditor’s bargain model that Jackson posits creditors, as risk-neutral wealth maximizers, would agree to *ex ante* to assure that the law operates as efficiently as possible). Jackson’s view is perhaps the strongest endorsement of a deterrence-based rationale for crafting the preference law. More recently, Professor Skeel has provocatively asserted that the equality norm no longer plays a dominant role in present-day bankruptcy law, and that continued attention on equality draws attention away from the real normative issues and concerns in play in twenty-first-century preference law. David A. Skeel Jr., *The Empty Idea of “Equality of Creditors,”* 166 U. PA. L. REV. 699, 700–02 (2018).

9. *See infra* Section III.A.1.

10. *See infra* text accompanying notes 191–202.

11. These defenses, or exceptions, to preference liability are collected in subsection (c) of § 547. There are currently nine defenses as well as an additional defense contained in subsection (h) that was added to the Code by Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Pub. L. No. 109–8, § 201, 119 Stat. 23 (2005) (codified as amended in scattered sections of 11 U.S.C.).

12. The statutory elements of an avoidable preference are listed in § 547(b) of the Code. *See infra* text accompanying notes 53–55.

attach.¹³ Specifically, where the property transferred by the debtor *de jure*, albeit perhaps not *de facto*, belongs to a party other than the debtor, the earmarking doctrine allows substance to prevail over form by providing the recipient of the alleged preferential transfer with a defense.¹⁴ The rationale is that if the transfer involves assets of a third party, then it does not deprive the later-to-be-formed bankruptcy estate of resources that would otherwise be available to satisfy claims of unsecured creditors as a group.¹⁵

Equitable in nature,¹⁶ the earmarking doctrine moderates the literal application of the elements of a voidable preference in circumstances where the transfer at issue has no actual preferential effect; i.e., it does not transgress the distributional aims of the bankruptcy law.¹⁷ The most prosaic example occurs where a third party extends credit to the debtor to permit the payoff of a specific debt and effectively limits the use of those funds to that purpose and that

13. See 11 U.S.C. § 547(b) (2012); see also *infra* Section II. The earmarking doctrine has also been pressed into service to determine whether the funds are property of the debtor for purposes of establishing a fraudulent transfer under § 548(a) of the Code. See, e.g., *Kapila v. Espirito Santo Bank (In re Bankest Cap. Corp)*, 374 B.R. 333, 338–39 (Bankr. S.D. Fla. 2007) (indicating that in determining whether money is property of the debtor for fraudulent transfer purposes, the operative question is whether the funds came under the debtor's dominion and control); see also *Sherman v. TBK Bank (In re Dependable Auto Shippers, Inc.)*, No. 17–3086, 2018 WL 4348049 (Bankr. N.D. Tex., Sept. 7, 2018) (involving both a preference and a fraudulent transfer challenge).

14. See generally *Cage v. Wyo-Ben, Inc. (In re Ramba)*, 437 F.3d 457, 460 (5th Cir. 2006) (noting that there cannot be a preference if the debtor has no equitable interest in the property transferred (citing *McCord v. Agard (In re Bean)*, 252 F.3d 113, 117 (2d Cir. 2001); *Adams v. Anderson (In re Superior Stamp & Coin Co.)*, 223 F.3d 1004, 1007 (9th Cir. 2000) (suggesting that in determining whether property that is transferred belongs to the debtor for purposes of § 547, the court should consider whether the transfer to the favored creditor reduces the funds to which other creditors of the same class can resort for the payment of their debts); *Jenkins v. Chase Home Mortg. Corp. (In re Maple Mortg., Inc.)*, 81 F.3d 592, 595 (5th Cir. 1996) (“If funds cannot be used to pay the debtor's creditors, then they generally are not deemed an asset of the debtor's estate for preference purposes.”); *Sherman v. TBK Bank (In re Dependable Auto Shippers, Inc.)*, No. 17–3086, 2018 WL 4348049 (Bankr. N.D. Tex., Sept. 7, 2018) (describing the objective to be served by application of the earmarking doctrine as intending to assure that substance prevails over form); see also *Smith v. Suarez (In re IFS Fin. Corp.)*, 417 B.R. 419, 435–36 (Bankr. S.D. Tex. 2009), *aff'd*, 669 F.3d 255 (5th Cir. 2012) (“The earmarking doctrine is widely accepted in the bankruptcy courts as a valid defense against a preference claim, primarily because the assets from the third party were never in the control of the debtor and therefore payment of these assets to a creditor in no way diminishes the debtor's estate.”).

15. See *Ganis Credit Corp. v. Anderson (In re Jan Weilert RV, Inc.)*, 315 F.3d 1192, 1199 (9th Cir. 2003) (citing *Superior Stamp*, 223 F.3d at 1008) (“The principal rationales supporting the earmarking doctrine are (1) the transferred funds *were not* property of the debtor, and (2) there was no diminution of the bankruptcy estate. . . .”).

16. See *infra* note 172 and accompanying text.

17. See, e.g., *Luker v. Lewis Auto Glass, Inc. (In re Francis)*, 252 B.R. 143, 145 (Bankr. E.D. Ark. 2000) (explaining the rationale for the doctrine as protecting from preference recovery a payment that does not diminish the estate).

purpose only. The consequence is that the new lender has essentially refinanced the existing obligation, such that, from the perspective of the debtor, the new lender is simply substituted for the creditor whose debt was retired.¹⁸ Other creditors are not affected by the transaction inasmuch as the pool of assets available for distribution on their claims is no greater but also no less than it was prior to the transfer. Functionally, what has transpired is identical in substance to a direct purchase by, and assignment of the original creditor's claim to, the new creditor. Otherwise, the status quo has been preserved. All that has changed is the identity of one of the debtor's creditors, but neither the total number of debts owed by the debtor nor the total number of creditors asserting a claim against the debtor's assets is affected.¹⁹

A less prosaic, and far more consequential, illustration of an attempt to shield a payment from recovery as a preferential transfer can be found in the recent bankruptcy court opinion in *In re WB Services, LLC*.²⁰ The decision arose out of a construction contract between the property owner and its general contractor, who later filed a Chapter 7 bankruptcy. The rather unique nature of construction

18. One caveat here is that the loan from the new creditor must also be unsecured. If the new debt is secured, and the security interest unavoidable, then there is a transfer of an interest in the debtor's property; *i.e.*, the collateral, which then does result in a diminution of the estate that is prejudicial to other general creditors. See D.A.N. Joint Venture, L.P. v. Mangan (*In re Flanagan*), 503 F.3d 171, 185–86 (2d Cir. 2007) (pointing out that an important limitation on the earmarking doctrine is that a new loan must be unsecured and, if not, the payment to the old creditor is voidable to the extent of the collateral transferred by the debtor); Taunt v. Fid. Bank of Mich. (*In re Royal Golf Products Corp.*), 908 F.2d 91, 94 (6th Cir.1990) (stating that payment to creditor with funds supplied by a third party will constitute a preference to the extent of the value of any security granted to the third party) (citing *Mandross v. Peoples Banking Co. (In re Hartley)*, 825 F.2d 1067, 1071 (6th Cir.1990)); *Brown v. Mt. Prospect State Bank (In re Muncrief)*, 900 F.2d 1220, 1224 (8th Cir. 1990) (same); *Buffalo Molded Plastics, Inc. v. Omega Tool Corp.*, 344 B.R. 394, 401 (Bankr. W.D. Pa. 2006) (observing that where a security interest is given by the debtor to the new creditor in order to receive the earmarked funds, more than the mere substitution of unsecured creditors has occurred); *Ledford v. First Nat'l Bank (In re Belme)*, 76 B.R. 121, 122 (Bankr. S.D. Ohio 1987) (stating that “unconditional adherence to the general rule of the earmarking doctrine is inappropriate where a *secured* creditor is substituted for an unsecured creditor, [and] a if third-party lender is granted a security interest in debtor's property as part of an ‘earmarking’ transaction, the court must focus on whether the transfer diminished the value of the debtor's estate”) (citing *Matter of Villars*, 35 B.R. 868, 872 (Bankr. S.D. Ohio 1983).

19. See generally *McLemore v. Third Nat'l Bank in Nashville (In re Montgomery)*, 983 F.2d 1389, 1395 (6th Cir. 1993) (explaining that the discharge of an existing debt with newly borrowed funds designated for that purpose has been held not to be a transfer of property of the debtor even if the funds pass through the debtor on their way to the old creditor). For other good explanations and analyses concerning the applicability of the earmarking doctrine to a preference action, see *Gray v. Travelers Ins. Co. (In re Neponset River Paper Co.)*, 231 B.R. 829, 833-35 (B.A.P. 1st Cir. 1999); *Moser v. Bank of Tyler (In re Loggins)*, 513 B.R. 682, 700–03 (Bankr. E.D. Tex. 2014); *Official Bondholders Comm. v. E. Util. Assocs. (In re EUA Power Corp.)*, 147 B.R. 634, 639–40 (Bankr. D.N.H. 1992).

20. *Davis v. Kice Indus., Inc. (In re WB Servs.)*, 587 B.R. 548, 561 (Bankr. D. Kan. 2018).

industry contracting presents several challenges insofar as application of the Bankruptcy Code is concerned.²¹ This is a product of the fact that, typically, much of the general contractor's work is done by and through third-party subcontractors and suppliers. Under state law, these parties, while not in direct privity, retain certain lien rights against the owner's property if amounts contractually due them from the general contractor go unpaid.²² To protect themselves, owners will resort to several approaches, including use of joint-payee checks, to assure that payments due subcontractors and suppliers are made and, thus, liens against their property are avoided.²³

This is what occurred in *WB Services*. At some point during the project, the owner became concerned about timely payment of subcontractors. As a result, it was agreed between the owner and the general contractor that future payments from the former to the latter would be made in the form of checks made payable jointly to the general contractor and specific subcontractors, including the defendant, Kice Industries.²⁴ Under this arrangement, the owner issued a check for \$118,191.35 payable to the general contractor *and* Kice. Per a prearranged procedure, the check was endorsed at the owner's facility by a representative of the general contractor and then delivered to Kice in return for a lien waiver.²⁵ Because the payment to Kice was made within ninety days of the general contractor's subsequent bankruptcy filing,²⁶ the trustee in that case filed an action to recover the payment as a preference.²⁷ In response, Kice raised several defenses,²⁸ including that the payment did not represent the transfer of an interest of the debtor in property because it essentially had been "earmarked" by the owner for Kice.²⁹

21. See generally Lawrence Ponoroff, *Construction Claims in Bankruptcy: Making the Best of a Bad Situation*, 11 BANKR. DEV. J. 343, 344 (1995) (noting that construction contracts present unique problems in bankruptcy because of the "complex web of legal, contractual, and financial arrangements characterizing most construction activities.").

22. *Id.* at 348–51.

23. See *id.* at 380–82.

24. *WB Servs.*, 587 B.R. at 553.

25. *Id.* at 553. For reasons not explained, the lien waivers actually covered only \$82,661.35 of the \$118,191.35 payment. *Id.*

26. This is one of the elements of a preference set forth in Code § 547(b). See also *infra* text accompanying notes 53–55.

27. *WB Servs.*, 587 B.R. at 553.

28. The court catalogued these defenses as: (1) "the payment was [not the] transfer an interest of the debtor in property", (2) the transfer "did not diminish the bankruptcy estate", and (3) that the transfer was part of a substantially contemporaneous exchange of new value within the meaning of § 547(c)(1). *Id.* at 554.

29. *Id.* The first two of the above-listed defenses are, of course, simply alternative ways of expressing the earmarking doctrine.

The court began its analysis by citing approvingly from the statement in a leading bankruptcy law treatise that, because the earmarking doctrine is a judicially-created exception to preference recovery, it should be narrowly construed.³⁰ The court also referenced a Tenth Circuit Bankruptcy Appellate Panel decision following a line of cases that adopt a conservative slant on the earmarking doctrine, limiting its application to situations where the new creditor is a codebtor on the original obligation.³¹ While acknowledging that the Tenth Circuit itself had not yet ruled on whether the doctrine should be so limited,³² the court nonetheless concluded that, because the owner was not a guarantor of the debtor's obligation and did not extend credit to the general contractor with the requirement that the funds be used to pay Kice, the joint-payee check was not shielded from recovery as a preference under the earmarking doctrine or otherwise.³³ Treating them as separate arguments, the court also rejected Kice's contentions that the general contractor had no independent obligation to pay Kice,³⁴ and that the general contractor/debtor's lack of possession of the transferred funds denuded it of an interest in the property.³⁵

30. *Id.* at 556–57 (citing 5 COLLIER ON BANKRUPTCY, § 547.03[2][a] at 21–22 (16th Ed. 2018)). See also *Motors Liquidation Avoidance Action Tr. v. JPMorgan Chase-Bank (In re Motors Liquidation Co.)*, 596 B.R. 774, 781 (Bankr. S.D.N.Y. 2019) (same).

31. *Davis v. Kice Indus. (In re WB Servs., LLC)*, 587 B.R. 548, 556–57 (Bankr. D. Kan. 2018). The Bankruptcy Appellate Panel decision referred to was *Manchester v. First Bank & Tr. Co. (In re Moses)*, 256 B.R. 641 (B.A.P. 10th Cir. 2008). *Manchester* is discussed in much more detail *infra* text accompanying notes 112–114.

32. *WB Servs.*, 587 B.R. at 557–58. The court did discuss at some length the Tenth Circuit's decision in *Zions First Nat'l Bank v. Christiansen Bros., Inc. (In re Davidson)*, 66 F.3d 1560 (10th Cir. 1995), a case in which Kice heavily placed reliance in support of its earmarking exception argument. The court, however, found *Davidson* distinguishable both because it involved a post-petition transfer and not a preference, and also because in *Davidson*, unlike the current case, the debtor had an independent legal (contractual) obligation to pay suppliers and subcontractors. See *WB Servs.*, 587 B.R. at 560.

33. *Id.* at 560, 563 (concluding that Kice failed to meet its burden of showing the debtor did not have an interest in the property transferred and therefore, the payment was not a preference). In reaching this result, the court relied on the reasoning expressed in *Code Electric, Inc. v. Crampton*, 197 B.R. 807 (Bankr. E.D.N.C. 1996) and *Napolitano v. Vibra-Conn, Inc. (In re R.J. Patton Co., Inc.)*, 348 B.R. 618 (Bankr. D. Conn. 2006). *WB Servs.*, 587 B.R. at 559–61.

34. *WB Servs.*, 587 B.R. at 560–62. Kice's argument was that, under the independent obligation doctrine, the funds constituting the payment could not have been property of the estate. See *supra* note 32. In this case, there was no obligation other than the debtor's general contractual obligation. *Id.* at 560–61.

35. *Id.* at 561–562. This factor—lack of possession of the funds—is often regarded as an element or factor in the earmarking analysis. See, e.g., *U. S. Lines, Inc. v. United States (In re McLean Indus., Inc.)*, 162 B.R. 410, 420–21 (Bankr. S.D.N.Y. 1993), *rev'd on other grounds*, 30 F.3d 385 (2d Cir. 1994) (holding that because the debtor had come into possession of and had control over the funds in question, the earmarking doctrine could not apply). However, there is no clear consensus on the point in the decisional law. See *infra* note 203.

This Article advances the view that the approach to the earmarking doctrine taken in *WB Services* is unduly and needlessly constraining. More specifically, this narrow construction of the doctrine serves no particular bankruptcy purpose or end and is not necessarily required in order to avoid prejudice to a codebtor on the obligation retired in the form of potentially having to pay the obligation twice.³⁶ Even more perplexing, this approach overlooks the fact that it is not just codebtors who may be negatively affected beyond return of the amount of a preferential transfer unless shielded by the earmarking doctrine.³⁷ At the same time, an underinclusive construction of the earmarking defense also provides an unearned benefit to other creditors in the form of an artificial increase in the size of the estate.³⁸ In each of these

The court also found that § 547(b)(5)'s "greater amount" test (*see infra* note 55 and accompanying text) was satisfied because Kice received 100 percent of its claim rather than the lesser amount it would have received as an unsecured creditor in the general contractor's bankruptcy case. *WB Servs.*, 587 B.R. at 562–63.

36. This is the oft-cited rationale for applying the earmarking doctrine in the codebtor case, but not beyond. *See WB Servs.*, 587 B.R. at 557–59. As discussed *infra* text accompanying notes 219–221, this rationale is suspect. Moreover, if it were a sound basis for recognizing the exception then it should also apply where one party makes a payment (rather than a loan) to the debtor with the expectation that the debtor would use the funds to pay a specific indebtedness to a party that might have lien rights against the payor. However, in *Buchwald Capital Advisors LLC v. Metl-Span I, Ltd. (In re Pameco Corp.)*, 356 B.R. 327, 335 (Bankr. S.D.N.Y. 2006), the attempt to invoke the earmarking doctrine as a defense on similar facts was rejected because the funds did not come from a "new creditor." *Cf. infra* note 236 and accompanying text.

37. While the opinion in *WB Servs.* does not reveal the result of this case, it will be recalled that Kice executed a lien waiver in return for the payment. 587 B.R. 548, 553. If that payment must be restored to the estate as a preferential transfer, that waiver, which ran in favor of a third party, arguably does not get restored, with the result that Kice would be cut off from the other recourse under state law provided for suppliers and subcontractors. The point being, the potential for inequity is not limited to codebtors (and may not even exist in most codebtor cases). *See infra* text accompanying notes 219–221. Even in a non-construction contract situation, it is easy to imagine the creditor receiving payment materially changing its position in reliance on the payment between the date of receipt and the date of the later preference action against it. This could make it extremely difficult or costly to unwind for the transferee/creditor over and above the cost of returning the preferential transfer.

38. To illustrate, assume on the 90th day before filing the debtor has \$100 in assets and 5 unsecured creditors each owed \$100. Obviously, if nothing changes, each creditor will receive \$20 in the bankruptcy case. But now assume new lender gives debtor, on the 45th day prior to bankruptcy, \$100 to payoff creditor #1, which is what happens. When the bankruptcy case is filed, again, nothing has changed—the debtor has \$100 to be split among five creditors holding claims of \$100 each. If, however, the trustee is able to recover the payment to creditor #1 as a preference, now there will be \$200 in assets to be shared among six creditors each with a claim of \$100. The result is a dividend to each creditor of \$33.33. This ignores, of course, administrative costs associated with recovering the preference. The point, however, is that the purpose of the preference law is to prevent a diminution of the estate and not specifically to augment it. *See Moser v. Bank of Tyler (In re Loggins)*, 513 B.R. 682, 697 (Bankr. E.D. Tex. 2014) ("[T]he test of whether a preference has occurred is not what the creditor receives, but what the bankrupt's estate has lost, because it is the diminution of the bankrupt's estate,

respects, limiting the earmarking defense to the codebtor scenario contravenes the conjoined principles of ratable distribution and asset maximization that are supposed to animate the bankruptcy law in the first place.³⁹

To support this argument, Part I of this Article begins by reviewing, at a very high level of generality, the evolution of voidable preferences in the bankruptcy law. Part II then traces the origins of the earmarking doctrine as a non-statutory exception to preference liability. Part III surveys the division in the case law over the scope of the earmarking doctrine. Next, Part IV examines the extent of the bankruptcy courts' equitable authority—the jurisdictional foundation upon which the earmarking doctrine rests—in light of recent efforts by the Supreme Court to rein in that authority. Part V critiques the trend in the decisional law, as illustrated by *WB Services*, to abandon a diminution of the estate perspective in applying the earmarking doctrine in favor of more confining standards that are tied either to digressive concerns bearing on the status of the new creditor or hyper-technical worries over the debtor's "control" over the earmarked funds. Following this, Part VI, proposes an alternative blueprint for deciding when to invoke the earmarking doctrine, which, it is submitted, corresponds more closely with the principal policy considerations that have come to define contemporary preference law. Lastly, this Part also addresses why the boundaries established by the Supreme Court on the scope of bankruptcy courts' equitable powers preclude extension of this new approach in a related factual context where the earmarking defense has been raised and might otherwise have had more than a modicum of relevance.

II. PREFERENCE DOCTRINE AND POLICY

There are several fine treatments in the literature detailing the long and somewhat ambivalent history of voidable preferences under

not the unequal payment to creditors, which is the evil sought to be remedied by the avoidance of a preferential transfer.") (citing *Va. Nat'l Bank v. Woodson (In re Decker)*, 329 F.2d 836, 840 (4th Cir.1964)).

39. The two principles go hand-in-hand. As explained by Tom Jackson, bankruptcy operates to force creditors to put aside their individual interests in return for receiving a ratable share of a larger pie. JACKSON, *supra* note 8, at 10–19. In effect, the Chapter 7 debtor purchases a discharge from further legal obligation on prepetition debts by surrendering all of his or her unencumbered, nonexempt assets, which are then liquidated in an orderly manner with a view toward maximizing value for unsecured creditors as a group. *See also* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 785 (1987) ("In bankruptcy, with an inadequate pie to divide and the looming discharge of unpaid debts, the disputes center on who is entitled to shares of the debtor's assets and how these shares are to be divided. Distribution among creditors is not incidental to other concerns; it is the center of the bankruptcy scheme.").

both English and American bankruptcy law.⁴⁰ There is, therefore, no need to plough the same ground here, other than to observe that, by the time the current Bankruptcy Code was enacted, preference law had for the most part lost its prior association with culpability and state of mind.⁴¹ The theory of contemporary preference legislation is largely we need not engage in any intense scrutiny to ferret out the underlying intentions of debtors and creditors as commercial citizens.⁴² Rather, preference law has evolved into a kind of no-fault liability offense.⁴³

That is to say, over time we have achieved a consensus, even if only a wobbly one,⁴⁴ that certain transactions undermine the trustee's ability to assure ratable distribution and obstruct the efficient production of commercial credit in a manner that requires redress if the goals of

40. In his comprehensive treatment of the subject, Professor Weisberg stated, "Preference law has remained one of the most unstable categories of bankruptcy jurisprudence. Indeed, its instability is obvious in the most recent, and perhaps most scientifically pretentious, efforts at legislating an American preference law, efforts that have been quickly undermined by the courts and then by Congress itself." Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3, 4 (1986). See also Countryman, *supra* note 7, at 714–25; McCoid, *supra* note 7, at 250–59; Thomas M. Ward & Jay A. Shulman, *In Defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing*, 61 WASH. U. L.Q. 1, 5–9 (1983). See also Skeel, *supra* note 8, at 704–09 (recounting the equality among creditors norm in American bankruptcy law, including the preference provision).

41. See Countryman, *supra* note 7, at 725 (pointing out that "for the last forty years under the old Act, the debtor's state of mind was of no concern in establishing voidable preferences . . . [F]or the entire history of the old Act, a trustee . . . had to prove something about the state of mind of the transferee-creditor"); McCoid, *supra* note 7, at 259 ("Preference law has thus moved from a notion of debtor fraud to [under the 1978 Act] a standard of absolute liability. . .").

42. See Ponoroff, *Evil Intentions*, *supra* note 3, at 1478 (pointing out that, "until adoption of the present Bankruptcy Code in 1978, every version of American bankruptcy legislation embodied some notion of 'culpability' among the essential elements of a preferential transfer."). See *infra* note 48.

43. *Southmark Corp. v. Grosz (In re Southmark Corp.)*, 49 F.3d 1111, 1116 n.11 (5th Cir. 1995) ("[t]he purpose of the transfer is not dispositive of the question whether it qualifies as an avoidable preference under section 547(b) because 'it is the effect of the transaction, rather than the debtor's or creditor's intent, that is controlling.'") (citing *T.B. Westex Foods, Inc. v. Fed. Deposit Ins. Corp. (In re T.B. Westex Foods, Inc.)*, 950 F.2d 1187, 1195 (5th Cir. 1992) (emphasis in original)). See also Tabb, *supra* note 7, at 1035 ("suggest[ing] that the true nature of preference law should be seen as akin to strict liability").

44. See Weisberg, *supra* note 40, at 5 (observing that "[b]ankruptcy law has been playing out a ritualized dance between formal legislative rules and normative commercial and moral standards for 500 years" and will continue to do so until some consensus is reached over essential purposes of a bankruptcy regime within the framework of our larger credit economy). But see Skeel, *supra* note 8, at 720–21 (discussing the intrusion on the equality norm created largely by the ordinary course of business exception to preference liability).

a collectivist debt collection proceeding are to be achieved.⁴⁵ When this occurs, the transaction must be unwound regardless of the innocence *vel non* of the participants.⁴⁶ It is why the preference law has no serious analog under state law, where, in direct contrast to bankruptcy policy, the debt-collection ethos is one of competition and awarding the spoils to the creditors that are first to arrive on the scene and thus, able to pounce most swiftly.⁴⁷

Accordingly, the elements of a voidable preference in § 547(b) are drawn in a formalistic fashion that impersonally prescribe certain classes of transactions that occur on the eve of bankruptcy, or, in the case of creditors with inside knowledge of the debtor's financial situation, even longer.⁴⁸ The requirement that the transfer occur within ninety days of the bankruptcy filing—in the case of non-insiders—is arbitrary.⁴⁹ It reflects an assumption that in the roughly three months prior to filing, as the debtor's situation spirals downward toward the inevitable end, there is a greater likelihood that payments

45. See H.R. REP. NO. 95-595, at 178 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6139 (“To argue that the creditor’s state of mind is an important element of a preference and that creditors should not be required to disgorge what they took in supposed innocence is to ignore the strong bankruptcy policy of equality among creditors.”); *see also* Buckley v. Jeld-Wen, Inc. (*In re Interior Wood Prods. Co.*), 986 F.2d 228, 232 (8th Cir. 1993) (noting that the intent of the parties is not among the factors to be considered in determining if a transfer by the debtor can be set aside as a preference).

46. See *supra* note 43.

47. See Susan Block-Lieb, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case*, 42 AM. U. L. REV. 337, 355–56 (1993) (“Pursuit of various state law remedies such as execution, attachment, garnishment, levy, and the like may involve a ‘race to the courthouse’ by a debtor’s creditors, with the creditors who win the race entitled to ‘grab’ the debtor’s assets away from the debtor’s slower creditors.”).

48. The preference period for insiders, who are obviously more attuned to the debtor’s financial situation, is one year. See 11 U.S.C. § 547(b)(4)(B) (2012). As originally enacted, § 547 of the Code continued to require the trustee to establish that the defendant-creditor had reasonable cause to believe the debtor was insolvent” at the time of transfer in the limited circumstance where the claim was being asserted against an “insider” (as defined in Bankruptcy Code § 101(30) and the transfer occurred during the extended insider preference period; i.e., more than 90 days before filing but within one year of the filing of the case. 11 U.S.C. § 547(b)(4)(B)(i)–(ii) (1982). This requirement was eliminated as part of the amendments to the Code accomplished under Title III to the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984).

49. Under § 60a(1) of the Bankruptcy Act of 1898 Act, Act of July 1, 1898, ch. 541, 30 Stat. 544 (1898), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978), the period was four months. While the prescribed length of the preference period may be arbitrary, the need for some temporal limit on the preference claw-back is not. By definition, preferences are disruptive of market transactions that, under non-bankruptcy law, are perfectly lawful commercial arrangements. Subsequently upsetting them after the fact undermines the policies of certainty and finality that commercial transactions depend upon. See McCoid, *supra* note 7, at 267–68 (discussing the uncertainty costs imposed by a creditors’ realization that a particular payment received may have to be disgorged in the event of a subsequent bankruptcy filing).

or transfers that advantage one creditor over its compatriots will occur. Rather than subject each such transfer to individualized scrutiny to assess if improper ulterior motive existed, either on the part of the debtor, the creditor, or both, the Code simply draws a line in the sand and says from ninety days out to the moment of filing any non-pro-rata transfers of property, or of an interest in property,⁵⁰ of the debtor to unsecured creditors must be restored to the estate,⁵¹ absent a meritorious defense.⁵² In this fashion, the law enforces *ex ante* a system of pro rata distribution.

Of course, it's a bit more nuanced than that simple explanation might lead one to believe. That's where the other elements of § 547(b)

50. The broad definition of “transfer” in 11 U.S.C. § 101(54) (2012), includes not only the outright alienation of property (e.g., a payment), but also a conveyance of a portion of a debtor’s interest in property—less than all the sticks. Of course, the most common example of the transfer of an interest in property is the granting to a creditor of a security interest in the debtor’s property.

51. In effect, § 547 operates to impose a sort of legal no-fly zone where the status quo must be maintained insofar as transfers of the debtor’s property are concerned in order to preserve the assets available for ratable distribution to unsecured creditors. The statute is clear that the trustee bears the burden of proof with respect to the elements of a voidable preference, and the defendant bears the burden of establishing a valid defense under subsection (c). *See* 11 U.S.C. § 547(g) (2012). Because the earmarking doctrine is extra-statutory there is some disagreement over which party bears the burden of proof. As it is related to one of the elements in 11 U.S.C. § 547(b) (2012)—i.e., an interest of the debtor in property—an argument can be made that the burden of proving the non-applicability of the doctrine ought to be on the trustee. However, since the earmarking doctrine operates as a defense, logically the defendant should bear the burden once the trustee makes a preliminary showing that the transfer was “of an interest of the debtor,” and most courts agree. *See* Chase Manhattan Mortg. Corp. v. Shapiro (*In re Lee*), 530 F.3d 458, 468 (6th Cir. 2008) (placing the burden of proving the earmarking defense on the defendant); Schubert v. Lucent Tech. Inc. (*In re Winstar Commc’ns, Inc.*), 554 F.3d 382, 400–01 (3d Cir. 2009). The Eighth Circuit has held, however, that “the trustee [has] the burden to prove the earmarking defense does not apply.” Kaler v. Cmty. First Nat’l Bank (*In re Heitkamp*), 137 F.3d 1087, 1089 (8th Cir. 1998). A hybrid approach was adopted by the court in FBI Wind Down Liquidating Tr. v. All Am. Poly Corp. (*In re FBI Wind Down, Inc.*), 581 B.R. 116, 133 (Bankr. D. Del. 2018) (“As long as the Liquidating Trustee has proven its initial burden of showing an interest of the debtor in property, the burden shifts to the Defendant to prove earmarking.”); *see also* Cage v. Wyo–Ben, Inc. (*In re Ramba, Inc.*), 437 F.3d 457, 460 (5th Cir. 2006) (indicating that the “trustee bears the burden of proving that the debtor had an interest in the” property transferred); Stingley v. AlliedSignal, Inc. (*In re Libby Int’l, Inc.*), 247 B.R. 463, 467 (B.A.P. 8th Cir. 2000) (holding because the earmarking exception “is not strictly an affirmative defense . . . under which the defendant has the burden of proof” but rather is an element of the trustee’s proof under § 547(b)). *But see* Manty v. Miller & Homes, Inc. (*In re Nation-Wide Exch. Servs., Inc.*), 291 B.R. 131,147 (Bankr. D. Minn. 2003) (observing that the cases that place the burden of proof on the trustee are not fully tenable as a matter of logic because, as a practical matter, it “essentially requires the proponent of a case in chief to prove a compounded negative—that is, to frame up what would be necessary to defeat an element of its own cause of action, by way of a transactional structure and sequence, and then to ‘prove’ that it had not been so in reality.”). Relatedly, if the doctrine is not an affirmative defense, then it is not waived by failing to plead it in the answer to a preference action. *See* Metcalf v. Golden (*In re Adbox, Inc.*), 488 F.3d 836, 842 (9th Cir. 2007).

52. *See supra* note 11.

(beyond transfer of an interest of the debtor in property) of a voidable preference come into play; *i.e.*, to or for the benefit of a creditor,⁵³ while insolvent⁵⁴, on account of an antecedent debt, and that meets the greater amount test of § 547(b)(5).⁵⁵ Each of these elements serves the equality explanation for the preference law. If the debtor is not insolvent (or rendered so by the transfer), other creditors are not disadvantaged by the transfer because there are still adequate fish and loaves to go around. If the transfer at issue was not on account of an antecedent debt, but rather in return for commensurate new value,⁵⁶ again the net effect is neutral insofar as other general creditors are concerned.⁵⁷ Finally, if the greater amount test (which requires the transferee-creditor to have received more due to the transfer than it would have received in a hypothetical liquidation under Chapter 7 of the Code in which the transfer did not occur) is not satisfied, then there is likewise no preference.⁵⁸ For example, a transfer to a fully-secured creditor will never meet the greater amount test because, by definition, there is a *pro tanto* return of value to the estate for each dollar paid in the form of release of collateral from the secured creditor's priority lien, and those dollars are now available for distribution to general unsecured creditors.⁵⁹

53. See *infra* text accompanying notes 247–51.

54. Insolvency is presumed during the non-insider preference period. See 11 U.S.C. § 547(f) (2012). Under the definition in Code § 101(32), insolvency is defined in the balance-sheet sense of liabilities in excess of assets at fair market value. This presumption serves to shift the burden of production to the defendant, but not the burden of proof, which remains on the trustee. See *Lawson v. Ford Motor Co. (In re Roblin Indus., Inc.)*, 78 F.3d 30, 34 (2d Cir. 1996).

55. The greater amount test focuses on whether the transferee is better off due to the transfer than it would have been had the transfer not been made and the debtor's estate liquidated under Chapter 7. See *infra* text accompanying note 58. See generally *Schoenmann v. Bank of the W. (In re Tenderloin Health)*, 849 F.3d 1231, 1235–36 (9th Cir. 2017). It is not necessary to establish a diminution of the debtor's assets to prove whether the "greater amounts test" is satisfied. See *infra* text accompanying note 263. This is why, in an earmarking situation the creditor receiving the payment may (indeed usually will) be better off, but there may still be no preference because there has been no depletion of the assets available for distribution to unsecured creditors. See *supra* note 38.

56. "New value" is defined in 11 U.S.C. § 547(a)(2) (2012).

57. Professor Countryman has described the greater amount test of § 547(b)(5) as an extension of the diminution of the estate doctrine widely adhered to under the Bankruptcy Act. See Vern Countryman, *Bankruptcy Preferences—Current Law and Proposed Changes*, 11 U.C.C. L.J. 95, 99 (1978). But see *infra* note 263.

58. "A preference is a transfer that enables a creditor to receive payment of a greater percentage of his claim . . . than he would have received if the transfer had not been made and he had participated in the distribution of the assets of the bankrupt[cy] estate." H.R. REP. NO. 95–595 at 177, (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6139.

59. *E.g. Brown v. Mt. Prospect State Bank (In re Muncrief)*, 900 F.2d 1220, 1224 n.4 (8th Cir.1990) (earmarking defense will not apply where a security interest is granted for

Stepping back a pace from the formal language of the Code in § 547(b) and imagining, in metaphoric terms, what it describes from the perspective of deeply-rooted bankruptcy policy, the image that emerges is that of a piggy bank containing a fixed number of coins (all of the same value) as of the beginning of the applicable preference period. Applying the bankruptcy rule of pro rata distribution to similarly-positioned (*i.e.*, unsecured) creditors, if the diversion of the coins transferred to the recipient-creditor during the preference period has the effect of reducing the number of coins available for distribution among all other unsecured creditors beyond the amount of the transferee's ratable share,⁶⁰ then a preference has occurred that may be avoided and, if applicable, recovered by the estate.⁶¹ Stated another way, in that circumstance, the transfer has resulted in an advantage to the preferred creditor *at the expense* of other creditors with similar rights, thus undermining the ideation of equity *inter se* that the Code seeks to assure.⁶²

Juxtaposed against this account of preference theory, the deterrence explanation for the preference law fails to provide a satisfying or adequate justification that might prove helpful in crafting sound

funds used to retire an unsecured debt); Official Comm. of Unsecured Creditors of 360 Networks (USA) Inc. v. AAF—McQuay, Inc. (*In re* 360 Networks (USA) Inc.), 327 B.R. 187, 190 (Bankr. S.D.N.Y. 2005) (opining that a transfer to a fully-secured creditor will not be regarded as preferential); Marlow v. Rollins Cotton Co. (*In re* Julien Co.), 168 B.R. 647, 659 (Bankr. W.D. Tenn. 1994) (describing the operation of the requirement in § 547(b)(5) that the creditor “receive[] more” as a result of the challenged transfer than it would have received in a hypothetical Chapter 7 liquidation on the basis that a payment to a fully-secured creditor does not diminish the estate). By contrast, if the claim is undersecured, the payment will be preferential to the extent of the difference between the amount of the indebtedness and the value of the collateral. This is due to the bankruptcy treatment of partially secured claims in § 506(a), providing that a claim is secured only to the extent of the value of the collateral. *See generally* Rice v. M-Real Estate (*In re* Turner Grain Merch.), 595 B.R. 295, 305–06 (Bankr. E.D. Ark. 2018) (explaining the difference for purposes of § 547(b)(5) of whether the claim is secured, unsecured, or partially secured). As a practical matter, the only other time the test will not be satisfied is in the case where the debtor's creditors would be paid 100 cents on the dollar in the hypothetical Chapter 7 liquidation.

60. This is the diminution doctrine that is central to preference analysis. Weisfelner v. NAG Invests. LLC (*In re* Lyondell Chem. Co.), 567 B.R. 55, 119 (Bankr. S.D.N.Y. 2017) (“Under the diminution of the estate test, a debtor's transfer of property constitutes a transfer of an interest of the debtor in property [for purposes of preference claim] if it deprives the bankruptcy estate of resources which would otherwise have been used to satisfy the claims of creditors.”) (quoting Parks v. FIA Card Servs., N.A. (*In re* Marshall), 550 F.3d 1251, 1256 (10th Cir. 2008) (internal quotation marks removed).

61. In the case of a transfer in the form of an actual payment, upon avoidance, § 550(a) authorizes the trustee to recover the property transferred or its value. If the transfer was of an interest in property (*see supra* note 50), the lien against the debtor's property will be stripped off by avoidance so there is nothing further to recover.

62. *See supra* note 38 and *infra* note 221.

and cogent responses to questions bearing on preference liability,⁶³ such as the scope of the earmarking doctrine. Discouraging creditors from racing to the courthouse to get ahead of their brethren only promotes equality if a pin is stuck in the map on the ninetieth day before filing for all to see. Then, presumably, creditors would know that any further collection efforts would be at risk of being unwound. However, the 90th day prior to the filing is, by definition, unknown and not knowable until the actual date of filing; it is always established retrospectively. The existence of the preference law, therefore, is just as likely to encourage creditors to act at the slightest sign of distress in order to get ahead of “the later to be set” 90-day marker as they are to be deterred. Indeed, since there is no penalty for accepting a preferential payment beyond its return, there would be little downside to initiating collection efforts even if a creditor *knew* its actions were occurring inside the preference period.⁶⁴ At the same time, and perhaps even more troubling, a deterrence explanation also revives the concept of *mens rea* back into preference analysis in a fashion that can have and has had a deleterious impact by expanding of the scope of the statutory exceptions to preference liability in a manner that not only fails to promote creditor equality but actually works against it, most notably the ordinary course of business exception in § 547(c)(2).⁶⁵ In sum,

63. While the legislative history of the Code does refer to dual policies of equality and deterrence to be served by the preference laws (*supra* note 6), it also indicates that a creditor's state of mind has nothing whatsoever to do with the policy of equality of distribution, and whether or not he knows of the debtor's insolvency does little to comfort other creditors similarly situated who will receive that much less from the debtor's estate as a result of the prebankruptcy transfer to the preferred creditor. To argue that the creditor's state of mind is an important element of a preference and that creditors should not be required to disgorge what they took in supposed innocence is to ignore the strong bankruptcy policy of equality among creditors. See H.R. REP. NO. 95-595, at 177 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6139.

64. See Countryman, *supra* note 7, at 748 (suggesting that, despite the legislative history discussing the aim of “detering creditors from scrambling for advantage,” it seems “ridiculous to expect [the preference law to produce] deterrence”); McCoid, *supra* note 7, at 263-64 (offering reasons to be skeptical of preference law's deterrent effect); Tabb, *supra* note 7, at 986-94 (discussing the primacy of the equality over deterrence explanation for the preference law); see also Brook Gotberg, *Optimal Deterrence and the Preference Gap*, 2018 BYU L. REV. 559 (2018) (citing empirical evidence in support of the proposition that the preference law has little deterrent effect and, without much enthusiasm for the deterrence rationale, offering for perspective a set of legislative modifications that might result in achieving deterrence of the sort that Congress had in mind in 1978).

65. See Ponoroff, *Flight From Equality*, *supra* note 7, at 361-64 n.172 (describing § 547(c)(2) as the exception that threatens to undermine the equality explanation for the preference law by signaling that “innocence” should be a defense); see also Skeel, *supra* note 8, at 720 (observing that “[m]uch of the leakage in current preference law can be traced to the expansiveness of the safe harbor for payments made in the ordinary course of business.”).

deterrence, whatever role it may have played in the past, makes little or no sense as a vitalizing principle supporting the inclusion of preference liability in modern bankruptcy law.

III. THE EARMARKING DOCTRINE

The earmarking doctrine traces its origins as a judicially-created exception to preference recovery back to the Bankruptcy Act of 1898.⁶⁶ The intellectual lineage of the doctrine can first be found in the Supreme Court's opinion rendered in *National Bank of Newport v. National Herkimer County Bank*,⁶⁷ a case involving two corporations under common management and, possibly, ownership.⁶⁸ In abbreviated form, the note of company #1 was issued to company #2 in payment for supplies and then indorsed by company #2 to the defendant/bank in return for credit.⁶⁹ On September 26, 1903, company #2 paid the note from its own funds and re-took possession of the instrument.⁷⁰ Company #2 then credited the amount of the payment to a larger open-account debt owed by it to company #1.⁷¹ Within four months of the payment to the bank, company #1 filed for bankruptcy and the trustee challenged the payment as a voidable preference.⁷²

In particularizing the essence of a preferential transfer under § 60 of the 1898 Act, the Court explained that:

[i]t is not the mere form or method of the transaction that the act condemns, but the appropriation by the insolvent debtor of a portion of his property to the payment of a creditor's claim, so that thereby the estate is depleted and the creditor obtains an advantage over other creditors.⁷³

While observing that cancellation of an account receivable of the debtor is susceptible to being a preferential transfer, the Court

66. See Act of July 1, 1898, ch. 541, 30 Stat. 544 (1898), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 [hereinafter the "1898 Act"]; see also *Adams v. Anderson (In re Superior Stamp & Coin Co.)*, 223 F.3d 1004, 1008 (9th Cir. 2000) (reviewing the history of the earmarking doctrine); *Moser v. Bank of Tyler (In re Loggins)*, 513 B.R. 682, 700-01 (Bankr. E.D. Tex. 2014 (same)).

67. 225 U.S. 178 (1912).

68. *Id.* at 181 (noting that ownership interests were not apparent based on the record, other than neither company held an equity position in the other, but management was largely in the same hands).

69. *Id.* at 181. Apparently, this arrangement was repeated on several occasions. *Id.* at 181-82.

70. *Id.* at 182.

71. *Id.* at 183.

72. *Id.* at 179, 183. As noted earlier, the preference period under the 1898 Act was four months. See *supra* note 49.

73. *Bank of Newport*, 225 U.S. at 184.

explained that, “unless the 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.”⁷⁴ The Court continued that such a diminution of the estate did not occur in this case because company #2 had standing, as an endorser of the note, to satisfy the obligation, which is what in fact occurred.⁷⁵ Therefore, the Court concluded that, “[n]either directly nor indirectly was this payment to the bank made by the [bankrupt company #1], and the property of that company was not thereby depleted.”⁷⁶ Notably, the result hinged on the fact that company #2 could not legally treat the payment as an allowable setoff against its debt to company #1 under § 68b of the Act.⁷⁷

In essence, company #2, as original payee of the note, was a creditor of company #1. Upon indorsement and delivery of the note to the bank, both companies became liable on the note to the bank. When the note was reacquired by company #2, it was substituted for the bank as obligee, but because the attempt to set off the payment against amounts owed to company #1 by company #2 was not recognized, there were neither fewer coins in the debtor’s piggy bank as a result of the payment to the bank nor greater claims in the aggregate against those coins.

The situation where the new creditor is, for instance, a guarantor differs from the situation where the new creditor is not a surety in that there is an independent obligation owed by the surety to the old creditor. Under the Code, prior to a payment from a guarantor, the

74. *Id.* at 184–85 (citations omitted).

75. *Id.* at 185. Of note, however, while this was certainly true of company #2’s situation, that status was not critical to the ultimate holding in the case, which, instead, was tied to the question of whether the debtor’s assets were depleted as a result of the transfer. *See infra* note 152. The point was important in the case because the payment from company #2 went directly to the bank, so its liability thereon was unquestioned. In the typical earmarking situation, the funds pass through the debtor as a conduit of sort. *See, e.g.,* Buckley v. Jeld-Wen, Inc. (*In re* Interior Wood Prods. Co.), 986 F.2d 228, 231 (8th Cir. 1993) (noting that “[t]he earmarking doctrine is typically applicable when a third party makes a loan to a debtor specifically to enable the debtor to satisfy the debt of a designated creditor. In other words, a new creditor is substituted for an old creditor.”).

76. *Bank of Newport*, 225 U.S. at 185. An additional, but flawed, rationale later courts offered in justifying application of the earmarking doctrine in the case of guarantors or other codebtors has been the view that such a result was needed to avoid unfairness and inequity to the new creditor, in that if the transfer to the old creditor is voided, and the money was placed in the bankruptcy estate, the new creditor, as guarantor, might end up having to pay a second time. *See supra* note 36 & *infra* text accompanying notes 217–219.

77. *Id.* at 186 (this meant that the amount of the indebtedness of company #2 could still be collected by the trustee for the estate).

surety holds a contingent reimbursement claim against the debtor.⁷⁸ Upon actual payment to the common creditor, the contingency is removed and the claim is allowed.⁷⁹ This is why a direct payment to the creditor is not preferential and why all earmarked payments from the surety to the common creditor should likewise not be regarded as preferential if made solely to discharge the common debt.⁸⁰ However, it needs to be stressed that it does not inevitably follow from this fact that this is the *only* circumstance where payments might properly escape characterization as a preference under the earmarking doctrine.⁸¹ Stated another way, a difference in degree does not always translate into difference in kind.⁸²

The Court in *National Bank of Newport* never used the term “earmarking,” and, technically, it was not what we have now come to call an “earmarking” case because the funds never passed through the debtor’s hands or came into its possession. However, the principle that a transfer could not be recovered from a transferee, regardless of form, if it did not interfere with the value of the pro rata dividend to unsecured creditors was established and began to be applied by the courts.⁸³ According to subsequent case authority,⁸⁴ invention of the term in this context is attributed to Judge Augustus Hand in a 1938 decision from the Second Circuit.⁸⁵ In that case, the court distinguished the facts from those of *National Bank of Newport* based on the absence of any evidence that the new creditor, with respect to the two alleged preferential transfers at issue, made its loans on the condition that the proceeds be applied to a particular existing debt.⁸⁶ The court continued, “[t]he existence of . . . control determines whether the payments were preferential transfers by the bankrupt [now

78. 11 U.S.C. § 101(5)(A) (2012).

79. 11 U.S.C. § 502(e)(2) (2012).

80. This is essentially what transpired in *Nat’l Bank of Newport*, 225 U.S. at 185. See *supra* note 75.

81. See *infra* Section III.A.2.

82. See *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.)*, 100 B.R. 127, 133 (Bankr. D. Mass. 1989) (making the point that the holding in *Nat’l Bank of Newport* did not hinge on the fact that the party making the payment was a surety).

83. See, e.g., *Bank of Am. Nat’l Tr. & Sav. Ass’n v. Small (In re Zaferis Bros.)*, 67 F.2d 140 (9th Cir. 1933); *First Nat’l Bank v. Phalen*, 62 F.2d 21 (7th Cir. 1932).

84. See *McCuskey v. Nat’l Bank of Waterloo (In re Bohlen Enters., Ltd.)*, 859 F.2d 561, 565 n.8 (8th Cir. 1988).

85. *Smyth v. Kaufman (In re J.B. Koplik & Co.)*, 114 F.2d 40, 43 (2d. Cir. 1940).

86. *Id.* at 42.

debtor] or were payments by a third party who did not make the loans generally but made them only on condition that a particular creditor receive the proceeds.”⁸⁷

That the earmarking doctrine survived enactment of the Code, even though the plain language of § 547 does not include “earmarking” among the statutory defenses set forth in § 547(c),⁸⁸ seems beyond serious quibble.⁸⁹ In response to an argument that the doctrine did not weather adoption of the Code as an integral facet of the current preference regime, the bankruptcy court in *In re EUA Power Corp.*⁹⁰ pointed out that the judicial development of the earmarking doctrine under the Bankruptcy Act was deeply entrenched in case law by the time when the Code was being drafted during the 1970s.⁹¹ The court continued that the legislative history pertinent to the preference statute of the Bankruptcy Code contains no indication that Congress sought to eliminate recognition of, what the court described as, “this well-established judicial interpretation of the statute.”⁹² The *EUA Power* court also pointed out that the statutory language regarding preferences under the Bankruptcy Act was essentially identical to the

87. *Id.* In support of their argument that the transfer was not preferential, the defendants relied on a decision from the court made two years earlier in which such an earmarking defense had been permitted. *Grubb v. General Contract Purchase Corp.*, 94 F.2d 70 (2d Cir. 1938), discussed *infra* text accompanying notes 119–36.

88. The earmarking doctrine is not properly a judicially-created addition to Code § 547(c), though it operates in much the same fashion, but rather a heuristic for construing the language “an interest of the debtor in property” in Code § 547(b). Although not the focus in this Article, this is why the earmarking doctrine has also been invoked and recognized in fraudulent transfer cases. *See supra* note 13. Code § 548 uses essentially the same language concerning “an interest of the debtor in property.” *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) (claiming that the exception in § 547(c)(1) represents a codification of the earmarking doctrine, and, thus, displaced the common law doctrine recognized under the 1898 Act).

89. *Glinka v. Bank of Vt. (In re Kelton Motors, Inc.)*, 153 B.R. 417, 425 (Bankr. D. Vt. 1993) (pointing out that the earmarking doctrine has received widespread acceptance in a variety of jurisdictions since adoption of the Code); *see also* authorities cited *infra* note 96.

90. *Official Bondholders Comm. v. E. Utils. Assocs. (In re EUA Power Corp.)*, 147 B.R. 634 (Bankr. D. N.H. 1992).

91. *Id.* at 640–41.

92. *Id.* at 641. It is also widely recognized that authority under the 1898 Act continues to be precedential, except where expressly stated otherwise in the Code or legislative history. *See Dewsnap v. Timm*, 502 U.S. 410, 419 (1992) (“[T]his Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history.”); *Midlantic Nat’l Bank v. N.J. Dept. of Env’tl. Protection*, 474 U.S. 494, 501 (1986) (“The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially-created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications.”) (citation omitted).

language of the preference section in the Bankruptcy Code.⁹³ In short, then, the court found that there was no basis for credibly maintaining that Congress intended to abolish the earmarking doctrine under the Code's preference regime.⁹⁴

As early as 1986,⁹⁵ the Fifth Circuit Court of Appeals observed: "The earmarking doctrine is widely accepted in the bankruptcy courts as a valid defense against a preference claim"⁹⁶ In that Chapter 11 case, the preference action was brought by the creditor's committee, which was granted authority by the bankruptcy court to bring the case after the debtor-in-possession refused to take action.⁹⁷ The new creditor was a subsidiary of the debtor that had hypothecated assets to secure the debt, but had not assumed *in personam* liability for the obligation.⁹⁸ The court concluded that, although the funds from the subsidiary had been deposited into the debtor's account, "no semblance of control [by the debtor] went with them."⁹⁹ Thus, the court found the lower court's application of the earmarking doctrine to be appropriate.¹⁰⁰ In so doing, the court rejected the committee's additional argument that the doctrine could not be employed because of the lack of proof that the third

93. *EUA Power*, 147 B.R. at 642; see also *McCuskey v. Nat'l Bank of Waterloo (In re Bohlen Enters., Ltd.)*, 859 F.2d 561, 565 (8th Cir. 1988) (noting that equivalent language has existed in the Bankruptcy Act for many decades). As a general proposition, where there is not meaningful difference between provisions of the 1898 Act and the Code, judicial precedent developed under the former may be used in interpreting the analogous provisions of the latter. See e.g., *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 208 (1983) (interpreting § 542(a) of the Code); *Union Leasing Co. v. Peninsula Gunitite, Inc. (In re Peninsula Gunitite, Inc.)*, 24 B.R. 593, 594 (B.A.P. 9th Cir. 1982) (involving administrative expense claims).

94. *EUA Power*, 147 B.R. at 641-42. See also *Steinberg v. NCNB Nat'l Bank (In re Grabill Corp.)*, 135 B.R. 101, 107-10 (Bankr. N.D. Ill. 1991) (rejecting an attack on the continued viability of the earmarking doctrine under the Code based on "ample support in the judicial gloss of the . . . Code and former Bankruptcy Act").

95. The first court of appeals decision under the Code to recognize the earmarking doctrine was *Kapela v. Newman*, 649 F.2d 887, 892 (1st Cir. 1981).

96. *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1356 (5th Cir. 1986), *reh'g denied*, 801 F.2d 398 (5th Cir. 1986) (citing *Kapela*, 649 F.2d at 893); *Brown v. First Nat'l Bank of Little Rock, Ark.*, 748 F.2d 490 (8th Cir. 1984); *Schilling v. Electronic Realty Assocs., Inc. (In re Hearn)*, 49 B.R. 143 (Bankr. W.D. Ky. 1985); *Hargadon v. Cove State Bank (In re Jagers)*, 48 B.R. 33 (Bankr. W.D. Tex. 1985); *Genova v. Rivera Funeral Home (In re Castillo)*, 39 B.R. 45 (Bankr. D. Col. 1984).

97. *Coral Petroleum*, 797 F.2d at 1354. The Fifth Circuit also upheld a challenge to the committee's standing. *Id.* at 1362-64.

98. *Id.* at 1353.

99. *Id.* at 1360.

100. See *id.* at 1362.

party payor intended to restrict application of the funds, and the related fact that the actual restrictions came from the defendant or the debtor.¹⁰¹

IV. SCOPE OF THE EARMARKING DOCTRINE

A. *Two Views: An Overview*

1. *The Codebtor Limitation*

There has been considerable discord in the case law in relation to when the earmarking doctrine will apply. As noted above in connection with the discussion of *WB Services*,¹⁰² the most restrictive view is the one that requires that the new creditor be a codebtor on the obligation that is satisfied with the funds provided by the “new lender.”¹⁰³ The justification offered for this view is that, in the codebtor situation, the guarantor or other obligor risks having to pay twice if the payment to the old creditor is construed to be, and recovered as, a voidable preference, and this risk does not exist when the new lender is not a guarantor or other codebtor.¹⁰⁴ It is not clear, however, that this distinction is entirely valid, as discussed elsewhere in this Article.¹⁰⁵ Moreover, it also wrongly assumes that there is no risk of inequitable

101. *Id.* at 1361 (demonstrating the third-party’s intent is one way of showing the debtor’s lack of dispositive control, but it is not the exclusive method, “especially if there is adequate proof of the lack of control by a debtor.”).

102. *See supra* text accompanying notes 24–35.

103. *See, e.g.,* *Manchester v. First Bank & Tr. Co. (In re Moses)*, 256 B.R. 641, 645–49 (B.A.P. 10th Cir. 2008) (advancing an argument that explains why the earmarking doctrine should not be extended beyond codebtor cases); *Gray v. Travelers Ins. Co. (In re Neponset River Paper Co.)*, 231 B.R. 829, 835 (B.A.P. 1st Cir. 1999) (affirming the bankruptcy court’s refusal to apply the earmarking doctrine on the ground, *inter alia*, that the funds at issue were not supplied by a guarantor; the use of the funds must benefit the party supplying the funds); *Geremia v. Fordson Assocs. (In re Int’l Club Enters., Inc.)*, 109 B.R. 562, 566–67 (Bankr. D. R.I. 1990) (stating “we agree . . . that extension of the earmarking doctrine beyond the guarantor situation is both unwise and unwarranted, and would inevitably result in an inequitable treatment of creditors.”). Other cases have applied the doctrine in non-codebtor cases but expressed reluctance over doing so. *E.g.,* *Lucker v. Lewis Auto Glass, Inc. (In re Francis)*, 252 B.R. 143, 146–47 (Bankr. E.D. Ark. 2000); *Glinka v. Bank of Vt. (In re Kelton Motors, Inc.)* 153 B.R. 417, 427 (Bankr. D. Vt. 1993) (noting the criticism of the doctrine beyond the codebtor case expressed by the Eighth Circuit in *McCuskey v. Nat’l Bank of Waterloo (In re Bohlen Enters., Ltd.)*, 859 F.2d 561, 566 (8th Cir. 1988)); *see infra* notes 145–57 and accompanying text for further discussion of the holding in *Bohlen*. Of course, a guarantor or other person liable on the debt is not really a “new creditor” inasmuch as the Code provides such parties with a contingent claim for reimbursement or contribution. *See* §§ 101(5)(A) and 502(e); *infra* text accompanying note 216.

104. *Moses*, 256 B.R. at 646 (observing that earmarking is equitable in codebtor cases because if the transfer were to be avoided, the codebtor would be subject to double liability); *see also supra* note 36.

105. *See supra* note 37 and *infra* text accompanying note 226.

treatment of the new creditor in non-codebtor cases,¹⁰⁶ a detail illustrated perhaps by the *WB Services* case itself.¹⁰⁷ In any event, even if this distinction were accurate, whether it presents a sufficiently principled rationale for drawing a line marking the outer boundary of the earmarking doctrine is a different question entirely, and one that this Article answers in the negative.¹⁰⁸

Decisions applying the codebtor limitation suggest that when the new creditor is not a guarantor, or the like, the earmarking doctrine benefits no one other than the old creditor who, “in equity, deserves no such benefit.”¹⁰⁹ In addition to being wrong as a matter of fact, it is strongly urged that focusing on benefit or advantage to the creditor receiving the challenged transfer is misguided since what makes a preference actionable is not that what the creditor receives,¹¹⁰ but what the debtor’s estate has lost.¹¹¹

In *In re Moses*,¹¹² the Tenth Circuit’s Bankruptcy Appellate Panel engaged in an exhaustive review of the case law to date, noting the sharp division of authority over whether the earmarking doctrine is limited to codebtor cases.¹¹³ Relying on the absence of express statutory authority for the doctrine, and citing the broad definition of property of the estate in § 541 of the Code,¹¹⁴ the court concluded

106. See *Bohlen*, 859 F.2d at 566 (“The 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.”).

107. See *supra* note 37.

108. See *infra* Section VI.A (suggesting that the scope of the earmarking doctrine should be driven by the policy objectives that the preference law was intended to serve and not by weighing the relative equities among creditors).

109. Cases taking this view include *e.g.*, *Bohlen*, 859 F.2d at 566 (noting that “[t]he only person aided by the doctrine is the old creditor, who had nothing to do with earmarking the funds, and who, in equity, deserves no such benefit.”); *Moses*, 256 B.R. at 647; *Davis v. Kice Indus., Inc.*, (*In re WB Servs., LLC*), 587 B.R. 548, 557 (Bankr. D. Kan. 2018).

110. See *infra* note 222.

111. See *supra* note 38 and *infra* note 222.

112. *Manchester v. First Bank & Tr. Co.* (*In re Moses*), 256 B.R. 641 (B.A.P. 10th Cir. 2000).

113. *Id.* at 645–49.

114. By and large, cases cite the Supreme Court’s decision in *Beiger v. Internal Revenue Serv.*, 496 U.S. 53 (1990) for the proposition that the property of the debtor for preference purposes is best understood as constituting the property that would have been treated as property of the estate if it had not been transferred prior to the filing of the debtor’s bankruptcy proceeding. *Id.* at 58–59; see, *e.g.*, *Stingley v. AlliedSignal, Inc.* (*In re Libby Int’l, Inc.*), 247 B.R. 463, 466 (B.A.P. 8th Cir. 2000); *Moser v. Bank of Tyler* (*In re Loggins*), 513 B.R. 682, 696–97 (Bankr. E.D. Tex. 2014) (citing *Libby Int’l*); *Sherman v. TBK Bank* (*In re Dependable Auto Shippers, Inc.*), No. 17–3086, 2018 WL 4348049, at *13 n.36 (Bankr. N.D. Tex. 2018). *But see infra* text accompanying notes 266–73 and 288–92, postulating that the definition of property of the estate in § 541(a) should not necessarily control what is understood to be an interest of the debtor in property for purposes of § 547(b).

that earmarking should not be extended beyond the codebtor situation.¹¹⁵ In what highlights the crux of the conceptual dissonance that has plagued this subject to date, the court buttressed its holding by pointing out that the new creditor's funds at issue would have been available for general creditors if they had not been paid to the old creditor.¹¹⁶

The problem with *Moses*, and decisions like it, is that they start from the proposition that the earmarking doctrine should not be a basis to ignore or replace the “transfer of an interest of the debtor in property” language in 547(b), which might in fact be a defensible line. However, they then proceed to do *just that* by making an exception in the codebtor setting as necessary to avoid “inequity.”¹¹⁷ The inherent contradiction between the basis for the limitation—the dictates of the language of the statute itself—and the justification for the exception to the rule—equity—could hardly be more profound.¹¹⁸

2. *The Grubb Approach*

The codebtor requirement approach is in sharp contrast with the more traditional attitude toward the scope of the earmarking doctrine first expressed by Judge Learned Hand in the Second Circuit's decision in *Grubb v. General Contract Purchase Corp.*, allegedly made by the debtor using funds provided by three different lenders.¹¹⁹ The first transfer involved a \$25,000 note to which the defendant was pressing the debtor for payment. In response, the

115. *Moses*, 256 B.R. at 647.

116. *Id.* at 651. This somewhat metaphysical argument lacks reality. It is true in the non-codebtor case that new lender's advance to the debtor creates an indebtedness owed it by the debtor in return for the loan proceeds, just as a direct purchase of the old creditor's claim would have done. In an earmarking situation, however, the point is the two transactions are functionally indistinguishable. In substance, all that has occurred is that there has been a mere substitution of creditors here without any property transfer. In a recent opinion, it should be noted that the Tenth Circuit BAP, taking a very restricted view of the earmarking doctrine, rejected this argument in an unpublished opinion. *Colbert v. Walters (In re Wagenknecht)*, Adv. No 18-01018, 2019 WL 2353534, at *11 n.30 (10th Cir. B.A.P., June 4, 2019). In that case the debtor's mother advanced him exactly the sum needed for the purpose of paying off a law firm creditor. *Id.* at *10-11. Nonetheless, the court concluded the payment diminished the estate within the meaning of *Parks v. FIA Card Servs. (In re Marshall)*, 550 F.3d 1251 (10th Cir. 2008), even if it was uncontroverted that the mother would not have made the loan to the debtor for any purpose other than to pay the law firm. *Wagenknecht*, 2019 WL at *12 (finding that the use of the phrase “discretionary use” in *Marshall* was not central to the holding in the case).

117. In fact, because a guarantor already has secondary liability on the old debt, it is not even accurate to refer to it as a “new creditor,” though it is routinely done, including in this Article from time-to-time. *Supra* note 103.

118. If the language of the statute does not allow exception, it would seem that it *does not allow* exception. *See infra* text accompanying notes 213-14.

119. *Id.* at 71.

debtor's principal, one Smith, arranged for Manufacturers Trust Co. to "take over" the loan with the intention that the debtor would pay it off within a few days.¹²⁰ On May 14, 1935, Smith signed a note for \$25,000 on behalf of the debtor, the proceeds of which were placed in the debtor's account by Manufacturers Trust.¹²¹ The plan was for the debtor to promptly arrange payment to the defendant, but actual payment, via a cashier's check, did not occur until the following morning.¹²²

The second and third challenged payments, totaling \$12,500, were related. Following issuance by the debtor to the defendant of \$14,000 in checks that were returned for insufficient funds, Smith assured the principals of the defendant that he would see to it that \$12,500 was secured for the defendant.¹²³ To that end, on May 18, the debtor, again through Smith, arranged to borrow \$6,000 from the Dover Plains National Bank, after assuring the bank that the debtor was "in a jam" and that the additional \$6,500 was to be lent by one Cline of Wassaic, New York through an Amenia, New York bank.¹²⁴ After confirming the loan from Cline, Dover Plains agreed to lend the funds "to tide [the debtor] over in an emergency."¹²⁵ The debtor had a certified check in favor of defendant drawn against the account in which the Dover Plains funds had been deposited.¹²⁶ Although Cline appeared not to care how the \$6,500 loan from him was used, at the request of the debtor, Cline had his bank draw a check made payable directly to the defendant.¹²⁷

Because the debtor was insolvent on May 15 and May 18, and filed bankruptcy in June, the trustee brought a preference action under § 60b of the 1898 Act to recover all three payments. In its answer, the defendant asserted that none of the three payments was made with funds in the debtor's control or from the debtor's assets and, therefore,

120. The opinion indicates Smith was in "absolute control of the" debtor. *Id.*

121. *Id.*

122. *Id.* at 71–72. According to the opinion, the defendant was to surrender its own note for cancellation upon such payment and deliver to the Manufacturers Trust Co. the collateral securing the note. Unbeknownst to everyone but Smith, the instrument under which the defendant's interest in the collateral was created had been forged by Smith. *Id.* at 72.

123. *Id.* at 72.

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.* Apparently, Smith originally misrepresented how the loan proceeds would be used, but a representative of the Amenia bank, knowing the funds were going to the defendant, induced Smith to be honest with Cline.

recovery should be denied.¹²⁸ The trial court agreed and dismissed the trustee's complaint.¹²⁹ As to the first payment, from Manufacturers Trust, the court of appeals sustained the lower court's dismissal of the trustee's claim, reasoning that, although the funds had been deposited in the debtor's account, the defendant was paid by a cashier's check the next morning, and that "[i]t is entirely plain that the trust company did not intend to let [the debtor] have any control over the credit before it got the collateral"¹³⁰ from defendant along with assignment of the debtor's note.¹³¹

As to the payment through Cline, the court reached the same conclusion despite the fact that, in this instance, "Cline had no interest in what disposition Smith would make of the money which he lent him; and imposed no condition on it."¹³² However, Cline's loan was credited by the Amenia bank to Smith, and not the debtor, and then delivered to the defendant by check made payable to the defendant. Thus, the court agreed that the debtor had no control over the funds and that Cline's promise to loan was also not an asset of the estate because "... the loan was to be for only a few days and the damages recoverable upon the breach of such a promise would have been scarcely more than nominal."¹³³ The court found the transfer of funds from the Dover Plains bank to be a closer call due to the fact that, even though the bank certified the check made directly payable to the defendant, the funds remained in the debtor's possession until the check was actually delivered and negotiated.¹³⁴ Nevertheless, based on evidence that the purpose of the loan was made clear and it was intended as a very short-term accommodation for this purpose, the court ruled that there was a sufficient showing to support the finding below.¹³⁵

128. In support of its position, the debtor cited the Supreme Court's holding in *Nat'l Bank of Newport, N.Y. v. Nat'l Herkimer Co. Bank*, 225 U.S. 178 (1912), arguing that the transactions at issue entailed no more than "[a] substitution of one creditor for the another without loss to the estate, as when a surety gives money to [its] principal to discharge the debt." *Id.* at 72.

129. *Grubb*, 94 F.2d at 72.

130. *Id.* As noted *supra* note 123, both Manufacturers Trust Co. and the defendant assumed the collateral to be good.

131. *Id.*

132. *Id.* at 71–72.

133. *Id.* at 72–73 (citations omitted).

134. *See id.* When a drawee-bank "accepts" a check, it is assuming primary liability to pay. However, the court noted that under the then-governing Negotiable Instruments Law a drawer may return a certified check to the drawee (as opposed to deliver it to the named payee) and obtain reimbursement of the amount charged to the drawer's account on acceptance. Today acceptance of a check is defined in § 3-409 of Article 3 of the Uniform Commercial Code and the effect of acceptance governed by § 3-413.

135. *Grubb*, 90.F.2d at 73.

Because *Grubb* reflected the prevailing attitude toward the earmarking doctrine at the time of the adoption of the Code, it is worth noting a few highlights from the description above. As to the Manufacturers Trust and Dover Plains' transactions, what seemed to matter most to the court was the intention of the new creditor, and much less so possession or even control by the debtor. As to the Cline transfer, where the new creditor was apparently indifferent with over what Smith and/or the debtor did with the proceeds, what loomed largest was the debtor's apparent absence of any meaningful control. This suggests that, in fact, the court was employing an overall approach where no one factor is dispositive or even essential. Rather, what appears ultimately to have been most salient for the court was to discern from the totality of the circumstances the true substance and net effect of each transfer; *i.e.*, was it more like a direct transfer from the new creditor to the old creditor or was it more like an undesignated loan to the debtor and then an unrelated payment to the old creditor. Put in alternative words, did it diminish the value of the debtor's assets (and the later-to-be-formed) estate in a manner that compromised the core policy of ratable distribution.¹³⁶ That approach has much to commend itself, as addressed more fully below.¹³⁷

B. Code Authority

As explained earlier, there is no quarrel that the earmarking doctrine was carried forward under the Bankruptcy Code.¹³⁸ As to the scope of the doctrine, the aforementioned decision of the Fifth Circuit in *Coral Petroleum*,¹³⁹ one of the early circuit court of appeals decisions to address the issue post-Code, appeared to carry-forward much (although not all) of the logical reasoning of the Second Circuit in *Grubb*.¹⁴⁰ Specifically, the new creditor, although an indirect

136. See *Warsco v. Preferred Tech. Grp.*, 258 F.3d 557, 564 n.11 (7th Cir. 2001) ("Courts considering this element [interest of the debtor in property] of the preference provision have focused on whether the transfer diminished the debtor's estate."). That rationale was also used by the Court in *Nat'l Bank of Newport*, 225 U.S. 178 (1912), to buttress principal holding. *Id.* at 184.

137. See *infra* Section D.1.

138. See *supra* text accompanying notes 89–94.

139. *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351 (5th Cir. 1986), *reh'g denied*, 801 F.2d 398 (1986); see *supra* text accompanying notes 96–101.

140. *Grubb v. General Contract Purchase Corp.*, 94 F.3d 70 (2d Cir. 1938). This is not to say that the holding in *Coral Petroleum* squarely corresponds with *Grubb* inasmuch as the Second Circuit's decision took account of a wide range of considerations (see *supra* text accompanying note 137) whereas *Coral Petroleum* placed much greater emphasis on dominion or control over the funds by the debtor.

subsidiary of the debtor, was not jointly liable on the obligation.¹⁴¹ Moreover, the court held that neither the deposit of funds in the debtor's account prior to payment nor lack of proof that the new creditor *intended* to restrict use of funds to payment of the defendant alone (or in combination) negated application of the earmarking doctrine.¹⁴² Rather, for the *Coral Petroleum* court, the "key" to resolution of the issue depended on whether, as a practical matter, the debtor had any meaningful control over the funds when the allegedly preferential transfer occurred.¹⁴³

By contrast with *Coral Petroleum* the Eighth Circuit, in *In re Bohlen*,¹⁴⁴ approached the earmarking doctrine with much greater restraint and also took a very different approach than the methodology employed by Judge Hand in *Grubb*.¹⁴⁵ A factually convoluted case essentially involving a check-kiting scheme conducted by the debtor's president,¹⁴⁶ the trustee challenged three payments, totaling over \$191,000, made to the defendant-bank during the preference period.¹⁴⁷ The bank defended alternatively under the earmarking doctrine and failure of the facts to demonstrate satisfaction of the greater amount test in § 547(b)(5).¹⁴⁸ The bankruptcy court held that a portion of the transferred funds was shielded from avoidance under the earmarking doctrine and the district court affirmed.¹⁴⁹

141. The subsidiary did, however, place a deposit in the amount of the loan with the defendant to serve as pledged collateral. *Coral Petroleum*, 797 F.2d at 1353.

142. *Id.* at 1361–63. The district court had ruled that, while the *form* of the transfer might have indicated a payment from the subsidiary to the debtor, there was no issue of material fact that the *substance* of this transfer was anything other than a payment by the subsidiary to the defendant and that "[w]hat essentially occurred was a substitution of Lee-ward as a creditor for the creditor status of Paribas-Suisse." *Id.* at 1356.

143. *Id.* at 1358. The court's emphasis on "control" over the funds or their deployment makes the holding narrower than the holding in *Grubb*. It is also, ultimately, not helpful. See Carlson & Widen, *supra* note 88, at 596-97 (pointing out that control is too manipulable to serve as a reliable criterion and "provide[] no guidance to courts whatever."); see also *infra* note 203 (collecting case authority that take a variety different approaches to the concept of control).

144. *McCuskey v. Nat'l Bank of Waterloo*, 859 F.2d 561 (8th Cir. 1988).

145. *Id.* at 566 (citing *Grubb* as among the cases that adopted what the court described as an extension of the earmarking doctrine that lacked any basis).

146. *Id.* at 562–64.

147. "All three checks were payable to the [defendant-bank]." *Id.* at 562.

148. *Id.* at 564. The opinion did not address the defendant's argument under § 547(b)(5), but, once it was determined that the proceeds from the new loan became property of the estate, it is unlikely that the trustee would have much difficulty in establishing satisfaction of the greater amount test.

149. *Id.* The bankruptcy judge concluded that approximately \$125,000 was shielded under the earmarking doctrine since that was the amount that the debtor had indicated to the new lender would be paid to the defendant to retire an existing debt. Instead, what the debtor

On further appeal, the Eighth Circuit noted that the earmarking doctrine had been routinely extended beyond the codebtor situation that obtained in the Supreme Court's decision *National Bank of Newport v. National Herkimer County Bank*,¹⁵⁰ and that many courts have applied it where the new creditor simply lends funds to the debtor or pays the old creditor directly.¹⁵¹ Even though the holding in *National Bank* did not necessarily depend on the fact that the new creditor was a guarantor,¹⁵² the *Bohlen* court expressed serious misgivings over the wisdom of this expansion of the earmarking doctrine in circumstances where there is no guarantor.¹⁵³ Nevertheless, the court refrained from ruling as to whether the earmarking doctrine "should be preserved, limited, or even rejected" in the non-guarantor scenario,¹⁵⁴ and instead adopted a three-part test for determining whether the earmarking doctrine applies.¹⁵⁵ Because the second element—performance of the agreement

did is paid off a larger obligation to the defendant/bank that had not been disclosed to the new lender.

150. 225 U.S. 178 (1912).

151. *Bohlen*, 859 F.2d at 564–65.

152. In *Nat'l Bank of Newport*, the Court did state that, as an endorser on the note from the debtor, the debtor's subsidiary had standing to pay the obligation, which is true. See *supra* text accompanying notes 75–76. However, there is nothing intrinsic to the holding in the decision that suggests that the source funds involved in payment of the old creditor must come from a surety of one kind or another. See *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.)*, 100 B.R. 127, 139 (Bankr. D. Mass. 1989) (observing, in rejecting the argument that the holding in *Nat'l Bank of Newport* was confined to sureties, that the Court's emphasis was upon the fact that the funds never become part of the debtor's property rather than upon the motive for payment).

153. *Bohlen*, 859 F.2d at 566; see also *Kaler v. Cmty. First Nat'l Bank (In re Heitkamp)*, 137 F.2d 1087, 1088–89 (8th Cir. 1998) (applying *Bohlen* in the context of the refinancing of a secured debt). The holding in *Heitkamp* is discussed critically *infra* Section VI.D., although not with respect to its conclusion that application of the earmarking doctrine is not limited to situations in which the new creditor is secondarily liable for the earlier debt.

154. *Bohlen*, 859 F.2d at 566.

155. *Id.* The three components of the test are:

- (1) the existence of an agreement between the new lender and the debtor that the new funds will be used to pay a specified antecedent debt
- (2) performance of that agreement according to its terms . . .
- (3) the transaction viewed as a whole (including the transfer in of the new funds and the transfer out to the old creditor) does not result in any diminution of the estate.

Accord Shubert v. Lucent Techs. Inc. (In re Winstar Commc'ns., Inc.), 554 F.3d 382, 400 (3d Cir. 2009).

between the new lender and the debtor in accordance with its terms—was not met on the facts of the case, the court concluded that the judgment below should be reversed.¹⁵⁶

In a dissenting opinion that tracks much more closely than the majority opinion to the argument advanced in this Article,¹⁵⁷ Judge McMillian noted that “[i]f a transfer has no effect on the assets of the debtor available for distribution to creditors, it is not a preferential transfer.”¹⁵⁸ On the facts of the case, the dissent observed that the transfer to the old creditor was traceable to funds that the new creditor advanced to the debtor specifically for that purpose and without intent that they would become unrestricted property of the debtor.¹⁵⁹ Thus, citing the lower court opinion in *Grubb*,¹⁶⁰ the *Bohlen* dissent concluded that “the debtor’s momentary physical control over the funds” was not alone sufficient to defeat the earmarking doctrine,¹⁶¹ and the payment of such funds to the old creditor in no way diminished the estate.¹⁶² For these reasons, Judge McMillan argued that the lower courts’ denial of the preference challenge should have been affirmed.¹⁶³

The majority opinion in *Bohlen* is puzzling. While sharply critical of cases that expand the scope of the earmarking doctrine beyond the codebtor situation, its’ holding did not limit application of the doctrine to that scenario; its three-prong test wholly ignores the status of the new creditor.¹⁶⁴ Moreover, nowhere in the standard applied by the court is the requirement, so central in *Coral Petroleum*, that the debtor

156. *Bohlen*, 859 F.2d at 567. The debtor had applied the funds to a loan other than the one that the new creditor stipulated should be paid off with the new loan proceeds. *Id.* at 563.

157. *See infra* Section VI.D.

158. *Bohlen*, 859 F.2d at 568 (McMillian, Circuit J., dissenting).

159. *Id.*

160. *Grubb v. Gen. Contract Purchase Corp.*, 18 F. Supp. 680, 682 (S.D.N.Y. 1937), *aff’d*, 94 F.2d 70 (2d Cir. 1938).

161. *Bohlen*, 859 F.2d at 568-69 (“[T]he debtor’s momentary physical control over the funds does not preclude application of the ‘earmarked funds’ doctrine”). *But see* Buchwald Capital Advisors LLC v. Metl-Span I, Ltd. (*In re Pameco Corp.*), 356 B.R. 327, 335 (Bankr. S.D.N.Y. 2006) (stating that “earmarking does not apply where a debtor exercises control over the funds, even for a brief period”); U. S. Lines (S.A.) v. United States (*In re McLean Indus.*), 162 B.R. 410 (S.D.N.Y. 1993) (holding that earmarking does not apply where a debtor exercises control over the funds, even for a brief period), *rev’d on other grounds*, 30 F.3d 385 (2d Cir. 1994).

162. *Bohlen*, 859 F.2d at 568 (McMillian, Circuit J., dissenting).

163. *Id.* at 569 (“To disregard the clear intention of the new creditor is to unjustly enrich the debtor’s estate as a result of the debtor’s own breach of its obligation. This is the kind of injustice that the ‘earmarked funds’ doctrine was created to avoid.”).

164. *Bohlen*, 859 F.2d at 566. The three-part test articulated by the court does not hinge in any way on the fact that the “new lender” was already liable on the obligation. It would apply equally to both codebtor and non-codebtor cases.

not exercise inappropriate control over the funds passing from the new to the old creditor. Rather, its' three-part standard focused on intent, execution, and net effect.¹⁶⁵ While this Article also advances the position that the absence of "control" should not be either a necessary predicate or the exclusive ground for application of the earmarking defense, the *Bohlen* test, or at least its first two elements, seem overly ritualized in requiring an actual agreement between the debtor and the new lender, and the faithful execution thereof. These requirements rather severely and unnecessarily crimp the field of operation for the third prong of the *Bohlen* test, which, ironically, is the requirement that is the one most sensitive to the relevant policy considerations; namely, diminution of the estate.¹⁶⁶

Before delving further into the issue of the proper range of the earmarking doctrine, there is good reason to parse the source of the authority that accounts for the doctrine in the first place, as it should inform that discussion at least to the extent of assuring that any proposed formulation for the earmarking concept rests on a sound legal foundation. As has been seen, there is ample evidence that the bankruptcy courts' prerogative to invoke the doctrine continued under the Code.¹⁶⁷ But since the license to do so does not stem from the language of the Code itself, as it also did

165. *Id.* at 568–69. "Control" really only becomes an issue in the dissent, which seems to assume that the fact the funds passed through the debtor's hands was an important factor to the majority. *See supra* text accompanying note 162. However, while not part of its three-pronged test for establishing an earmarking defense, the majority opinion concluded that, even if relevant, the debtor exercised impermissible control. *Bohlen*, 859 F.2d at 567 ("One cannot conceive of greater or more telling 'control' of the new funds by the debtor than to have the debtor use them for its own purposes and in violation of its agreement with the new lender."). The court also disagreed with the statement of the bankruptcy judge below that "a court of equity should 'look through form to substance' and should 'act to achieve the intended result [of the parties]'. Failure to do so, [the bankruptcy court urged,] would result in unjust enrichment to the estate and the general creditors." *Id.* Contrary to the majority opinion of the Eighth Circuit, it is a central tenet of this treatment that it is precisely such an approach (as recognized by the bankruptcy court in *Bohlen*) that should guide application of the earmarking doctrine in the future. *See infra* Section VI.A.

166. The *Bohlen* standard devalues the diminution concept since, if either step 1 or step 2 are not satisfied, the analysis never reaches the diminution question. Contrarily, this Article urges that if there is no diminution of the estate, step 2 is dispensable and step 1—the intent requirement—should be satisfied with something less than an agreement between the debtor and the new lender. *See infra* Section VI.D; *see also* Manty v. Miller Homes, Inc. (*In re* Nation-Wide Exch. Serv., Inc.) 291 B.R. 131, 146–47 n.18 (Bankr. D. Minn. 2003) (noting that, as a technical matter, the third factor in *Bohlen* is a little confusing since there is no estate in existence at the time of the transfer. "It might be better understood as a requirement that the transfer leave the debtor's asset structure in parity with the state it was in before the transaction.").

167. *See supra* text accompanying notes 89–94.

not under the 1898 Act,¹⁶⁸ it is fair to question from whence does the ability to graft this exception on to the preference law derive, and just how broadly might the authority extend?

V. EQUITABLE JURISDICTION OF THE BANKRUPTCY COURTS

Although the academic commentary contains a creative argument to the contrary based on an interpretation of the contemporaneous new value exception of § 547(c)(1) that obviates the need entirely for the earmarking doctrine,¹⁶⁹ it is universally accepted in the decisional law that the earmarking doctrine, which originated as a judicially-conceived invention that was essentially equitable in nature,¹⁷⁰ continued as such under the Code.¹⁷¹ For instance, the majority opinion in *Bohlen*, observed that the cases that have involved the earmarking doctrine either in codebtor cases or otherwise have done so by invoking general equitable principles.¹⁷² While expressing misgivings over the wisdom of extending the doctrine to the non-codebtor situation on a similar basis, the court in *Bohlen* did not reject the authority of the bankruptcy courts to employ equitable principles in proper circumstances. Rather, the court merely surmised that such principles might not demand the kind of broad interpretation that many courts had accorded to the earmarking doctrine.¹⁷³

168. See 1898 Act § 60b.

169. See Carlson & Widen *supra* note 88, at 591-92 (asserting that the “contemporaneous exchange for new value” exception § 547(c)(1) codified, and thus abolished the earmarking doctrine as an “extra-statutory, judge-created exception to § 547(b) liability.”). While this view has not received any traction, it is certainly true that part of the rationale for codification of § 547(c)(1) is that other creditors are not adversely affected by the transfer if, as a practical matter, the debtor has received new value. *Dietz v. Calandrillo (In re Genmar Holdings, Inc.)*, 776 F.3d 961, 963 (8th Cir. 2015). This is why this statutory defense is often raised in addition to the earmarking defense. *E.g.*, *Golfview Dev. Ctr., Inc. v. All-Tech Decorating Co., (In re Golfview Dev. Ctr., Inc.)*, 309 B.R. 758 (Bankr. N.D. Ill. 2004).

170. See *supra* note 83 and accompanying text.

171. *E.g.*, *Caillouet v. First Bank and Tr. (In re Entringer Bakeries, Inc.)*, 548 F.3d 344, 347 n.3 (5th Cir. 2008) (describing the earmarking doctrine as a judicially-created, equitable exception to § 547(b) “that holds that money loaned to a debtor by a new creditor to pay an existing debt to an old creditor is not a ‘transfer of an interest of the debtor in property.’ ”); *Hansen v. McDonald Meat Co. (In re Kemp Pac. Fisheries)*, 16 F.3d 313, 316 n.2 (9th Cir. 1994) (“earmarking doctrine is a creature of equity”); *Barreto v. Cooperativa de Ahorro y Credito de Aguiadilla (In re Barreto)*, 2018 WL 5883911, * 5, ADV. PROC. 16-0172 (D. P.R., Nov. 7, 2018) (same); see also *supra* authorities cited in note 96.

172. *Bohlen*, 859 F.2d at 565–66 (observing that “the language used has been that the debtor was holding the new funds ‘in trust’ or in a ‘fiduciary capacity.’ ”).

173. *Id.* at 567. The court stated that “[e]quity does not require a court to construct a hypothetical transaction which did not occur in order to allow what is really a preference to remain in the old creditor’s hands.” Of course, by recognizing applicability of the earmarking doctrine in the codebtor situation, that’s exactly what the court did.

The adage that bankruptcy courts are “courts of equity” is routinely bandied about and has been for a long time.¹⁷⁴ Whether that apothem is in fact true, and to what extent, has been the subject of considerable dialogue in the literature.¹⁷⁵ The bankruptcy courts’ equitable authority is generally understood to derive from § 105(a) of the Code.¹⁷⁶ Whatever the scope of that authority may once have been,¹⁷⁷ there is little room for doubt that it has been circumscribed

174. See, e.g., *Pepper v. Litton*, 308 U.S. 295, 304 (1939) (“[F]or many purposes ‘courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity.’” (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 240 (1934)); *Cohen v. KB Mezzanine Fund II (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 454 (3d Cir. 2006) (noting that bankruptcy courts have the “equitable authority to ensure ‘that substance will not give way to form, that technical considerations will not prevent substantial justice from being done’”) (quoting *Pepper*, 308 U.S. at 305)); see also *Bank of Marin v. England*, 385 U.S. 99, 103 (1966) (observing “that equitable principles govern the exercise of bankruptcy jurisdiction”) (Harlan, J., dissenting) (citing *Pepper*, 308 U.S. at 304–05)); *Sec. and Exch. Comm’n. v. U.S. Realty & Improvement Co.*, 310 U.S. 434, 455 (1940). Judge Ahart has traced the origins of the maxim that the “bankruptcy court is a court of equity” to the Bankruptcy Act of 1841. See Act of Aug. 19, 1841, ch. 8, 5 Stat. 440 (An Act to establish a uniform system of bankruptcy throughout the United States) (repealed 1843); Alan M. Ahart, *The Limited Scope of Implied Powers of a Bankruptcy Judge: A Statutory Court of Bankruptcy, Not a Court of Equity*, 79 AM. BANKR. L.J. 1, 13–16 (2005).

175. Alan M. Ahart, *A Stern Reminder that the Bankruptcy Court Is Not a Court of Equity*, 86 AM. BANKR. L.J. 191, 191 (2012) (asserting that the Supreme Court’s decision in *Stern v. Marshall*, 564 U.S. 462 (2011) corroborated his 2005 conclusion that the bankruptcy courts are not courts of equity); Edith H. Jones, *The Bankruptcy Galaxy*, 50 S.C. L. REV. 269, 270–71 (1999) (“Approaching bankruptcy from the standpoint of a law court instead of an equity court may, in my view, lead to a more even balance between debtors’ and creditors’ rights.”); Marcia S. Krieger, “*The Bankruptcy Court Is a Court of Equity*”: *What Does That Mean?*, 50 S.C. L. REV. 275, 310 (1999) (arguing that while the shibboleth that bankruptcy courts are courts of equity is among the most frequently uttered in the court room, “[f]rom historical, procedural, jurisprudential, and practical perspectives the bankruptcy court is not a court of equity. It is, instead, a specialized court of limited jurisdiction applying statutory law . . .”). *But see* Randolph J. Haines, *The Conservative Assault on Federal Equity*, 88 AM. BANKR. L.J. 451, 455 n.23 (2014) (referring to the arguments the bankruptcy courts are not courts of equity as “formulistic” and observing that the jurisdictional amendments in 1978 and 1984 were intended to broaden, not narrow, bankruptcy courts’ jurisdiction from what it had been under the 1898 Act).

176. Section 105(a) of the Code states, in pertinent part: “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code].” 11 U.S.C. § 105 (2012). It derives from § 2(a)(15) of the of 1898 Act, and, according to the legislative history, is intended to operate similarly to the Federal All Writs Act, 28 U.S.C. § 1651 (2012). H.R. Rep. No. 95-595, at 316–317 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 5973; see also Adam J. Levitin, *Toward a Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime*, 80 AM. BANKR. L.J. 1, 27 (2006) (suggesting that the equitable powers of the bankruptcy courts may also stem from 28 U.S.C. § 1481, providing that “[a] bankruptcy court shall have the powers of a court of equity, law, and admiralty . . .”, even though that provision no longer appears in the current compilation (or the previous three) of the United States Code).

177. See *supra* note 175; see also *Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd.*, 507 U.S. 380, 389 (1993) (noting that bankruptcy courts are “necessarily entrusted with broad equitable powers”).

to some considerable degree in recent years.¹⁷⁸ Most notably, in *Law v. Siegel*,¹⁷⁹ the Supreme Court held that the bankruptcy courts' statutory authority under § 105(a) to issue any order that is "necessary or appropriate to carry out the provisions of the Bankruptcy Code" does not allow a bankruptcy court to ignore or override the explicit mandates of specific provisions of the Bankruptcy Code.¹⁸⁰ Further, the Court ruled that any inherent authority of the courts was similarly not license to contravene the express terms of a specific Code provision.¹⁸¹

A question, thus, arises over whether a broad application of the earmarking doctrine—or for that matter any application—exceeds the acknowledged scope of the bankruptcy courts' equitable

178. As early as 1988, the Supreme Court held that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988). See generally Nicholas B. Malito, *Recent Developments: Section 105(a) of the Bankruptcy Code*, 2014 NORTON ANNUAL SURVEY OF BANKRUPTCY LAW 13 (2014) (noting that each year the appellate courts decide at least one case aimed at reinforcing the limitations of the equitable authority of the bankruptcy courts under § 105(a)). While the appellate courts have been more attentive in recent years to limiting the scope of the bankruptcy courts' authority under § 105(a), the intellectual justification for the effort undoubtedly finds its moorings in Judge Posner's opinion in *In re Chicago, Milwaukee, St. Paul, and Pacific Railroad Corp., Co.*, decided under the 1898 Act, in which Judge Posner wrote: "The fact that a proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be." 791 F.2d 524, 528 (7th Cir. 1986) (citing *Shondel v. McDermott*, 775 F.2d 859, 867–68 (7th Cir. 1985)).

179. 571 U.S. 415, 420–21 (2014); see also *United States v. Sutton*, 786 F.2d 1305, 1308 (5th Cir. 1986); accord *Smart World Techs., LLC v. Juno Online Servs., Inc. (In re Smart World Techs., LLC)*, 423 F.3d 166, 184 (2d Cir. 2005) (citing *New Eng. Diaries, Inc. v. Dairy Mart Convenience Stores, Inc.*, 351 F.3d 86, 91–92 (2d Cir. 2003)) (describing bankruptcy courts' § 105(a) powers as generally limited to filling gaps in the statutory language).

180. *Law*, 571 U.S. at 421 (internal citations omitted). The decision in *Law* represented a sharp pull-back from the view expressed by the Court just seven years earlier in *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365 (2007), where the Court referred to "the broad authority of bankruptcy judges to take any action that is necessary or appropriate 'to prevent an abuse of process,' " and the "inherent power of every federal court to sanction 'abusive litigation practices.'" *Id.* at 375–76. For a more cynical, but perhaps realistic, explanation for the Supreme Court's recent reduction in the scope of bankruptcy judges' inherent power, see John A.E. Pottow & Jason S. Levin, *Rethinking Criminal Contempt in the Bankruptcy Courts*, 91 AM. BANKR. L.J. 311, 312 (2007) (questioning whether we are in a new era of "bankruptcy judge (dis)respectability.") At a minimum, there is no doubt that the high Court has used the bankruptcy cases that have come before it to advance a "plain meaning" approach to statutory construction. See *Chase Manhattan Mort. Corp. v. Shapiro (In re Lee)*, 530 F.3d 458, 470 n.10 (6th Cir. 2008) (commenting on the "common theme" in the Court's bankruptcy jurisprudence that courts should apply a plain meaning approach in construing Code provision, except when doing so would produce a result patently at odds with the intent of Congress).

181. *Law*, U.S. 571 at 421 (referencing the power to sanction abusive litigation practices, the Court stated that "[c]ourts' inherent sanctioning powers are likewise subordinate to valid statutory directives and prohibitions.").

powers.¹⁸² At least one contemporary decision, after considering the more recently-imposed limitations on applying equity in bankruptcy, held nonetheless “that the earmarking doctrine is valid and does not contravene any express provision of the Bankruptcy Code. The judicially-created earmarking doctrine balances the express provisions in section 541, property of the estate, and section 547, preferences.”¹⁸³ This analysis seems correct. There is a consequential difference between defying a specific provision of the Code, as occurred in *Law v. Siegel*, or creating a substantive right that does not otherwise exist,¹⁸⁴ and providing judicial gloss beyond the express language of a statute in order to effectuate its intended purpose. In fact, the latter is the hallmark of a common law system, even when dealing with statutory text.¹⁸⁵

Therefore, *Law v. Siegel* and other cases that deny application of § 105(a) in situations where its use is contrary to or wholly outside of the bounds of actual provisions of the Bankruptcy Code do not bar inclusion of the earmarking exception under the orthodoxy of contemporary preference theory. The teaching of those authorities simply does not extend so far as to foreclose the ability of or the

182. *Barreto v. Cooperativa de Ahorro y Credito de Aguiadilla (In re Barreto)*, No. 14-08712, 2018 WL 5883911, at * 6, Adv. Proc. 16-0172 (D. P.R., Nov. 7, 2018) (acknowledging that, after *Law*, the equitable powers of the bankruptcy courts have been “significantly diminished.”).

183. *Id.* at * 6 (citing *Official Bondholders Comm. v. E. Utils. Assocs. (In re EUA Power Corp.)*, 147 B.R. 634 (Bankr. D. N.H. 1992)). Of note, in *Czyzewski v. Jevic Holding Corp.*, 138 S. Ct. 973, 984 (2017), the Supreme Court had another opportunity to evaluate the reach of equity powers under the Bankruptcy Code. The *Jevic* analysis took into account to considerations that were not emphasized in *Law v. Siegel*, including the relevance of fundamental bankruptcy policies to the analysis and the nature of the proposed action as interim or final relief.

184. *Sutton*, 786 F.2d at 1308 (“That statute [§ 105] does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity.”) (citing *S. Ry. Co. v. Johnson Bronze Co.*, 758 F.2d 137, 141 (3d Cir. 1985)).

185. Louise Weinberg, *Federal Common Law*, 83 NW. U.L. REV. 805, 834 (1989) (observing that we cannot know what a statute means until a court *says* what it means on specific facts, and concluding from this that:

The common law is *all the law we have* . . . [W]e understand that statutory interpretation happens in courts. We are all realists now; we know that a statute gives us only something to go on until we have some pronouncements from the judiciary [which] . . . in turn, give[s] us only something to go on until we have some pronouncements from the judiciary.

While statutory interpretation and common law decision making are not, in fact, identical; the difference is one of degree rather than of kind.

need for the bankruptcy courts to provide an interpretive gloss to a statute that is, after all, uniquely federal in purpose and content.¹⁸⁶

The point to be made is that, when invoked, the earmarking doctrine, as traditionally conceived,¹⁸⁷ neither flouts nor clashes with the express language of § 547(b). To the contrary, it decodes the language of the statute in a manner that assures that critical legislative intent is enforced. That is to say, a principled application of the earmarking doctrine introduces some play into the joints of the system so as to ameliorate the adventitious results that excessive deference to formalistic mechanical rules can sometimes produce. No legislative prescription, no matter how painstakingly conceived and tightly drawn, can ever be sensitive enough to capture all of the fluid nuances of commercial behavior and the norms of the marketplace. In sum, the bankruptcy courts' equitable authority in § 105(a) to "carry out" provisions of Title 11 would be impoverished beyond all recognition if it did include the capacity to ensure that "substance will not give way to form" when applying

186. Under *Butner v. United States*, 440 U.S. 48, 56 (1979), the bankruptcy courts are bound to defer to state law, absent a compelling federal interest, when dealing with state law property rights, interests, and priorities. However, the preference law has no counterpart under state law. See *supra* text accompanying notes 45–47 and accompanying text. The principles expressed by the Supreme Court in *Erie Railroad v. Tompkins*, 304 U.S. 64 (1938), shunning development of a federal common law in areas traditionally subject to authority of the state courts, is not a barrier. Thus, the bankruptcy courts possess more discretion in assuring that, on particular facts, the statute is applied consistent with legislative purpose.

187. That conception being that, in substance, nothing has changed other than one creditor has been substituted for another creditor. See *supra* note 14–15 and accompanying text.

the technical elements of a voidable preference.¹⁸⁸ Thus, it seems clear that there remains a continuing legal foundation for judicially-grafted limitations on the reach of § 547(b).

VI. ANALYSIS OF THE STATE OF THE EARMARKING DOCTRINE

Earlier, it was observed that two views about the scope of the earmarking doctrine have emerged: limit its application to the codebtor setting or extend it to funds advanced by a new creditor with no prior relationship to the transaction or liability on the old debt.¹⁸⁹ That assertion is true and not true. True in the sense that those are the two main, antipodal views involving the cardinal dimensions of the earmarking doctrine, but not true because of multiple different, overlapping, and inconsistent tests that have been developed to determine when funds qualify as earmarked so as to immunize their transfer from preference liability whether in the codebtor or the true third-party setting.

188. As a general proposition, there is a strong bias in the law that the substance of a transaction, rather than its form, should determine its consequences. In the preference realm, see *Halbert v. Dimas (In re Halbert)* 576 B.R. 586, 592 (Bankr. N.D. Ill. 2017) (noting, in connection of whether a debt was in the nature of a domestic support obligation for purposes of § 547(c)(7), a determination must be made based on the totality of the circumstances, “looking at the substance of the obligation owed, and not its form.”); *Stanziale v. Khan (In re Evergreen Energy, Inc.)*, 546 B.R. 549, 563–64 n.43 (Bankr. D. Del. 2016) (recognizing that substance must prevail over form in the determination of whether a party is an “insider” for purposes of § 547(b)); cf. *Corp. Resource Servs., Inc. v. Wells Fargo Bank, N.A. (In re TS Emp’t, Inc.)* 597 B.R. 494, 531 (Bankr. S.D.N.Y. 2019), a case involving, *inter alia*, an attempt by the trustee to set aside certain transfers as constructively fraudulent based on the absence of reasonably equivalent return value. In rejecting the trustee’s position, the court noted that fraudulent transfer law has always “exalted substance over form” and that “the ‘real test of a fraudulent conveyance . . . is the unjust diminution of the debtor’s estate.’” (citing *Orr v. Kinderhill Corp.*, 991 F.2d 31, 36 (2d Cir. 1993) (quoting 1 GARRARD GLENN, *FRAUDULENT CONVEYANCES AND PREFERENCES* § 195, at 348 (rev. ed. 1940)). A similar argument can be validly made with respect to the preference statute. See *supra* note 96. Similarly, although there is a split in the circuits over whether state or federal law governs the exercise, at least seven courts of appeal have held that bankruptcy courts possess the authority to recharacterize a transaction branded as a loan to the entity-debtor from a debt to an equity contribution, thereby effectively subordinating that interest to the claims of the debtor’s general unsecured creditors. See Lawrence Ponoroff, *Whither Recharacterization*, 68 RUTGERS U. L. REV. 1217, 1219 (2016). But see *Rodriguez v. Cyr (In re Cyr)*, 602 B.R. 315, 348 (Bankr. W.D. Tex., Apr. 1, 2019) (declining the trustees request that the court use “its equity powers to delve behind the form of the transactions and relationships to determine the substance,” on the basis that the court cannot use its equity powers to override the law.) (“While this Court may be a court of equity, this Court is of the opinion that equity follows the law.”) (internal citations omitted).

189. See discussion *supra* Section A.

In *In re Moses*,¹⁹⁰ discussed earlier,¹⁹¹ the bankruptcy appellate panel observed that there were three tests that had developed in the case law for determining application of the earmarking doctrine: an “intent” test,¹⁹² a “control” test,¹⁹³ and a “diminution of the estate” test.¹⁹⁴ In *In re Marshall*,¹⁹⁵ the Tenth Circuit managed to classify the randomized decisional law into just two approaches for ascertaining whether a transfer of property was a transfer of “an interest of the debtor in property” for purposes of § 547(b): a “dominion/control” test¹⁹⁶ and a “diminution of the estate” test.¹⁹⁷ In a thoughtful student Note analyzing the earmarking doctrine in connection with credit card transfers,¹⁹⁸ the author determined that the case law could be grouped into two different tests denominated: the “Bohlen” test¹⁹⁹ and the “control” test.²⁰⁰ Finally, in his influential treatise, Professor Tabb groups the cases into a “diminution of the estate” and a “control of funds” approach.²⁰¹

While not entirely unhelpful, these classifications obviously are not and cannot be wholly accurate, consistent, or precise. Moreover, the fact that different efforts to catalogue the case law under a limited number of standards has produced different results implies rather strongly that the boundaries of these categories are neither as fixed nor as mutually exclusive as the expression of them in finite terms might imply. It also illustrates that these different tests and concepts

190. *Manchester v. First Bank & Tr. Co. (In re Moses)*, 256 B.R. 641 (B.A.P. 10th Cir. 2000).

191. *See supra* text accompanying notes 112–16.

192. *In re Moses*, 256 B.R. at 649–650 (the court ascribed this approach to the Eighth and Third Circuits).

193. *Id.* at 650 (citing decisions from the Fifth, Sixth, Seventh and Ninth Circuits).

194. *Id.*; *see generally In re Safe-T-Brake of S. Fla., Inc.*, 162 B.R. 359 (Bankr. S.D. Fla. 1993); *Glinka v. Bank of Vt. (In re Kelton Motors, Inc.)*, 97 F.3d 22 (2d Cir. 1996) (as examples of this approach, the court cited two bankruptcy court decisions).

195. *In re Marshall*, 550 F.3d 1251 (10th Cir. 2008).

196. *Id.* at 1255. The court indicated that this test (dominion/control) was followed by the Sixth and Seventh Circuits.

197. *Id.* The court identified this approach (diminution) as representing the view of the Fifth and Ninth Circuits as well, of course, of the Tenth Circuit Bankruptcy Appellate Panel.

198. Michael Benzaki, *Accepting the Earmarking Doctrine: Courts Should Accept this Defense to Preference Actions in Connection with Credit Card Transactions*, 24 AM. BANKR. INST. L. REV. 473, 483 (2016). *See generally, In re Marshall*, 550 F.3d 1251, as an example of a case rejecting the argument that credit card payments do not represent the transfer “of an interest of the debtor in property.”

199. *Benzaki, supra* note 199, at 483.

200. *Id.* at 483–84. *See generally, Gray v. Travelers Ins. Co. (In re Neponset River Paper Co.)*, 231 B.R. 829, 835 (B.A.P. 1st Cir. 1999).

201. *See* CHARLES JORDAN TABB, *LAW OF BANKRUPTCY* § 6.11, 501–04 (4th ed. West 2016).

are elastic and, in a non-pejorative sense, quite susceptible to manipulation. For instance, even among courts that regard “control” as a decisive factor, there is no consensus over what quantum of control is enough to preclude application of the earmarking doctrine.²⁰²

The reality is that the reported earmarking decisions cannot be neatly classified into any fixed number of categories; they range across a spectrum because of the inherently idiosyncratic nature of the underlying factual backstory in each case. Therefore, the attempt to stuff them all into a limited number of pigeonholes is, if not futile, certainly artificial. What the “tests” that have been identified for determining when the doctrine applies really represent is a list of prudential considerations that should be borne in mind in analyzing the facts of future cases and in developing perhaps more useful precedent going forward than has been the case to this point.

As its serpentine history affirms,²⁰³ the preference law itself has been characterized by multiple, oft-conflicting premises and objectives.

202. Compare *Cadle Co. v. Mangan (In re Flanagan)* 503 F.3d 171, 185 (2d Cir. 2007) (“The proper application of the earmarking doctrine depends not on whether the debtor temporarily obtains possession of new loan funds, but instead on whether the debtor is obligated to use those funds to pay an antecedent debt.”), and *Adams v. Anderson (In re Superior Stamp & Coin Co.)*, 223 F.3d 1004 (9th Cir. 2000) (holding that just because the funds are deposited in the debtor’s account and the debtor has the power to divert the loan to a different use does not negate application of the earmarking doctrine), and *Sherman v. TBK Bank (In re Dependable Auto Shippers, Inc.)*, No. 16-034855-BJH, 2018 WL 4348049 at *8 (Bankr. N.D. Tex., Sept. 7, 2018) (articulating the standard in terms of level of control, but concluding that ultimately, “‘it is the effect of the transaction, rather than the debtor’s or creditor’s intent, that is controlling.’”) (citing *T.B. Westex Food, Inc. v. Fed. Dep. Ins. Corp. (In re T.B. Westex Foods, Inc.)*, 950 F.2d 1187, 1195 (5th Cir.1992)), and *Halter v. Aircomfort (In re Consolidated FGH Liquidating Tr.)*, 392 B.R. 648 (Bankr. S.D. Miss. 2008) (observing that “the determinative factor as to whether the property is part of the debtor’s estate is whether the debtor has dispositive control over the property”), with *Campbell v. Hanover Ins. Co. (In re ESA Evtl. Specialists)*, 709 F.3d 388, 395–96 (4th Cir. 2012) (stating that the earmarking defense only applies when the proceeds of the new loan are transferred directly by the lender to the old creditor, or are paid to the debtor with the understanding that they will be paid to the creditor in satisfaction of his claim, so long as the proceeds are clearly earmarked), and *Buchwald Cap. Advisors v. Metl-Span I, Ltd. (In re Pameco Corp.)*, 356 B.R. 327, 335 (Bankr. S.D.N.Y. 2006) (rejecting earmarking as a defense “where a debtor exercises control over the funds, even for a brief period”), and *U. S. Lines, Inc. v. United States (In re McLean Indus. Inc.)*, 162 B.R. 410, 420–21 (S.D.N.Y. 1993), *rev’d on other grounds*, 30 F.3d 385 (2d Cir. 1994), and *Davis v. Kice Indus., Inc. (In re WB Servs., LLC)*, 587 B.R. 548, 561–62 (Bankr. D. Kan. 2018) (reasoning that the debtor’s lack of possession of the funds does not automatically equate to the lack of an interest of such funds). Adding to the maelstrom of confusion, some courts seem to ignore control entirely. See *Stingley v. AlliedSignal, Inc. (In re Libby Int’l, Inc.)*, 247 B.R. 463, 469 (B.A.P. 8th Cir. 2000) (ruling that it is net effect of the transfer on the estate, and not debtor’s control over transferred funds, that is dispositive in deciding whether earmarking doctrine applies to prevent transfer from being avoided as preference, but earmarking does not apply when there is no new creditor); see also *supra* notes 143–44 and accompanying text.

203. See Weisberg, *supra* note 40, at 4 (describing the preference law as “one of the most unstable categories of bankruptcy jurisprudence.”).

Thus, it should be no surprise that the jurisprudence regarding the scope of the earmarking exception is equally, if not indeed more, jumbled and confused. Finding a way out of the thicket requires identifying certain critical points of reference—representational beacons if you will—and then keeping them firmly in sight as the analysis proceeds. For purpose of this treatment it is proposed that diminution of the estate and equality of distribution among creditors with similar rights might profitably serve as those beacons. The former, because of its determinative connection to the very concept of a voidable preference²⁰⁴ and because it is the one theme most common to the various approaches and tests identified above for circumscribing the reach of the earmarking doctrine. The latter because of its causal relationship to the former as well as its centrality to overall bankruptcy policy.²⁰⁵ Consequently, while there may be, as noted, prudential considerations that argue in favor or against a bankruptcy court's application of the earmarking doctrine in a given case, there is no sure-fire, definitive litmus test, and its absence should not be reason for lament.

In attempting to offer an alternative strategy for delineating the scope of the earmarking doctrine, it might, initially, be helpful to establish the clear, diametrical extremes. First, there can be no serious doubt about the fact that there is some field of operation for

204. See *Warsco v. Preferred Tech. Grp.*, 258 F.3d 557, 564 n.11 (7th Cir. 2001) (noting, in relation to the “interest of the debtor in property” language of § 547(b): “We have recognized in the past that diminution of the debtor’s estate is not an element of the preference statute. See *In re Smith*, 966 F.2d 1527, 1536 n.13 (7th Cir.1992), *cert. denied sub nom.* Baker & Schultz, Inc. v. Boyer, 506 U.S. 1030 (1992). However, we also have recognized that ‘the ‘diminished estate’ element of a preferential transfer is consistently applied,’ and we previously have refused to disturb its application. *Id.* In keeping with our prior precedent and that of other circuits, we continue to consider whether the transfer in question diminished the debtor’s estate.”); see also *In re Southmark Corp.*, 49 F.3d 1111, 1117 (5th Cir.1995) (stating that “the primary consideration in determining if funds are property of the debtor’s estate is whether the payment of those funds diminished the resources from which the debtor’s creditors could have sought payment.”); *In re Kemp Pac. Fisheries, Inc.*, 16 F.3d 313, 316 (9th Cir.1994) (explaining the earmarking doctrine on the basis that the transaction in question merely substituted one creditor for another without diminishing the value of the bankruptcy estate); *Litton v. Apperson Crump, PLC*, 580 B.R. 686, 689 (Bankr. N.D. Miss. 2018) (the fundamental inquiry is whether the transfer diminished or depleted the estate); *Kelley v. McCormack (In re Mitchell)*, 548 B.R. 862, 877 (M.D. Ga. 2016) (expressing disapproval over the conflating of the diminishment of the estate criterion that inheres in the definition of “transfer of an interest of the debtor in property” for purposes of both §§ 547 and 548 with the “diminution” requirement inferred in the application of § 547(b)(5), and noting the trustee must prove both) (citing 5 COLLIER ON BANKRUPTCY, *supra* note 30, at ¶ 547.03[2] n.29); *infra* note 264.

205. See *supra* note 2. The maxim of equality of distribution among similarly-situated claims was also a basic norm of the 1898 Act; see also *Nathanson v. NLRB*, 344 U.S. 25, 29 (1952) (“[t]he theme of the Bankruptcy Act is ‘equality of distribution’”).

an earmarking doctrine.²⁰⁶ This means that there is a general consensus that the language of the preference statute alone does not supply the rule of decision in every case. Even the most circumscribed formulation of the earmarking concept would have it apply in the case where the new creditor is a codebtor on the obligation discharged with the funds supplied by the new creditor.²⁰⁷ Moreover, whether relying on constructive trust or other fiduciary capacity fictions,²⁰⁸ nearly all courts that address the issue agree that application of the doctrine is not negated in that situation by the fact that the funds technically pass through the debtor's hands or otherwise come under its sway.²⁰⁹

On the other extreme, it is equally clear, even when the source of the funds is a codebtor, that if the debtor has unfettered control over the funds from the new creditor and those funds are not (or are not intended) to be restricted in at least some fashion, whether by the

206. See *Smith v. Suarez (In re IFS Fin. Corp.*, 417 B.R. 419, 435-36 (Bankr. S.D. Tex. 2009), *aff'd*, 669 F.3d 255 (5th Cir. 2012) (“The earmarking doctrine is widely accepted in the bankruptcy courts as a valid defense against a preference claim . . .”).

207. See *supra* notes 112-15 and accompanying text.

208. *McCuskey v. Nat'l Bank of Waterloo (In re Bohlen Enters., Ltd.)*, 859 F.2d 561, 565-66 (8th Cir. 1988) (noting that in the guarantor situation, even when the funds are put in the debtor's possession, courts have in some instances employed notions of “trust” and “fiduciary capacity” to avoid reaching the conclusion that the funds represented an interest of the debtor in property). The constructive trust device bears many similarities with the earmarking doctrine. It, too, is an equitable remedy that essentially imposes a trust-like duty on a party in possession of property in which another has a superior claim. See William L. Rothschild, *How to Treat Constructive Trust Claims in Bankruptcy*, 35 Nov. AM. BANKR. INST. J. 24 (2016) (describing the constructive trust remedy as implementing the following principle: “If I hold legal title to a property but did something bad to get it, a court of equity may rule that that the person I took the property from retained an equitable interest from the moment of taking, and awards that person both the property and any profits or proceeds that I received while I held it.”). In the preference context, the theory is that the funds transferred by the debtor justly belonged to another and, thus, should not be regarded as property in which the debtor had an interest for purposes of § 547(b). Thus, many preference cases where the earmarking defense is raised also involve claims based on constructive trust theories. See, e.g., *Halperin v. Moreno (In re Green Field Energy Servs., Inc.)*, 2015 WL 5146161, Case No. 13-12783(KG) (Bankr. D. Del., Aug 31, 2015); see also Benzaki, *supra* note 199, at 490-93 (advancing the position that courts should expand the scenarios where the earmarking doctrine might be pressed into service by using the “more liberal standard” adopted by courts for ascertaining when a constructive trust will be deemed to exist).

209. For example, the standard established by the court in *Bohlen*, 859 F.2d at 566, could be satisfied despite the funds coming under the debtor's control. See *supra* notes 155-57 and accompanying text; see also *Campbell v. Hanover Ins. Co. (In re ESA Envtl. Specialists)*, 709 F.3d 388, 395-96 (4th Cir. 2013) (allowing that that the earmarking defense applies *either* when “the proceeds of the new loan are transferred directly by the lender to the old creditor, or are paid to the debtor with the understanding that they will be paid to the creditor in satisfaction of his claim so long as the proceeds are clearly earmarked”). *But see Buchwald Cap. Advisors v. Metl-Span I, Ltd. (In re Pameco Corp.)*, 356 B.R. 327, 335 (Bankr. S.D.N.Y. 2006) (finding that a debtor's exercise of control over funds, even for if only for a brief period, will defeat earmarking).

creditor supplying the funds or otherwise,²¹⁰ then such funds represent an interest of the debtor in property (*i.e.*, a new loan) that, within the preference period, must be preserved to assure that the principle of ratable distribution is not compromised due to a diminution of the value of the estate that is created upon the debtor's subsequent bankruptcy filing. So, on the outer extremes, there is accord as to certain scenarios where the doctrine definitely applies and other fact settings when it unquestionably does not. The obvious challenge is how to manage the cases that fall in-between those two poles in a manner that not only promotes equitable results in each such case but that, in the aggregate, also provides for the development of a more coherent and consistent jurisprudence in relation to the earmarking defense.

A. *The Weaknesses in the
Codebtor Requirement*

The line of authority that would restrict utilization of the earmarking doctrine to situations where the funds at issue come from a guarantor or other codebtor are misguided in a number of respects.²¹¹ First, as noted earlier, the explanation for the limitation belies the rationale for the exception.²¹² Stated another way, if there is no room for an equitable exception to the supposedly unambiguous language of the statute, then it is difficult to understand why concerns over the inequity of a codebtor potentially being subject to double liability should warrant invocation of an exception in that circumstance but none others.²¹³

Second, it is, in point of fact, difficult to see how the codebtor would actually end up with double liability. To illustrate, assume, well outside the preference period, Ivanov guaranties Popov's obligation to Vasiliev. Both the Popov debt and the Ivanov guarantee are unsecured. If Popov files for bankruptcy while the obligation to Vasiliev remains outstanding, Vasiliev has a claim against the estate for the amount of the debt that is entitled to share *pari passu* in any distributions on behalf of unsecured claims. Ivanov would also have a claim that is based on his right to reimbursement should he discharge

210. See *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1361 (5th Cir. 1986), *reh'g denied*, 801 F.2d 398 (5th Cir. 1986) (holding that new creditor's failure to restrict the funds not fatal to application of the earmarking doctrine).

211. It has also been argued that these are not truly earmarking cases because when the surety pays the old creditor the surety is satisfying its own independent obligation to the old creditor, not extending new unsecured credit to the debtor. Carlson & Widen, *supra* note 88, at 603–604.

212. See *supra* text accompanying note 117.

213. A further flaw in that reasoning is the implicit assumption that there is no risk of a similar inequity when the new lender is not already a codebtor. See *supra* note 37.

the obligation to Vasiliev under Ivanov's contract of guaranty.²¹⁴ However, Ivanov's claim is contingent until he actually makes good on the guaranty. Under Code § 502(e)(1)(B), that contingent claim is disallowed because there should only be a single recovery from the estate with respect to what, as a practical matter, is only a single obligation. Now, if we assume Ivanov paid Vasiliev in full *before* the filing of Popov's petition, then, under § 502(e)(2), Ivanov's claim would no longer be contingent and, thus, would be allowed,²¹⁵ but there's no threat of a double recovery because Vasiliev, having been paid, no longer has a claim.

Next, we add to the mix that, prior to filing but during the preference period, Ivanov transferred funds to Popov solely for the purpose of, and restricted to, paying the obligation to Vasiliev, and that's exactly what happened. If the trustee is able successfully to recover the payment from Vasiliev as a preference because all of the other elements of § 547(b) are satisfied how is Ivanov prejudiced? The thinking, presumably, is that now Vasiliev, having paid back the preference, will go after (seek collection) from Ivanov and, if Popov's case is a no-asset case,²¹⁶ then Ivanov will have effectively paid the obligation twice.²¹⁷ What this postulated chain of events ignores is that the original payment from Ivanov to Vasiliev, whether directly or through Popov, should have discharged Ivanov's obligation under the contract of guaranty.²¹⁸ Upon return of the preference, Vasiliev will have a prepetition, unsecured claim against Popov's estate.²¹⁹ Thus, all that has really transpired is that Vasiliev has been

214. This follows from the Code's broad definition of "claim" in § 101(5)(A).

215. See generally *In re Drexel Burnham Lambert Grp., Inc.*, 146 B.R. 98, 102 (Bankr. S.D.N.Y. 1992).

216. No-asset cases are hardly uncommon in Chapter 7. See Ed Flynn, *Chapter 7 Asset Cases and Trustee Compensation*, 33 AM. BANKR. INST. J., June 2014, at 48–49 (noting that in most states the amount of cases that are asset cases is below five percent). Moreover, even if there is some distribution for general creditors, unless they are paid 100 cents on the dollar, Ivanov would still end up paying more than the face value of the obligation. Full-pay liquidations are exceedingly rare.

217. *Manchester v. First Bank & Tr. Co. (In re Moses)*, 256 B.R. 641, 646 (10th Cir. B.A.P. 2000) (pointing out that courts have applied the earmarking exception in codebtor cases "because if the transfer [is] avoided, the codebtor would be subject to double liability.").

218. For example, in the case of a negotiable instrument, payment by a party with liability thereon, which would include a surety, operates to discharge the party making such payment. See UCC § 3-601, 602. The fact that the payment is clawed back by the trustee in the debtor's bankruptcy case does not automatically reinstate the obligation to the common creditor.

219. See 11 U.S.C. § 502(d), allowing as a claim against the estate the amount paid by a party who has repaid a preferential transfer under § 550(a).

substituted for Ivanov in the bankruptcy case and will end up suffering the loss for the entire obligation, and Vasiliev will have been deprived of the benefit of its guaranty.

For this reason, unless it is clear that the transfer from Ivanov to Popov was truly an extension of new credit and not intended to satisfy Ivanov's obligation under the existing guaranty, application of the earmarking doctrine is necessary *to avoid* disrupting the real economic nature of and allocation of risk associated with the transaction as originally struck. Moreover, this can be done without adversely affecting other unsecured creditors because, in substance, there has been no diminution in the value of the debtor's assets; no fewer coins in the piggy bank to pay the same number and amount of claims. However, the point to be stressed is that employment of the earmarking doctrine in this hypothetical, while perfectly appropriate, was *not* necessary in order to prevent Ivanov from being exposed to liability twice for the same obligation. In other words, the non-debtor situation is different from the new creditor scenario to be sure, *but* there is nothing intrinsic to the codebtor state of affairs that clamors for a different construction of, or equitable exception to, the language "interest of the debtor in property" only when the source of the funds at issue comes from a party already obligated on the debt.

Additionally, cases applying the codebtor limitation assert that when the new lender is a non-codebtor, utilization of the earmarking doctrine provides no benefit to the new creditor or the debtor. Instead, they claim it serves only to advantage the old creditor to whom no such advantage is due or warranted.²²⁰ This explanation ignores the basic point that it is "the diminution of the [debtor's] estate, not the unequal payment to creditors, which is the evil sought to be remedied by the avoidance of a preferential transfer."²²¹ The fact that one creditor has been preferred or is better off is irrelevant if nothing has been lost by

220 *E.g.*, *Davis v. Kice Indus., Inc.*, (*In re* WB Servs., LLC), 587 B.R. 548, 557 (Bankr. D. Kan. 2018) (citing *Manchester v. First Bank & Tr. Co.* (*In re* Moses), 256 B.R. 641, 647 (B.A.P. 10th Cir. 2000)) (quoting *McCuskey v. Nat'l Bank of Waterloo* (*In re* Bohlen Enters., Ltd.)), 859 F.2d 561, 566 (8th Cir. 1988)).

221. *See, e.g.*, *Moser v. Bank of Tyler* (*In re* Loggins), 513 B.R. 682, 697 (Bankr. E.D. Tex. 2014) ("[T]he test of whether a preference has occurred is not what the creditor receives but what the bankrupt's estate has lost because it is the diminution of the bankrupt's estate, not the unequal payment to creditors, which is the evil sought to be remedied by the avoidance of a preferential transfer.") (citing *Va. Nat'l Bank v. Woodson*, 329 F.2d 836, 840 (4th Cir. 1964), and quoted with approval in *Texas Amer. Bancshares, Inc. v. Clarke*, 954 F.2d 329, 339 (5th Cir. 1992); *accord* *Tex. Am. Bancshares v. Clarke*, 954 F.2d 329, 339 (5th Cir. 1992) (citing *Va. Nat'l Bank v. Woodson* (*In re* Decker), 329 F.2d 836, 839-40 (4th Cir. 1964); *Campbell v. Hanover Ins. Co.*, 457 B.R. 452, 457 (W.D.N.C. 2011); *Barreto v. Cooperativa de Ahorro y Credito de Aguiadilla* (*In re* Barreto), No. 14-08712 (ESL), 2018 WL 5883911, at * 5 (D. P.R., Nov. 7, 2018); *Ryan v. Andrews* (*In re* Chrimer), No. 7-07-10201, 2008 WL 5157506, at *2 (Bankr. N.M., Sept. 23, 2008); *see also infra* note 259.

the estate.²²² After all, the same indictment could be made of a creditor that receives payment while the debtor was solvent,²²³ but that does not make the transfer preferential. In addition, focus on the entitlement of the old creditor reestablishes into the dynamic an unhealthy preoccupation with the culpability of the parties rather than a more dispassionate focus on the impact on unsecured creditors in the aggregate.²²⁴ Finally, and perhaps most disquieting, these cases also overlook the fact that failure to recognize a role for the earmarking defense in certain non-codebtor cases may also be prejudicial to the new creditor, as observed earlier in connection with the discussion of *WB Services*.²²⁵ Thus, the codebtor limitation is based on a faulty premise, and also mistakenly assumes that the reasons that make application of earmarking exception proper in the codebtor situation also make its application unwarranted in non-codebtor circumstances. Altogether, a pretty muddled kettle of fish.

222. For example, in *Cadle Co. v. Mangan (In re Flanagan)*, 503 F.3d 171 (2d Cir. 2007), the debtor's father lent him just over \$100,000 to pay off a judgment creditor which had obtained a show cause order to have the debtor held in contempt for failing to cooperate in that creditor's efforts to locate assets with which to satisfy its judgment. *Id.* at 176. The loan was accomplished, in part, by the father's taking over an \$85,000 loan the debtor had secured from a third party, secured by stock certificates with a value in excess of \$100,000. *Id.* The debtor delivered the loan proceeds to his lawyer who deposited them with the court registry in order to pay the defendant. *Id.* at 175–76. The court concluded that there was no doubt that the father had made the funds available for the sole purpose of paying defendant and that the earmarking doctrine should apply even though the debtor had temporary possession of the funds. *Id.* at 185. The court noted, however, the generally accepted exception in cases where the new loan is secured. *Id.* at 176; *see also supra* note 18. However, even though the father's debt was fully collateralized, because the lien obtained by the father entailed supplanting the \$85,000 secured obligation, the court agreed with the bankruptcy court that the net diminution of the estate occasioned by the transaction was limited to the difference between the loan amount and \$85,000, representing the extent to which the father had encumbered theretofore unencumbered property. *Id.* at 186. Thus, the transfer could only be avoided to the extent of approximately \$15,000. *See also* *Campbell v. Hanover Ins. Co.*, 457 B.R. 452, 457–58 (W.D.N.C. 2011) (applying the earmarking doctrine to insulate from preference liability a transfer made for the purpose of purchasing a letter of credit for the defendant, which otherwise refused to issue future payment and performance bonds needed by debtor for government construction contracts). *But see* *Colbert v. Walters (In re Wagenknecht)*, Adv. No 18-01018, 2019 WL 2353534 (10th Cir. B.A.P. June 4, 2019) (the presence of the funds in the debtor's estate, no matter how fleeting, results in a diminution of the estate from the perspective of other creditors).

223. The question of solvency under § 547(b) is measured at the time of the transfer challenged as preferential. Thus, a debtor could be solvent on the eighty-ninth day before filing and become insolvent thereafter, thus prompting the bankruptcy filing.

224. *See supra* text accompanying note 65.

225. *See WB Servs.*, 587 B.R. at 557. As discussed *supra* note 37, the supposition that the possibility of suffering an inequitable result from having to return a preferential payment only attains in the case of codebtors is flawed.

B. Making Sense of the Chaos

Regardless of whether the so-called “new creditor” really is a new creditor and not one already burdened with an independent obligation to the old creditor,²²⁶ the question becomes how to approach the cases that fall between the two extremes of direct payment to the old creditor with no involvement by the debtor, on the one hand, and an unrestricted advance of funds directly to the debtor with no understanding or concern over how the proceeds will be used, on the other. The beginning of an answer may be found by going back over eighty years to the Second Circuit’s decision in *Grubb v. General Contract Purchase Corp.*²²⁷ As discussed in some detail earlier,²²⁸ the *Grubb* court found three separate transfers from three different creditors to be protected under the earmarking doctrine. Yet, the basis for so concluding differed in each case. In one transaction the funds were actually deposited in the debtor’s account, but the defendant was paid by a check drawn by the new creditor on itself.²²⁹ In another, the funds were placed in the debtor’s account, but the new creditor accepted liability on an instrument drawn by the debtor on that account and made payable to the defendant.²³⁰ Finally, in the third case, the funds were paid directly to the defendant by the new creditor, but that lender was indifferent about how the funds were to be utilized and was simply doing the debtor’s bidding.²³¹

Thus, in analyzing the transfers, the court took into account control, intent, method of payment, timing, and outcome, but no one factor was alone or in combination with another necessarily dispositive. Instead, the court’s *modus operandi* might most appropriately be described as ascertaining, based on the totality of the circumstances with respect to each of the transfers under scrutiny, if the policy objectives sought to be served by the preference scheme were implicated.²³² Were that not the case, it is

226. See *supra* note 103.

227. *Grubb v. Gen. Contract Purchase Corp.*, 94 F.2d 70 (2d Cir. 1938).

228. See *supra* text accompanying notes 119–36.

229. *Grubb*, 94 F.2d at 71–72.

230. *Id.* at 72.

231. *Id.*

232. In fairness, the opinion never expressly states that this is the exercise in which the court is engaged, and *Grubb* is often-cited as turning on the question of “control.” See *In re Kelton Motors, Inc.*, 153 B.R. 417, 425 (Bankr. D. Vt. 1993) (“In a nutshell, *Grubb* held that funds not within the direct control of a debtor do not become property of the estate. Other courts have reached similar conclusions, even where the new creditor did not pay the old creditor directly but instead entrusted the funds to the debtor to pay the old creditor.”). However, *Grubb* could just as easily be characterized as permitting application of the doctrine

difficult to imagine how all three of the very disparate kind of transactions in *Grubb* could have been protected under the earmarking defense.²³³ This makes a considerable amount of sense since concepts like “control” and “intent” are inherently slippery, with subtle shadings of difference from case-to-case, and, thus, not truly capable of being applied consistently.²³⁴ For instance, some cases will regard the debtor as having control of funds if they are not restricted in some fashion by the new creditor,²³⁵ while others will focus on the level of physical control the debtor exercised over the funds.²³⁶ Still other cases minimize the importance of physical control and instead fix attention on whether the debtor had the ability to designate to whom the funds should be directed, regardless

despite the fact that the debtor had not only possession but also some control over the funds in question. This highlights the awkwardness and disutility of using “control” as the standard. *See infra* text accompanying note 235. In any event, it is urged that *Grubb* is more accurately described as applying a holistic “totality of the circumstances” test, not constrained by any one single factor.

233. The three transactions at issue were quite dissimilar in terms, *inter alia*, of who made the payment, who had possession of the funds, the timing of the payments, the form of payment, the intent of the new creditor, etc.

234. For example, in *In re Smith*, 966 F.2d 1527 (7th Cir. 1992), *cert. denied sub nom. Baker & Schultz, Inc. v. Boyer*, 506 U.S. 1030 (1992), a majority of the court felt that the debtor had sufficient control to negate application of the earmarking doctrine. *Id.* at 1536–37. Judge Flaum agreed that control was the determining factor but dissented on the basis that the debtor did not have possession over the funds long enough to constitute “control.” *Id.* at 1540 (Flaum, J., dissenting). *See also supra* notes 144, 162–63, & 203. Regarding the lack of clarity regarding intent, *see infra* note 238 and accompanying text.

235. *E.g.*, *In re White*, 600 B.R. 335, 337 (Bankr. E.D. Pa. 2019) (refusing to apply the earmarking doctrine outside of the new lender context); *Moser v. Bank of Tyler (In re Loggins)*, 513 B.R. 682, 700–03 (Bankr. E.D. Tex. 2014) (earmarking does not apply when there is no new creditor substituted for an old creditor); *Buchwald Cap. Advisors v. Metl-Span I, Ltd. (In re Pameco Corp.)*, 356 B.R. 327, 335 (Bankr. S.D.N.Y. 2006) (holding that even if the general contractor made a prepetition transfer of funds to a subcontractor with the expectation that, the subcontractor, who later became a Chapter 11 debtor, would use funds to pay its indebtedness to supplier, the debtor did not *borrow* those funds, thus precluding application of the earmarking doctrine). *But see supra* note 300.

236. *See, e.g.*, *Sherman v. TBK Bank (In re Dependable Auto Shippers, Inc.)*, No. 16-34855-BJH, 2018 WL 4348049 at *8 (Bankr. N.D. Tex., Sept. 7, 2018) (noting that courts in the Fifth Circuit emphasize the level of control); *Campbell v. Hanover Ins. Co.*, 457 B.R. 452, 457 (W.D.N.C. 2011) (concluding that the earmarking doctrine is not limited to situations when the new lender makes a direct payment to the old creditor, but also when the funds are placed in the debtor’s account).

of the intent of the new creditor.²³⁷ Finally, some cases emphasize performance consistent with the parties' agreed intent, largely irrespective of pre-transfer control.²³⁸

This crazy quilt underscores the fact that these concepts do not themselves represent intrinsic values, but rather operate as blunt instruments employed for purposes of determining if the purposive goals sought to be achieved by the preference law are in play. Just as the elements of a voidable preference have shifted, even though imperfectly,²³⁹ from ones focused on intent and culpability to ones that concentrate on *effect*,²⁴⁰ so, too, should application of the earmarking doctrine, as gloss on one of those elements, ultimately revolve around the true economic substance of the transaction and its correspondence with preference policy. If the loan at issue would not have been sought and/or granted but for the plan and desire to retire another outstanding debt, and that is in fact what the loan proceeds were used for, it would seem the inquiry should be at an end.²⁴¹ The need to parse the facts even more finely to ascertain if they fit into some perceived, but inherently inexact, understanding of what is meant by "dominion over," "control," and "intention" would seem a waste of time—not to mention a waste of estate assets consumed in needless, protracted litigation.

At its core, bankruptcy entails the need to balance the competing interests of debtors and creditors and, quite often, to balance bankruptcy policy against other social policies that inevitably become

237. See, e.g., *Parks v. FIA Card Servs. (In re Marshall)*, 550 F.3d 1251, 1257 (10th Cir. 2008) (earmarking "only applies when the lender requires the funds be used to pay a specific debt"); *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1361 (5th Cir. 1986), *reh'g denied*, 801 F.2d 398 (5th Cir. 1986) (proving the third-party's intent is one way, but not the exclusive method, for proving the debtor's lack of adequate control).

238. See *McCuskey v. The Nat'l Bank of Waterloo (In re Bohlen Enters., Ltd.)*, 859 F.2d 561, 567–68 (8th Cir. 1988), discussed *supra* notes 145–57 and accompanying text; see also *Cadle Co. v. Mangan (In re Flanagan)*, 503 F.3d 171, 184 (2d Cir. 2007) (holding that if the new creditor does not impose a specific requirement as to the funds' use, they become part of the estate and, as such, potentially subject to the trustee's avoidance powers).

239. See Ponoroff, *Flight From Equality*, *supra* note 7, at 335–36 (describing post-1978 amendments to the preference statute as reflecting a backsliding toward emphasizing culpability rather than effect).

240. See *supra* text accompanying notes 42–47.

241. *But see* *Colbert v. Walters (In re Wagenknecht)*, 2019 WL 2353534, Adv. No 18-01018 (B.A.P. 10th Cir., June 4, 2019) (the presence of the funds in the debtor's estate, no matter how fleeting, results in a diminution of the estate from the perspective of other creditors). Of course, *Wagenknecht* essentially reads the earmarking exception out of preference analysis notwithstanding its long and widely-recognized existence.

implicated in bankruptcy cases.²⁴² Consequently, bankruptcy judges are experienced, and, frankly, usually pretty good at, well, balancing.²⁴³ They are likewise accustomed to being presented with a dizzying array of financial transactions, not infrequently designed to mask in some manner, shape, or form, the true pecuniary essence and commercial reality of the deal.²⁴⁴ Moreover, even when there is no gamesmanship afoot, some commercial transactions can just get plain complicated, making it challenging at times to ferret out real economic purpose or impact behind the opaque curtain shrouding the deal. Thus, bankruptcy judges are also habituated in and quite

242. See, e.g., Troy A. McKenzie, *Judicial Independence, Autonomy, and the Bankruptcy Courts*, 62 STAN. L. REV. 747, 754 (2010) (commenting that bankruptcy cases “routinely involve a wide range of subject matters beyond technical parsing of the Bankruptcy Code,” and that “[b]ankruptcy judges are often called upon to decide sensitive questions of social and economic policy that garner the attention of the public and political actors.”); Nancy B. Rapoport, *Seeing the Forest and the Trees: The Proper Role of the Bankruptcy Attorney*, 70 IND. L.J. 783, 837–43 (1995) (highlighting several areas where bankruptcy policies encounter and clash with other social policies).

243. See David A. Skeel, Jr., *Employees, Pensions, and Governance in Chapter 11*, 82 WASH. U. L.Q. 1468, 1480 (2004) (discussing why bankruptcy judges are better suited than most other judges to conduct the “delicate task” of balancing competing interests); Charles Jordan Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75, 114 (1991) (noting, in relation to Chapter 11 reorganizations, that bankruptcy judges “operate in a legal and economic maelstrom,” and that bankruptcy judges frequently have “the difficult task of balancing” competing concerns “with little time for reflection.”).

244. Susan Block-Lieb, *The Costs of a Non-Article III Bankruptcy Court System*, 72 AM. BANKR. L.J. 529 (1998) (pointing out, as part of making the case for a bankruptcy court system staffed by Article III judges, that bankruptcy courts handle as broad a range of non-federal, as well as federal, case law; indeed, probably a higher proportion than the Article III courts). In a large Chapter 11 case, bankruptcy judges may be called upon to address such difficult issues as modifying health or retirement plans affecting thousands of employees, terminating collective bargaining agreements, resolving mass tort claims (including the rights of future, unknown claimants), et cetera. All of these issues require a sensitive balancing of competing social, economic, and even political considerations. Indeed, the Code often expressly calls in some instances for such balancing. For example, § 1114(g)(3) instructs the bankruptcy court to enter an order modifying payment of retiree benefits if, among other things, “such modification is necessary to permit the reorganization of the debtor and assures that all creditors, the debtor, and all of the affected parties are treated fairly and equitably, and is clearly favored by the balance of the equities.” Even in the more common non-big business case, bankruptcy judges routinely balance multiple factors that pull in different directions. As just one example, in deciding whether to lift the automatic stay in order to allow the continuation of litigation in a non-bankruptcy forum, the court must consider a range of differing considerations that may or may not be relevant in each case and that are not always entitled to equal weight. See, e.g., *In re Sonnax Indus., Inc. v. TRI Components Prods. Corp.* (*In re Sonnax Indus., Inc.*), 907 F.2d 1280, 1286 (2d Cir. 1990) (listing a dozen factors to be weighed in deciding whether litigation should be permitted to continue in another forum) (citing *In re Curtis*, 40 B.R. 795, 799–800 (Bankr. D. Utah 1984)); see also *Wiley v. Hartzler* (*In re Wiley*), 288 B.R. 818, 822 (B.A.P. 8th Cir. 2003) (setting forth a 5-factor test); *In re Preferred Underwriting Alliance, Inc.*, 351 B.R. 174, 177 (Bankr. N.D. Ala. 2006) (setting forth a 10-factor test). Regardless of the actual number of factors to be balanced, the point is that bankruptcy judges are quite familiar with the exercise.

proficient at uncovering the real quiddity of particular transactions regardless of how those transactions might on the surface have been cast for one reason or another.²⁴⁵

Preference cases generally involve a similar balancing of the bankruptcy law policy of equal distribution with the competing commercial norm of finality or repose in market transactions.²⁴⁶ These cases also arise in an almost infinite number of factual milieus, ranging from very simple to incredibly sophisticated transactions, and each is just a piece in a larger mosaic. Therefore, rather than adopting one test or another for determining when a transfer will be regarded as not involving an interest of the debtor in property under the earmarking exception, and potentially stifling deeper insight in the process, it is proposed that these cases be resolved individually on their unique facts. The exercise needs to be guided, however, by fixed attention on the question of diminishment during the preference period of the assets soon to become the bankruptcy estate, with its consequent reverberation for equality of distribution. The point being, this determination must occur in a reasoned and fluid way, not with an inflexible adherence to form. It must also be accompanied by attention to the considerations that tend to be discriminating talismans of whether the court is faced with what is merely a pure pass through of funds, on the one hand, or a new loan that truly adds to the coins in the piggy bank, on the other.

C. *Diminution of the Estate and Indirect Preferences*

It is submitted that the one constant in preference analysis is that if payment to a creditor neither depletes the assets available for distribution to unsecured creditors nor increases the liabilities of

245. For instance, getting down to the underlying economic substance of particular transactions occurs in connection with actions seeking either the equitable subordination or recharacterization of particular claims. See generally Ponoroff, *supra* note 189 (addressing both doctrines).

246. McCoid, *supra* note 7, at 269 (speaking of the 90-day limit on the preference period). Today, the issue tends to get played out in application of the ordinary course of business defense in § 547(c)(2), which is intended to leave undisturbed normal financial transactions. See *Lawson v. Ford Motor Co. (In re Roblin Indus., Inc.)*, 78 F.3d 30, 41 (2d Cir. 1996); H. REP. NO. 595, 95th Cong., 1st Sess. 373 (1977), reprinted in 1978 U.S.C.C.A.N. 6329. Unfortunately, due to the expansion in the scope of the exception since the Code was originally enacted, 547(c)(2) now represents a threat to the foundational equality aspiration of the preference law. See Ponoroff, *Flight From Equality*, *supra* note 7, at 354–65; see also *supra* text accompanying note 65.

the debtor, then it is not preferential.²⁴⁷ Some of the jurisprudence surrounding so-called “indirect preferences” elucidates this point. Under the Code, one of the elements of a preferential transfer is that the transfer, among other things, have been made “to or for the benefit of a creditor.”²⁴⁸ Thus, an avoidable preferential transfer may be either direct or indirect, with the latter being one made to a third party that benefits the defendant/creditor.

The most common example of an indirect preference is a payment made by an insolvent debtor in satisfaction of a guaranteed, but otherwise unsecured, obligation within 90 days prior to the bankruptcy. Although the payment is not made to or received by the guarantor, it nevertheless benefits the guarantor since it operates to terminate the guarantor’s conditional liability to the preferred creditor.²⁴⁹ Conversely, if the payment had not been made, the guarantor would have been a creditor in the debtor’s ensuing bankruptcy case with a contingent claim for the amount of the underlying debt.²⁵⁰ Because the debtor’s payment allowed a creditor (the guarantor) to receive more than it would have received if the payment had not been made, the payment is a preference and may be recovered from *either* the transferee or the indirect beneficiary.²⁵¹

Another example of an indirect preference, and the one that is instructive for present purposes, occurs when the debtor arranges for an existing unsecured obligation to be supported by a standby letter

247. This point was emphasized by Judge McMillian in his dissent in *McCuskey v. Nat’l Bank of Waterloo (In re Bohlen Enters. Ltd.)*, 859 F.2d 561, 568 (8th Cir. 1988) (McMillian, J. dissenting) (describing the inherent “logic” of the earmarking doctrine as protecting payments that neither decrease nor increase the liabilities of the debtor) (citing *Grubb v. General Contract Purchase Corp.*, 18 F. Supp. 680, 682 (S. D. N.Y. 1937), *aff’d* 94 F.2d 70 (2d Cir. 1938)); *see also supra* note 205 and *infra* note 260.

248. *See* 11 U.S.C. § 547(b)(1) (2012).

249. *See, e.g.*, *Armstrong v. Marine Bank Dane Co. (In re Prescott)*, 51 B.R. 751, 756 (Bankr. E.D. Wis. 1985) (finding that a junior secured party that had guaranteed the debtor’s obligation to the senior lender received an indirect preference when the senior lender seized the debtor’s property to reduce the overall indebtedness). Note, the definition of transfer under § 101(54) includes involuntary as well as voluntary transfers.

250. The Code defines “creditor” as an “entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor.” 11 U.S.C. § 101(10)(A) (2012). A claim, in turn, means a “right to payment,” regardless of whether it is contingent or noncontingent. 11 U.S.C. § 101(5)(A) (2012). *See also supra* text accompanying note 216.

251. Pursuant to Code § 550(a), the trustee is entitled to recover the amount of the preference from *either* the actual transferee or the party who was indirectly benefited by virtue of the transfer.

of credit.²⁵² If the creditor, as beneficiary under the letter, later draws on the letter upon default by the debtor on the principal obligation, no preference has occurred because the proceeds received when the draft is honored represent property of the issuing bank, not the debtor.²⁵³ Likewise, there has been no diminution in the value of the debtor's unencumbered assets relative to claims against those assets or, upon filing, the value of the estate. Instead, the issuer, who becomes a creditor of the debtor when the draft by the beneficiary is honored, has simply been substituted for the beneficiary in the debtor's later bankruptcy case. At its core, the situation is identical to a prototypical earmarking case.

A preference issue arises, if at all, at the time the letter of credit is first issued and delivered to the creditor/beneficiary, assuming it occurs during the preference period and the other statutory elements are met. Specifically, if the debtor's contingent obligation to the issuer is unsecured, then, as noted above, there has been no diminution in the value of the estate or prejudice to other creditors. However, if the back-up promissory note given by the debtor to the bank is collateralized with the debtor's property (as it often is), then a preferential transfer has taken place and it may be recovered from the creditor/transferee no differently than if the security interest had been given directly to that creditor.²⁵⁴ In this situation, a transfer of

252. The standby letter of credit functions differently from the commercial letter of credit. The latter is used as a payment mechanism in the sale of goods transaction, particularly in international transactions; the former is used as essentially a kind of "guarantee" against default on contractual obligations. The standby letter adds the obligation of the issuing bank to the obligation of the debtor to pay money. For example, a creditor may loan money to a debtor on certain terms. Although the debtor will promise to repay the loan, the creditor may, at the time of the original extension of credit or later, demand a greater assurance of repayment. One way to accomplish this is to have the debtor arrange for a bank to issue in the creditor's favor an irrevocable standby letter of credit for the amount of the loan. Then, if the debtor subsequently defaults on his payment obligation, the creditor can turn to the bank for payment of the amount due. The standby letter of credit backs up the performance of a financial obligation—repayment of a loan—and thus functions as a kind of repayment guarantee. See generally Gerald T. McLaughlin, *Standby Letters of Credit and Penalty Clauses: An Unexpected Synergy*, 43 OHIO ST. L. J. 1, 4 (1982).

253. See *In re W. L. Mead, Inc.*, 42 B.R. 57, 60 (Bankr. N.D. Ohio 1984); *In re M. J. Sales & Distrib. Co.*, 25 B.R. 608, 614 (Bankr. S.D.N.Y. 1982); Douglas G. Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. CHI. L. REV. 130 (1982); see also *Boyd v. Sachs (In re Auto Specialties Mfg. Co.)*, 153 B.R. 510, 519 (Bankr. W.D. Mich. 1993) (payment on a letter of credit is not a preference unless it results in a dollar-for-dollar reduction in the assets of the estate).

254. *E.g.*, *Metro Commc'ns, Inc. v. Pacific-10 Conference (In re Metro Commc'ns, Inc.)*, 115 B.R. 849, 854 (Bankr. W.D. Pa. 1990) (holding that an indirect transfer for purposes of § 547(b) occurs when the debtor pledges its assets to a third party as collateral in exchange for the third party's issuance of a letter of credit for the benefit of another existing creditor of the debtor). As a practical matter, a secured obligation has been substituted for an unsecured obligation, which is preferential. See *supra* note 18 and accompanying text.

an interest in property of the debtor, consisting of the collateral pledged to the issuing bank in order to secure the letter, occurs when the letter of credit is issued for the indirect benefit of the creditor. When the letter is later paid, the result of the transaction is that a secured obligation has been substituted for an unsecured one, and, consequently, the distributable estate diminished proportionately.²⁵⁵ The letter of credit beneficiary profited, albeit indirectly, upon the letter's issuance and, assuming insolvency, to the prejudice of other unsecured creditors.²⁵⁶ The key point of distinction and difference between the two transactions (i.e., obligation to issuer secured or unsecured) is the totemic diminution concept with its corresponding impact on ratable distribution.

By the same token, the pivotal point of similarity between the stand-by letter of credit scenario and the earmarking doctrine is the impact of the transactions on the distributive ideals of the bankruptcy system. Even if a transfer meets the formal definition of a preference based on an expansive definition of an interest of the debtor in

255. The Fifth Circuit's decision in *Kellogg v. Blue Quail Energy, Inc.* (*In re Compton Corp.*) exemplifies the analysis. The debtor, Compton, arranged the issuance of a \$585,000 letter of credit from MBank for the benefit of a supplier, Blue Quail that had previously delivered an oil shipment to Compton, the payment for which was delinquent. As is customary, Compton paid a fee for the issuance of the letter and executed a backup demand note payable to MBank in the face amount of the letter. Since MBank already had a blanket security interest in Compton's assets under a security agreement containing an all obligations clause, the demand note was automatically secured. The day after the issuance of the letter, an involuntary petition was filed against Compton. Several weeks later, MBank honored a \$569,000 draft drawn by Blue Quail. MBank added that amount to its secured claim in Compton's bankruptcy case and, because sufficient value existed in the collateral, its total claim was paid in full. Subsequently, the trustee sued Blue Quail in order to recover the \$569,000 transfer as a preference. The bankruptcy court granted Blue Quail's motion for summary judgment on the basis that the payment under the letter involved a transfer of MBank's property and did not constitute a transfer of the debtor's property. The district court affirmed on this ground and added that the increase in MBank's secured claim did not change the analysis since the transfer was for the sole benefit of the bank and in no way benefited Blue Quail. The Fifth Circuit reversed and permitted recovery against Blue Quail. The court observed that even though the offending transfer was made to MBank, the effect of the transaction was to commit the estate's assets to the repayment of an unsecured, antecedent debt within 90 days of the bankruptcy filing. *See generally In re Compton Corp.*, 831 F.2d 586 (5th Cir. 1987).

256. *Am. Bank v. Leasing Serv. Corp.* (*In re Air Conditioning, Inc.*), 55 B.R. 157, 159 (Bankr. S.D. Fla. 1985) (finding that a preference had occurred where, within ninety days prior to bankruptcy, a letter of credit was issued to a creditor on account of an antecedent unsecured debt and the debtor gave collateral to the issuing bank), *aff'd in part, rev'd in part*, 72 B.R. 657 (S.D. Fla. 1987), *aff'd in part, rev'd in part*, 845 F.2d 293 (11th Cir. 1988), *cert. denied*, 448 U.S. 993 (1988). For an example of an indirect preference case involving an earmarking challenge, *see generally Campbell v. Hanover Ins. Co.*, 457 B.R. 452 (W.D.N.C. 2011) (involving a loan made to the debtor to permit the debtor to obtain a letter of credit for the benefit of the defendant that had refused to issue new payment and performance bonds unless the debtor obtained the letter of credit to assure repayment of its outstanding indebtedness).

property, if the net impact on general creditors is benign, there is no sound policy basis to force recovery of the payment in question; indeed, to do so serves no purpose other than to vindicate the unsavory goal of exalting form over substance. The earmarking defense, by deformalizing the statutory definition of a voidable preference in appropriate circumstances sidesteps this displeasing outcome.

VII. DIMINUTION AS THE TOUCHSTONE FOR THE EARMARKING DOCTRINE

A. *An Alternative Standard*

At the time the Code was adopted, some commentators opined that the diminution of the estate understanding of a voidable preference no longer had any place in the analysis under the new bankruptcy law and that its continued application would serve only to undermine the structural integrity of § 547.²⁵⁷ Just as the argument that the earmarking doctrine did not survive enactment of the Code met with little success,²⁵⁸ rumors of the death of the diminution doctrine were greatly exaggerated as well. Courts have continued routinely to employ the doctrine as a mechanism for explaining why particular transactions contravene foundational bankruptcy purposes,²⁵⁹ as well as use the conceptualization of diminution of the estate (or the to be formed estate) as a benchmark for discriminating between those transfers that are subject to avoidance under § 547 from those that

257. See Thomas M. Ward & Jay A. Shulman, *In Defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing*, 61 WASH. U. L.Q. 1, 57 (1983) (criticizing the doctrine as inimical to the Code's attempt to encapsulate preference law in a closed universe of rule and exception); see also Carlson & Widen, *supra* note 88, at 592 ("Section 547(c)(1) has displaced the pre-Code common law doctrine that a trustee can only recover to the extent of 'diminution of the estate'—a notion that is even older than its adoption in the earmarking doctrine.").

258. See *supra* text accompanying notes 89–94.

259. While not explicitly incorporated into the Code's formulation of a preferential transfer, the diminution of the estate concept has retained its vitality in Code cases. See, e.g., *Hansen v. MacDonald Meat Co. (In re Kemp Pac. Fisheries, Inc.)*, 16 F.3d 313, 316 (9th Cir. 1994) (stating that the diminution doctrine has been developed to determine whether property transferred by the debtor belongs to the debtor for § 547 purposes); *Laker v. Vallette (In re Toyota of Jefferson, Inc.)*, 14 F.3d 1088, 1092 (5th Cir. 1994) (explaining application of the subsequent advance rule in § 547(c)(4) to shield an otherwise avoidable transfer from preference recovery on the ground that the effect of the transactions between the debtor and the creditor occasioned no diminution of the estate, and thus did not harm other creditors); see also *Buckley v. Jeld-Wen, Inc. (In re Interior Wood Prods. Co.)*, 986 F.2d 228, 231 (8th Cir. 1993) (holding that, although there is no express statutory requirement, most courts have found a diminution of the estate requirement implicit in the language of the statute); *In re Smith*, 966 F.2d 1527, 1535 (7th Cir. 1992) ("[C]ourts have also long held that to be avoidable, transfers must result in a depletion or diminution of the debtor's estate."), *cert. denied sub nom. Baker & Schultz, Inc. v. Boyer*, 506 U.S. 1030 (1992).

are not.²⁶⁰ Despite the appeal and perhaps even the systemic benefits that might flow from application of a purely mechanistic rule, it is impossible to deal in a consistent, principled way with the variety of transactions that give rise to preference issues without resort to the essential consequential objective. It is a central tenet of this Article that the joining of equality policy with the diminution notion helps keeps us, if not pointed with precise aim to that objective in preference cases, at least moving in the right direction.

Without question, certain defenses in § 547(c), most notably the ordinary course of business exception in § 547(c)(2), devitalize the equality aims served by the definition of a voidable preference in § 547(b).²⁶¹ Several other defenses, however, are explicable directly in terms of the diminution of the estate gloss on that definition in § 547(b).²⁶² These include the substantially contemporaneous exchange exception in subdivision (c)(1), the enabling loan defense in (c)(3), the subsequent advance of new value exception in subdivision (c)(4), and the floating liens safe harbor in subdivision (c)(5). All of these exceptions it should be noted were part of the Code when enacted,²⁶³ and each in some fashion or another identify and safeguard transactions that really have no preferential effect in the sense of making the plight of unsecured creditors any worse off as a consequence of transactions occurring during the preference period. Thus, it's easy to see the iterative linkage of the diminution abstraction with the very conception of when and why a particular transfer does or does not implicate the preference law.

Because of the equality imperative, although a preferential transfer operates to the benefit of the recipient-creditor, that fact alone is not sufficient to render the transfer voidable as a preference. The barometer for determining if a preference has occurred is based not on what the transferee/creditor receives but rather on what the debtor's

260. *Dubis v. Heritage Bank & Tr. Co. (In re Kenosha Liquidation Corp.)*, 158 B.R. 774, 779 (Bankr. E.D. Wis. 1993) (stating that a diminution of the estate is the paramount consideration in determining whether a preferential transfer has occurred). *But see* Weisberg, *supra* note 40, at 128 (suggesting that “[a] good number of cases flatly reject the . . . doctrine—or its underlying sentiment”).

261. *Supra* note 65; *see* Ponoroff, *Flight From Equality*, *supra* note 7, at 361 (referring to the defense in § 547(c)(2) as the exception that threatens to “consume[] the rule” and as “the undisputed darling of the credit industry”); Tabb, *supra* note 7, at 1035 (advocating repeal of section 547(c)(2) as undermining the operation of preference law as a rule of strict liability); *see also* Skeel, *supra* note 8, at 720 (“Much of the leakage in current preference law can be traced to the expansiveness of the safe harbor for payments made in the ordinary course of business.”).

262. *Ponoroff, Flight From Equality*, *supra* note 7, at 342 (describing these exceptions as meeting the technical definition of a preference, but not having preferential effect in the sense involving transactions that they do not result in a diminishment of the estate).

263. *See* Countryman, *supra* note 7, at 758–59.

estate (and, derivatively, the debtor's general creditors) has lost; there can be no preference if the property or property interest transferred is not property in which the debtor had an equitable interest.²⁶⁴ Therefore, the cases that cite an unearned advantage enjoyed by the creditor receiving the payment as reason not to apply the earmarking doctrine miss the point.²⁶⁵

Similarly, although it is routinely (if not universally) the practice,²⁶⁶ it is proposed that it is unwise to overlay in a hyper-technical, reflexive fashion the expansive definition of property of the estate in § 541(a) on to the language in § 547(b) concerning an interest of the debtor in property.²⁶⁷ Because of the effect that the filing of a bankruptcy petition has in separating a debtor's pre- and post-petition financial life once the case has been commenced,²⁶⁸ it is necessary and appropriate to go to great pains to assure that all of the property in which the debtor has a legal or equitable interest of any kind will be applied to payment of prepetition debts. However, in the period *prior* to filing, including during the applicable preference periods, fluctuations in the value of the debtor's assets may and typically do occur on a regular basis. These are not always problematic, as reflected by certain

264. See *Moser v. Bank of Tyler (In re Loggins)*, 513 B.R. 682, 697 (Bankr. E.D. Tex. 2014). See also *Wind Power Sys., Inc. v. Cannon Fin. Grp. (In re Wind Power Sys., Inc.)*, 841 F.2d 288, 292 (9th Cir. 1988) (“An exchange that does not take value away from the debtor's estate cannot be a transfer within the reach of section 547.”); *In re Tenderloin Health*, 849 F.3d 1231, 1244 (9th Cir. 2017) (“The pertinent question is whether the deposit depletes the assets of the estate available for distribution to creditors.”); see also *supra* notes 222, 259. To be clear, that there was a diminution of a debtor's assets relates to the determination of whether a transfer of a debtor's interest in property had preferential effect, and not to whether the “greater amounts test” is satisfied. *Kelley v. McCormack (In re Mitchell)*, 548 B.R. 862, 876–77 (Bankr. M.D. Ga. 2016) (holding that the analyses of whether an interest of the debtor in property for purposes of the earmarking doctrine and if the greater amount test has been satisfied are separate and independent.); see also *Rainsdon v. Am. First Fed. Credit Union*, Adv. Proceeding No. 16-8034-JDP, 2017 WL 4158329 at *5 (Bankr. D. Id. Sept. 18, 2017). Professor Countryman had a slightly different slant on the relationship between the diminution doctrine and the greater amount test of § 547(b)(5). See *supra* note 58.

265. See *supra* notes 38, 222 and accompanying text; see *infra* note 285 and accompanying text.

266. See *supra* note 114. See also *In re Mitchell*, 548 B.R. at 875 (“[I]n determining whether a transaction constituted a transfer of the interest of the debtor in property,” of the kind potentially subject to avoidance as preference or fraudulent transfer, a bankruptcy court “must find that the debtor disposed of or parted with rights that he had in property, [with] such rights being defined by state law unless altered by applicable federal law or a countervailing federal interest.”).

267. See also *infra* text accompanying notes 288-92. Of course, the case law is in decided disagreement with this proposition. *E.g.*, *Glinka v. Bank of Vt. (In re Kelton Motors, Inc.)*, 97 F.3d 22, 27 (2d Cir. 1996).

268. See Lawrence Ponoroff, *Neither ‘Twixt nor ‘Tween: Emerging Property Interests in Bankruptcy*, 61 ARIZ. L. REV. 101, 102 (2019) (“[E]ntry of the order for relief in a bankruptcy case operate to hew a distinct and largely impenetrable barrier between the debtor's pre- and postbankruptcy lives.”).

preference defenses that rest on the fact that there was not a net diminution of the value of the estate measured at two points in time: the 90th day prior to filing (or one year in the case of insiders) and the date of filing, even though there may have been wild fluctuations in the amount of the debtor's unencumbered assets in-between.²⁶⁹ The earmarking doctrine similarly operates as an exception, albeit equitable and not statutory, when the property transferred represented funds that, while perhaps appearing to be property of the debtor, were, in fact, always destined to be applied in retirement of the obligation due to a specifically identified creditor. Thus, as in the case of other statutory exceptions, the effect of the transfer is essentially neutral insofar as the distributable unencumbered assets are ultimately concerned.²⁷⁰

This is why the fact that the assets in question may be (or upon filing would become) property of the estate under the language of § 541(a) should not automatically preclude an earmarking argument based on events occurring at an earlier point in time. Instead, the focus should be on the analysis of whether a pre-filing transfer operated to the prejudice of unsecured creditors as a whole by reducing the coins in the piggy bank without a corresponding reduction of claims against those coins.²⁷¹ After all, that is the original justification for the doctrine

269. Of course, the defense in § 547(c)(5) for floating liens on inventory and receivables is the most familiar example of this, but the “subsequent advance” rule in § 547(c)(4) similarly ignores fluctuations in the amount of the preference during the 90-day period.

270. The closest analogy is constructive trust theory, under which a party that holds property as to which another party has a superior equitable claim, will be deemed, by operation of law, rather than consent, to hold such property in trust for the benefit of the second party. See generally *Benzaki*, *supra* note 199, at 487-90; William L. Rothschild, *How to Treat Constructive Trust Claims in Bankruptcy*, 35 AM. BANKR. INST. J., Nov. 2016, at 24. Once property is made subject to a constructive trust, it becomes excluded from the property of the estate. 11 U.S.C. § 541(d) excludes from the property of the estate assets as to which the debtor holds bare legal, but not equitable title. Given the similarities, it is not uncommon for both the earmarking doctrine and constructive trust theory to be raised as alternative defenses in response to a preference action. See, e.g., *Cadle Co. v. Mangan (In re Flanagan)*, 503 F.3d 171, 182, 186 (2d Cir. 2007) (affirming lower court's partial allowance of the earmarking defense, but concluding that the facts did not support imposition of a constructive trust); *In re Mitchell*, 548 B.R. at 880-83; see also *supra* note 209.

271. The preference law is intended to prevent a net diminishment of the debtor's assets available for distribution to unsecured creditors in the 90 days preceding the filing. Thus, if, as a practical matter, the transaction under scrutiny did not have this effect, regardless of how the property might be classified once the case is actually filed, its transfer should not be regarded as a preference. E.g., *Whitmore v. Innovation Ventures, LLC (In re Lopez Roman)*, 599 B.R. 87, 97 (Bankr. C.D. Cal. 2019) (holding that the test is not simply whether *any* interest was transferred, but rather whether there is a diminishment of “the fund to which creditors of the same class can legally resort for the payment of their debts’”) (citing *Adams v. Anderson (In re Superior Stamp & Coin Co.)*, 223 F.3d 1004, 1007 (9th Cir. 2000)).

in the first place.²⁷² Moreover, its application does not exceed the limits placed on the bankruptcy courts' equitable jurisdiction in *Law v. Siegel*, because § 541(a) defines the estate *as of the commencement of the case*, and not some prior point in time.²⁷³

This observation suggests that the tortured and, in the end, pointless preoccupation exhibited in some cases over whether the debtor had control of the funds or authority over their disposition is misguided.²⁷⁴ Application of the earmarking doctrine should turn on whether the purpose for the new credit accommodation was to satisfy an existing debt and whether the funds were in fact so used prior to filing. In this connection, it also should not matter necessarily whether the intent to restrict application of the funds to that specific purpose was held by the new creditor or the debtor, so long as it can be shown that this was one or the other's intention from the outset.²⁷⁵ Instead, the core question for the court in these cases should be, looking at the totality of the circumstances, can the old creditor demonstrate that the transfer under challenge was from funds that were either intended to be used to pay off that old creditor's debt, or, if not, that they were sufficiently "restricted" such that it is unlikely that they would have been used by the debtor for any other purpose.²⁷⁶ Of course, in all of these cases, we already know that the funds *were* used for that purpose.

272. The court in *Sherman v. TBK Bank (In re Dependable Auto Shippers, Inc.)*, No. 16-34855-BJH, 2018 WL 4348049, at *6 (Bankr. N.D. Tex. Sept. 7, 2018) makes this point by noting that if the funds have been entrusted to the debtor to pay a specific debt, they never really become property of the estate. The court, however, like most others, ruled that the phrase "interest of the debtor in property" should be understood as consistent with the definition in § 541(a) of "property of the estate." This position overlooks the fact that, unless the entrusted funds are still in the debtor's possession or under its control as of the filing date, they are not property of the estate where they have been transferred consistent with the earmarking designation. At that point, the trustee's recourse, if any, should be the constructive trust theory and not preference liability.

273. The limits of this statement exist where, even though there is technically no net diminution of the estate, the Code specifically calls for a different result based on when the transfer is deemed to have occurred. This is why the earmarking doctrine has found little purchase in the context of a secured refinancing with a delayed recordation of the new lien. *See infra* Section VI.D.

274. *See supra* note 203.

275. This is consistent with the holdings in *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1361, 1364 (5th Cir. 1986), *reh'g denied*, 801 F.2d 398 (5th Cir. 1986) and *Grubb v. Gen. Contract Purchase Corp.*, 94 F. 70, 73 (2d Cir. 1938). *See supra* text accompanying notes 101, 131–33, and 233.

276. *In re Dependable Auto*, 2018 WL 4348049, at *7–8 (specifically considering the "totality of the circumstances" with the goal of assuring the "substance over form approach" . . . assess[es] claims of the earmarking defense").

The gravamen of this suggested approach is to ensure that the outcome corresponds with underlying economic substance and reality.²⁷⁷ If the defendant can demonstrate that the funds were supplied by the new creditor specifically for purposes of retiring that creditor's debt, and that's indeed what happened, the defense should prevail, plain and simple.²⁷⁸ Alternatively, if the defendant cannot establish intention, but can show either through direct evidence or circumstantially that the funds were earmarked in a fashion that provides confidence that they were from the get-go always advanced for the purpose of satisfying the debtor's obligation to the defendant that, too, should be enough to sustain the earmarking defense.²⁷⁹

B. Operation of the New Standard

So, let's return to the hypothetical used earlier where Popov is indebted to Vasiliev on an unsecured obligation, but, in this case, there is no surety. Instead, Ivanov is truly a "new creditor." If the payment to Vasiliev occurs during the preference period, and all of the other elements of § 547(b) are satisfied, the trustee should be able to meet his or her burden of establishing a prima facie case. For Vasiliev then to defend successfully based on the earmarking exception to the

277. See *Coral Petroleum*, 797 F.2d at 1359 (5th Cir. 1986) (denying the earmarking defense based on debtor's possession of funds as it would elevate form over substance). By the same token, the form of the transaction should not be used to create the appearance of an earmarking situation when, in fact, one does not exist. See *Rieser v. Bruck Plastics Co. (In re Trinity Plastics, Inc.)*, 138 B.R. 203, 208 (Bankr. S.D. Ohio 1992) (ruling that the court should avoid formalistic applications of the earmarking doctrine and, based on analysis of the underlying circumstances, focus on whether the transfers in question diminished the value of the debtor's estate).

278. In the situation where the funds transferred derived from a sale of unencumbered assets, the earmarking doctrine would not preclude characterizing the transfer as a preference since there is no "new creditor," and thus no replacement of the assets transferred. See *Feldman v. People First Fed. Credit Union (In re White)*, 600 B.R. 335, 340 (Bankr. E.D. Pa. 2019) (rejecting application of the earmarking doctrine where no new lender exists); *Moser v. Bank of Tyler (In re Loggins)*, 513 B.R. 682, 700-03 (Bankr. E.D. Tex. 2014). This result does not follow, however, where the asset(s) in question were fully encumbered prior to the sale and the assumption of the liability is not in lieu of a higher purchase price that might have redounded to the benefit of unsecured creditors. In effect, the circumstances mirror the new creditor rationale insofar as the impact on the estate is concerned. See generally *Cage v. Wyo-Ben, Inc. (In re Ramba, Inc.)*, 437 F.3d 457, 459 (5th Cir. 2006), discussed *infra* note 301, wherein, in connection with the purchase of the debtor's drilling division, the purchaser paid certain outstanding debts of the debtor to key suppliers and received the assets free and clear of all liens. Because the purchase price and the assumed debts did not exceed total amount due to the secured lender, payment of the amount of the assumed obligations to the debtor would not have benefitted general creditors. *Id.* at 461.

279. This is where "control" might become a factor, but not in the manner necessarily suggested by the court in *Coral Petroleum*, 797 F.2d at 1358-59 (distinguishing possession from "general" control). The inherently slippery and nebulous meaning of the term "control," see *supra* note 203, limits its utility as a guiding concept. The alternative approach to proving control or lack thereof is explored *infra* in Section VI.D.

“interest of the debtor in property” requirement of the statute, it would be incumbent on Vasiliev to demonstrate that Ivanov intended for, and it was always understood that, his loan to Popov would be used by Popov exclusively for the purpose of paying off the obligation to Vasiliev.²⁸⁰ Failing that, Vasiliev could still defend successfully by showing either that the earmarked funds never passed through Popov’s hands or that, even though Popov had apparent unrestricted possession of the funds briefly,²⁸¹ they were obtained by Popov with the intent of retiring Popov’s obligation to Vasiliev, and that is precisely what occurred.²⁸²

If we remain guided by the twin beacons of diminution of the estate and equality of distribution, there is no good reason why, in effect, satisfaction of virtually any of the tests that have been bandied about over the years²⁸³ ought not to be sufficient to recognize the earmarking defense. Once more, the question is not did the old creditor receive more than it would have had the payment not occurred, which is the focus of the greater amount test in § 547(b)(5),²⁸⁴ but instead whether unsecured creditors as a group were prejudiced by the transfer due to the diminishment of the distributable estate.²⁸⁵ From that perspective, if there is clear proof that the new creditor extended the loan proceeds only for the purpose of paying off a particular debt, or that the debtor never intended to exercise its ability to designate the application of the funds other than to payment of the old creditor’s obligation, then what

280. Because the earmarking doctrine operates both as a defense and also relates to one of the elements of the trustee’s proof under § 547(b), there is some disagreement over who bears the burden of proof. *See supra* note 51.

281. This was of course true with regard to one of the transfers at issue in *Grubb v. Gen. Contract Purchase Corp.*, 94 F.2d 70, 71–72 (2d Cir. 1938). *See supra* text accompanying notes 122–28; *see also* *Caillouet v. First Bank and Tr. (In re Entringer Bakeries, Inc.)*, 548 F.3d 344, 349–50 (5th Cir. 2008) (noting that, under Fifth Circuit precedent, possession does not equate to control).

282. *See, e.g.*, *Adams v. Anderson (In re Superior Stamp & Coin Co.)*, 223 F.3d 1004, 1009 (9th Cir. 2000) (reversing decision of the bankruptcy court that had rejected an earmarking defense on the basis that possession of the funds in question gave the defendant the power, though not the right, to use the funds for a purpose other than the one for which the funds had been advanced).

283. *See* text accompanying *supra* notes 191–202.

284. *See supra* notes 55, and 58–59 and accompanying text.

285. *E.g.*, *Wind Power Sys. Inc. v. Cannon Fin. Grp., Inc. (In re Wind Power Sys., Inc.)*, 841 F.2d 288, 292 (9th Cir. 1988); (“[a]n exchange that does not take value away from the debtor’s estate cannot be a transfer within the reach of section 547.”); *Campbell v. Hanover Ins. Co. (In re ESA Envtl. Specialists Inc.)* 709 F.3d 388, 395 (4th Cir. 2013) (citing circuit precedent as the test being not unequal payment to creditors, but what the estate has lost); *see also supra* notes 38, 222.

transpired is the substitution of one unsecured creditor for another²⁸⁶; no harm, no foul. However, in the latter case, because of the difficulty in many cases of actually *proving* the debtor's intent with any degree of certainty or reliability (never mind economy), proof by circumstantial evidence ought to be permitted, and, in that connection, it is proposed that a mechanism as simple and obvious as timing might be used as a reliable proxy for intent.²⁸⁷

C. Distinguishing § 541(a) and § 547(b)

Before turning to that mechanism, it warrants reemphasizing that a proper analysis may also require disaggregation of the broad definition of the “property of the estate” under 541(a) once the bankruptcy case is filed from the determination of an interest in the debtor in property in advance of filing for purposes of § 547(b).²⁸⁸ The expansive definition in § 541(a) serves a purpose that is not yet implicated prior to the filing of the bankruptcy petition. Specifically, the former establishes the commencement of the case as the date of cleavage for establishing the parties' respective rights in property, thus implementing the rudimentary bankruptcy policy of separating the debtor's pre and post-petition financial lives.²⁸⁹ The widely inclusive scope of the definition of property of the estate in § 541(a) should be read and applied accordingly.²⁹⁰

286. This assumes, of course, that the earmarked funds are used applied in accordance with the condition imposed by the new lender. This proved to be a disabling factor in *McCuskey v. Nat'l Bank of Waterloo (In re Bohlen Enters., Ltd.)*, 859 F.2d 561, 567 (8th Cir. 1988). See *supra* note 157 and accompanying text.

287. See *infra* text accompanying notes 294–95.

288. See *supra* text accompanying notes 266–73.

289. *Porrett v. Hillen (In re Porrett)*, 564 B.R. 57, 66 (D. Idaho 2016) (opining that “commencement of the case ‘sets a date of cleavage’ and establishes the moment at which the parties' respective rights in property must be determined.”) (citations omitted); *In re Sturgis Iron & Metal Co., Inc.*, 420 B.R. 716, 749 n.63 (Bankr. W.D. Mich. 2009) (“[T]he entire bankruptcy process is based upon a division in [t]ime, [sic] with claims that arose prepetition against the debtor being treated in one manner and claims that arose against the estate postpetition being treated in a different manner.”); *Siegel v. Fed. Dep. Ins. Corp (In re Indymac Bancorp Inc.)*, 2012 WL 1037481, at *12 (Bankr. C.D. Cal. Mar. 29, 2012) (noting that the phrase “as of the commencement of the case” in § 541(a)(1) is intended to set a date of cleavage for establishing the parties' respective rights in property).

290. See, e.g., *Gladstone v. Bancorp*, 811 F.3d 1133, 1139 (9th Cir. 2016) (“The legislative history of the Bankruptcy Code reveals that the concept of property of the estate is to be interpreted broadly.”) (quoting *Chappel v. Proctor (In re Chappel)*, 189 B.R. 489, 493 (B.A.P. 9th Cir. 1995)); *Chartschlaa v. Nationwide Mut. Ins. Co.*, 538 F.3d 116, 122 (2d Cir. 2008) (holding that property of the estate for purposes of § 541(a) consists of “every conceivable interest of the debtor, future, nonpossessory, contingent, speculative, and derivative, . . . [including] causes of action owned by the debtor or arising from property of the estate.”) (citation omitted).

By contrast, when the issue is whether funds represented an interest of the debtor in property in the context of an action to avoid a pre-filing payment, the language should be read and applied consistent with the policies and purposes behind the preference law, most notably equality of distribution and assuring that there is no diminishment of (and also no artificial increase in) the size of the distributable estate in relation to the debtor's unsecured creditors during the pre-filing preference period.²⁹¹ The earmarking doctrine is premised of course on the fact that funds provided to the debtor to pay a specific indebtedness are not recoverable as a preference because those dollars were never meaningfully property of the debtor, so the transfer does not in actuality disadvantage other creditors. In this context, property of the debtor can and should be given a more flexible definition that takes into account the equality policy that modern preference law was conceived and tailored to serve.²⁹²

D. A Temporal Limitation

The suggestion above to expand the scope of the earmarking exception even in the non-codebtor situation if either (1) the new loan was specifically extended with an understanding that the proceeds would be used only to pay the old creditor and that is what occurred, or (2) it can be demonstrated that the debtor had no intention of using its control and dominion over the new loan proceeds other than to pay off a specific debt, and that the loan was acquired for this purpose, requires elaboration in relation to the later circumstance. In the first scenario, proof will likely be available with relative ease from the new lender's documentation of the transaction.²⁹³ In the second context, reliable proof of actual intent will often be difficult and costly to obtain. Therefore, a neutral delegate needs to serve in its stead.

Borrowing a page from the preference law itself, it is proposed that the most expedient surrogate would be a temporal one. As an example, it might be sufficient to say that, in the absence of other direct evidence of intent,²⁹⁴ in order for the new lender's funds to be regarded as

291. *See supra* note 38 and accompanying text.

292. *But see supra* note 8.

293. If the extension of new credit is not an unconditional loan that might benefit all of the debtor's creditors, the lender is likely to have some written evidence that the funds were being advanced for the specific purpose of paying all or at least a portion of a particular debt owed by the debtor. This should be readily discoverable by the holder of that particular debt. Failing that, it would be necessary to fall back on the debtor's intent as evidenced by its failure to exercise control in the manner proposed below in this Section VI.B.

294. Such evidence might come in the form of proof of an agreement or understanding between the debtor and the old creditor concerning the restricted use of the funds. *See Coral*

“restricted,” the payment to the old creditor must have occurred no later than two business days from the date of the debtor’s receipt of the funds (or perhaps even a more truncated period of time; e.g., twenty-four hours), provided of course that the payment occurs prior to the commencement of the debtor’s bankruptcy case.²⁹⁵ Failing that, the funds would be treated as unrestricted and truly a new loan, meaning that any subsequent transfer would be of property as to which the debtor, and its creditors, have an interest for purposes of the preference law. A rule bounded by these parameters, while concededly arbitrary, would have the benefit of setting a clear, bright line that would be administratively simple to manage, unlike the inherent complexity entailed in establishing at what point the debtor exercised impermissible control. Moreover, it is frankly no more arbitrary than the statutory 90-day preference period; sometimes we just need a line and it matters rather less where we draw that line than that there be a shared understanding of where it is drawn.

Even with this limitation, the earmarking exception as proposed above would be more capacious in reach than any of the currently existing standards or tests that have been proposed under the Code. In fact, drawing the defense in this fashion would make it closest in operation with the approach taken by Judge Hand in *Grubb v. General Contract Purchase Corp.*²⁹⁶ While ensuring no prejudice to other creditors, it would allow certain otherwise preferential transfer to survive attack. In so doing, it would have the dual benefit of providing a measure of protection to the old creditor, who perhaps detrimentally relied on the payment in relinquishing certain rights or otherwise,²⁹⁷ and, at the same time, could operate to throw a life-line to financially-struggling debtors in some instances since, often, the old creditor will be one that is asserting the most ardent collection pressure. Substitution of the creditor inclined to put the screws to the debtor with one presumably more placable and willing to give the debtor time might just be enough to allow the debtor to stave off bankruptcy entirely. Surely that is in the interests of all concerned and could

Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351, 1361–63 (5th Cir. 1986), *reh’g denied*, 801 F.2d 338 (1986) (holding that failure to demonstrate intent to restrict the new loan proceeds by the new lender was not fatal to the earmarking defense); *see also supra* note 143 and accompanying text. In this case, the court might allow a somewhat longer period of time between receipt of the funds and payment of the old creditor before barring use of the earmarking exception.

295. This is necessary of course because, upon the commencement of the case, such funds would become estate property under 11 U.S.C § 541(a)(1) (2012) and subject to restriction under the automatic stay of § 361.

296. 94 F.2d 70 (2d Cir. 1938).

297. *See supra* note 37.

actually make general creditors better off in the long run. However, without the protection of a clear, and, frankly, more expansive earmarking defense, the old creditor will have less incentive to give the debtor the opportunity it needs to arrange alternative financing or otherwise right the ship.²⁹⁸

*E. An Exclusion:
Delayed Recordation on Refinance*

There is another factual situation that has arisen in several reported decisions where the earmarking doctrine has been invoked in an attempt to insulate an alleged preferential transfer from avoidance. These are cases where the debtor has refinanced a secured obligation, either with the original or a new lender, prior to filing its bankruptcy case, but the lender neglects to perfect its new interest in (and often to file a release the old lien on) the collateral until the 30-day grace period in § 547(e)(2)(a) has expired.²⁹⁹ Under the logic employed above for delineating the scope of the earmarking doctrine in the more conventional setting of a new loan, this scenario might have been thought as similarly ripe for reform.³⁰⁰ However, application of the earmarking

298. A more-or-less bullet-proof defense might incline the old creditor to accept the payment and move on as opposed to initiate aggressive collection activity against the debtor in order to get ahead of the beginning of the preference period. *See supra* text accompanying note 64.

299. Section 547(e) governs when the transfer of a security interest in personal property or a lien on real estate is deemed to take place. The possibilities are that the transfer occurs when it was made or when it is perfected (made known publicly). Because the law frowns on so-called “secret liens,” the time of perfection is generally treated as the time of transfer, but subject to a grace period during which perfection will be regarded as relating back to the date the interest was granted. Since the effective date of BAPCPA, that grace period is thirty days. Earlier, it had been only ten days. *See* 11 U.S.C § 547(e)(2) (2006).

300. In certain situations where the peculiar circumstances of the case mirror the acknowledged rationales for the earmarking doctrine, some courts provide protection from preferential avoidance in connection with asset sales transactions as well as new loans. *See* *Cage v. Wyo-Ben, Inc. (In re Ramba, Inc.)*, 437 F.3d 457 (5th Cir. 2006), involved a preference challenge to certain transfers by the buyer of the debtor’s drilling operations division of a portion of the purchase price to unsecured creditors of the debtor which, under the purchase agreement, were being assumed by the buyer. The court concluded the payments were not preferential, since debtor’s assets were fully encumbered at time of sale, meaning that the funds would never have been available to general creditors in the bankruptcy case. *Id.* at 460. Specifically, as part of and essential to the sale to the buyer, the secured lender agreed to release its security interests in the assets of the drilling division and to allow some of the purchase price to go toward paying the debtor’s liability to certain critical suppliers upon which the drilling operations depended. In the ordinary case, when a third party pays a creditor of an insolvent debtor with a portion of the purchase price for the debtor’s assets, the payment will be recoverable as a preference because of the loss of those funds for general creditors. *Buckley v. Jeld-Wen, Inc. (In re Interior Wood Prods. Co.)*, 986 F.2d 228, 232 (8th Cir. 1993) (refusing to apply the earmarking doctrine in a purchase and sale of assets situation). “On the other hand, if the funds used to pay the creditor were not part of the sale price

principle in this context is problematic, primarily due to the tightening in recent years of the bankruptcy courts' equitable powers,³⁰¹ even when transfer of the security interest is made in return for new value.³⁰² In addition, affording relief from the rules governing when the transfer of a collateral interest in the debtor's property is deemed to occur would also violate the commercial law's opprobrium for "secret liens" that § 547(e)(2) of the Code is intended to operationalize by limiting the time an unrecorded lien can be effective.³⁰³

The decision of the bankruptcy court in *In re Power*³⁰⁴ is illustrative. The debtors in the case originally financed a vehicle through the Idaho Central Credit Union ("ICCU"), secured by a lien on the vehicle.³⁰⁵ In April of 2016, the debtors decided to refinance the purchase-money loan with the proceeds of a new loan from the defendant, granting the defendant a lien on the same vehicle.³⁰⁶ However, due to a mistake in the title application, the defendant's lien was not noted on the certificate of title until May 20, a full 37 days after the debtors' execution of the promissory note to the defendant.³⁰⁷

The debtors then filed their Chapter 7 bankruptcy case on July 18, and the trustee in the case promptly initiated an action seeking to set aside the defendant's lien on the vehicle as a preference under § 547(b).³⁰⁸ Specifically, the trustee urged that because perfection of the defendant's security interest did not occur until after the 30-day safe harbor in § 547(e)(2) had expired, the transfer of the interest in

for the debtor's assets, then it is unlikely that the payment diminished the debtor's estate." *Warsco v. Preferred Tech. Grp.*, 258 F.3d 557, 565 (7th Cir. 2001). Finally, some courts just seem to be much stricter in terms of requiring a new lender as a necessary condition before even entertaining an earmarking argument. *See supra* note 279 and *infra* note 312.

301. *See supra* Section IV.

302. *See Carlson, supra* note 7, at 247 n.145.

303. *See generally* Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 768–77 (1984) (describing the role of the preference law in addressing the problem of ostensible ownership). The evils of ostensible ownership (secret liens) are frequently promoted as the justification for the perfection requirements of Article 9. *See* Douglas G. Baird & Thomas H. Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175, 191–93 (1983).

304. *Rainsdon v. Am. First Fed. Credit Union (In re Power)*, 2017 WL 4158329, Adv. Proceeding No. 16–8034–JDP (Bankr. D. Id. Sept. 18, 2017).

305. *Id.* at *1.

306. *Id.* at *1–2. The defendant paid off ICCU, which then released its lien on the vehicle. *Id.*

307. *Id.* at *4. Under Idaho law, a security interest in a motor vehicle is treated as perfected on the date that the state department of transportation receives a properly completed application. There was some lack of clarity on the facts as to when the application was submitted, but the most favorable of the possibilities from the creditor's perspective was thirty-seven days after the date that the interest was granted. *Id.*

308. *Id.* at *4.

the debtor's property occurred, at the earliest, on May 20, when the properly completed application of a new certificate of title was received by the Idaho Department of Transportation.³⁰⁹ That being the case, the trustee argued—not without some force—that the transfer was now on account of an antecedent debt.³¹⁰ The defendant did not dispute the technical preference analysis but urged that the transfer of the security interest to it should be insulated from avoidance based upon the earmarking doctrine, pointing out that all that had occurred was that a secured interest in the vehicle had been replaced by another secured interest.³¹¹

While the defendant's position was also not without some weight, the court rejected it for two reasons. First, the court found that the earmarking doctrine is recognized to protect a transfer of funds from a new creditor to an existing creditor,³¹² and the trustee in the instant case was not challenging the payoff of ICCU by the defendant.³¹³ Rather, in this case, the basis of the preference action was the transfer by the debtor of a security interest to collateralize the new loan that was not perfected within the safe harbor period of § 547(e)(2)(A); i.e., thirty days. Thus, the transfer encumbered property that had previously been unencumbered and, in so doing, diminished the debtors' estate.³¹⁴ The second, and arguably more

309. *Id.* Ordinarily, renewal of an existing lien or security interest would not be “a new transfer within the meaning of section 547 if it merely continues an existing interest; it does not diminish the collection of assets to be distributed among the general creditors.” *Wind Power Sys., Inc. v. Cannon Fin. Grp., Inc. (In re Wind Power Sys., Inc.)*, 841 F.2d 288, 292 (9th Cir. 1988); accord *Gregory v. Cmty. Credit Co. (In re Biggers)*, 249 B.R. 873, 878 (M.D. Tenn. 2000) (noting that a refinancing transaction is ordinarily not a preference). Of course, this presumes that the debtor's property is continuously subject to the lien or security interest, which is what went wrong in *In re Power*, 2017 WL 4158329, at *6.

310. Under § 547(e)(1) of the Code, the transfer of a lien or security interest is deemed to take place when it becomes effective between the parties, provided it is perfected within thirty days of that time; if it is not so perfected, then it is deemed to occur upon the latter perfection, creating a gap between attachment and perfection. *See supra* note 300. Effectively, ICCU's lien was released and, when the defendant tardily perfected its lien, the debtors' assets were diminished by the amount the lesser of the amount secured by the lien or the value of the collateral.

311. *In re Power*, 2017 WL 4158329, at *7 (effectively trying to invoke the doctrine to support the argument that, in substance, the defendant simply took over the ICCU lien, such that the one secured creditor was substituted by another); *see supra* note 279.

312. *Id.* at *8; *see also* *Stingley v. AlliedSignal, Inc. (In re Libby Int'l, Inc.)*, 247 B.R. 463, 469 (B.A.P. 8th Cir. 2000) (holding that the earmarking doctrine does not apply when there is no new creditor substituted for an old creditor).

313. *See also* *Buchwald Cap. Advisors v. Metl-Span I, Ltd. (In re Pameco Corp.)*, 356 B.R. 327, 335 (Bankr. S.D.N.Y. 2006) (refusing to apply the earmarking doctrine in situations where the funds used to pay the old creditor were simply payments of sums due to the debtor rather than newly borrowed funds). *But see infra* note 340 and accompanying text.

314. *Power*, 2017 WL 4158329, at *8.

compelling, justification for the court's holding was that the bankruptcy court lacked the power to protect the transfer under these circumstances.³¹⁵ Specifically, the court allowed that of all of the decisions addressing application of earmarking logic to the security interest of a new creditor, only the Eight Circuit has ruled that the earmarking doctrine can be invoked to insulate the otherwise avoidable transfer of a security interest to a new lender from preference liability.³¹⁶

In response to that perspective, the *Power* court cited approvingly from the First Circuit's opinion in *In re Lazarus*,³¹⁷ a case involving comparable facts in which the circuit court reasoned that the earmarking doctrine cannot provide the new creditor "an escape from the plain language of section 547(b) in the case of a belatedly-perfected transfer of a security interest."³¹⁸ This position appears to be unassailable, as § 547(e) is quite explicit in relation to the time of transfer, which is to say that if the creditor's interest in property is not perfected within the statutory grace period then the transfer is deemed to occur at the later time of perfection.³¹⁹ This means that it does not relate back to the time the security interest attached (*i.e.*, become effective between the parties) and, thus, must be regarded as on account of an antecedent debt. For this reason, if the other elements of § 547(b) were satisfied as of this date, the transfer properly qualifies as a voidable preference. To rule otherwise based on equitable considerations would contravene the instruction of the Supreme

315. *Id.* at *5 (citing *Law v. Siegel*, 571 U.S. 415, 420 (2014) for the proposition that the court may not unilaterally extend the 30-day period of § 547(e)(2), "or otherwise adjust the rights of the parties based upon its own sense of justice").

316. *Id.* at *7 (referring to *Kaler v. Cmty. First Nat'l Bank (In re Heitkamp)*, 137 F.2d 1087 (8th Cir. 1998)), discussed further *infra* text accompanying notes 323–24.

317. *Collins v. Greater Atlantic Mort. Corp. (In re Lazarus)*, 478 F.3d 12 (1st Cir. 2007).

318. *Id.* at 16. To use the earmarking doctrine as a means for indefinitely extending the 30-day grace period in § 547(e) would undermine the balance struck by Congress between allowing secured creditors a reasonable time to record and the policy of protecting other creditors against "secret" liens, which is served by perfection. As it is, the argument has been made that thirty days is already far more than is reasonably necessary. See CHARLES JORDAN TABB, LAW OF BANKRUPTCY § 6.9, p. 497 (4th ed., West 2016).

319. See *Chase Manhattan Mort. Corp. v. Shapiro (In re Lee)*, 530 F.3d 458, 468–72 (6th Cir. 2008) (refusing to apply the earmarking doctrine to save a late-filed mortgage from avoidance as a preferential transfer and noting that the multiple transfer approach adopted in *Lazarus* represents the overwhelming weight of authority); see also *Collins v. JP Morgan Chase (In re Flannery)*, 513 B.R. 1, 5 (Bankr. D. Mass. 2014) (rejecting an attempt to apply the earmarking doctrine to defend against trustee's effort to avoid a belatedly filed mortgage as a preference); *Gold v. Interstate Fin. Corp. (In re Schmiel)*, 319 B.R. 520, 528–29 (Bankr. E.D. Mich. 2005) (holding that the earmarking doctrine, if applicable in connection with home mortgage refinancing transaction involving a belatedly perfected mortgage perfected, would protect only the old mortgagee, the recipient of earmarked funds, and not new lender).

Court in *Law v. Siegel*³²⁰ that the bankruptcy court's equitable authority does not extend to construing an explicit statutory provision beyond its logical limits.

The decision of the court in *Power* is unquestionably correct and represents the strong weight of authority.³²¹ The Eighth Circuit's decision in *In re Heitkamp*,³²² which essentially sought to collapse all of the stages of the refinancing arrangement into a single, or *unitary*, transaction,³²³ has been properly criticized because it ignores the statutory language relating to the definition of "transfer" in § 101(54), as supplemented by § 547(e) governing the time of transfer of a security interest.³²⁴ These provisions together dictate that the failure to perfect a security interest or record a lien against real estate within thirty days after the date the security interest or lien became effective between the debtor and the lender render the transfer on account of an antecedent debt for preference analysis purposes.³²⁵ The argument that the steps involved in a situation of this ilk should be regarded as a "unitary transaction," and thus one not entailing a diminution of the estate, disregards the Code's explicit scheme for determining when the transfer of an interest in the debtor's property shall be deemed to occur.³²⁶ Despite the appeal of the argument that other creditors were

320. *Law v. Siegel*, 571 U.S. 415 (2014); *Lee*, 530 F.3d at 472 (applying the earmarking doctrine in this scenario would "write § 547(e) out of the Bankruptcy Code and, in the process, defeat the sound policy the statute was intended to promote—the discouragement of secret liens."); see also *Rainsdon v. Am. First Fed. Credit Union (In re Power)*, 2017 WL 4158329, at *5, Adv. Proceeding No. 16–8034–JDP (Bankr. D. Id. Sept. 18, 2017). (noting that the defendant's equitable argument to avoid avoidance of its lien was foreclosed by the Supreme Court's holding in *Law*); see also *Encore Credit Corp. v. Lim*, 373 BR 7, 17 (E.D. Mich. 2007) ("The safe harbor provision would be meaningless if a secured creditor could perfect its interest at any time and still be able to use the earmarking doctrine.").

321. See *Lee*, 530 F.3d at 468 (identifying *Lazarus*, 478 F.3d 12 (1st Cir. 2007) as the "prevailing" view) (citations omitted).

322. *Kaler v. Cmty. First Nat'l Bank (In re Heitkamp)*, 137 F.3d 1087 (8th Cir. 1998); *accord Krigel v. Sterling Nat'l Bank (In re Ward)*, 230 B.R. 115 (B.A.P. 8th Cir. 1999).

323. *Heitkamp*, 137 F.3d at 1089 (finding no diminishment since one secured creditor was simply replaced by another).

324. See *supra* note 321. But see Kevin M. Baum, Apparently, "No Good Deed Goes Unpunished": The Earmarking Doctrine, Equitable Subordination, and Inquiry Notice are Necessary Protections When Refinancing Consumer Mortgages in an Uncertain Market, 83 ST. JOHN'S L. REV. 1361, 1376–91 (2009) (arguing in favor of the appropriateness of the single transfer, or unitary approach, endorsed by the court in *Heitkamp*).

325. See *Chase Manhattan Mort. Corp. v. Shapiro (In re Lee)*, 530 F.3d 458, 472 n.11 (6th Cir. 2007) (distinguishing cases where the new lien is perfected inside of the statutory grace period); see also *supra* note 310.

326. See *Lee*, 530 F.3d at 473 (discussing "[t]he problems that arise when courts effectively rewrite bankruptcy statutes"). Part of the rationale in *Heitkamp*, 137 F.3d at 1089, was to focus on the net effect of the transactions in question and not simply the form they took, which is in part the justification for the expansive view of the earmarking doctrine

not only not misled,³²⁷ but perhaps even advantaged by the refinancing transaction due to a lower rate of interest charged on the new secured obligation,³²⁸ resort to the earmarking defense to defeat a preference challenge in this situation simply cannot be sustained under Code policy or the current state of the Supreme Court's bankruptcy jurisprudence.³²⁹

A similar abortive attempt to expand the earmarking doctrine so as to protect a lender from its own carelessness, in spite of clear Code authority detailing the consequences of such negligence, can be found in *In re Motors Liquidation Co.*,³³⁰ a non-prototypical earmarking case staggering on its facts simply because of the amount of money put in peril by a neglectful mistake. What happened was that General Motors pre-bankruptcy lenders had two credits outstanding to GM: a \$300,000 lease financing obligation and a 1.5 billion term loan.³³¹ As part of a prearranged plan, prior to filing its Chapter 11 petition, GM paid off the \$300,000 debt, but the lawyers for the banks' agent mistakenly filed documentation purporting to release the banks' "main lien" securing the \$1.5 billion loan as well as the smaller loan.³³²

After the GM Chapter 11 case was filed, the unsecured creditors' committee realized what had transpired and sought to have the banks' loan declared unsecured because of the lapse in the continuous perfection of the banks' security interest.³³³ The bankruptcy court ruled in favor of the banks based on the fact that release of the lien on

advanced in this treatment. There is some appeal to that argument. The difference, however, is the existence of an unequivocal statutory mandate. Thus, I have more sympathy for the argument that the transfer of a belatedly perfected lien in connection with a refinancing transaction does not involve earmarked property. *Lee*, 530 F.3d at 471.

327. In *Lee*, the new lender argued that, because discharge of the old lien did not occur until after the new mortgage was recorded, third parties were at all times on notice that the property was encumbered. However, the court declared that fact as "beside the point." 530 F.3d at 466.

328. The fact that no one was misled, and that the new loan reduced the interest rate the debtor was paying by two percent so that the debtor "could perhaps pay his debts," was the basis of Judge Merritt's dissent in *Lee*. 530 F.3d at 474–75 (Merritt, J., dissenting). These points are quite fair, but the fly in the ointment is the clear statutory authority. *See supra* note 332.

329. *Supra* note 321.

330. *Motors Liquidation Co. v. JP Morgan Chase Bank*, 596 B.R. 774 (Bankr. S.D.N.Y. 2019).

331. Official Comm. of Unsecured Creditors of *Motors Liquidation Co. v. JP Morgan Chase Bank, N.A. (In re Motors Liquidation Co.)*, 777 F.3d 100, 101 (2d Cir. 2015).

332. *Motors Liquidation*, 596 B.R. at 777.

333. *Id.* at 778.

the term loan was not what the parties intended.³³⁴ The Second Circuit reversed on the ground that the filing of the termination statement was, even though unintended, authorized and, therefore, effective according to its terms.³³⁵ The case was then remanded to the bankruptcy court to determine if the banks remained secured and to what extent absent the main lien.³³⁶ It was at this juncture that the banks raised the earmarking argument.

Specifically, the banks urged that because the debtor-in-possession financing from the U.S. and Canada was intended to pay off their \$1.5 billion loan, they had a defense to the committee's action to set aside their lien based on the earmarking doctrine.³³⁷ The bankruptcy court acknowledged that there was no circuit authority recognizing the earmarking doctrine in this particular context,³³⁸ but added that "[e]xisting case law, developed in cases with very different factual circumstances than those presented here, does not necessarily prescribe all of the limits for application of the doctrine."³³⁹ The court heeded, however, that, even if the doctrine might be invoked in this type of situation, it was inapposite on the facts of this case because there was no clear obligation to use the debtor-in-possession ("DIP") financing to pay the lenders on the term loan.³⁴⁰ Moreover, insulating the banks' lien from avoidance would result in a diminishment of the estate, inasmuch as an unsecured loan (the banks' loan) would be

334. *Id.*; see Official Comm. of Unsecured Creditors of Motors Liquidation Co. v. JP Morgan Chase Bank (*In re Motors Liquidation Co.*), 486 B.R. 596, 647–48 (Bankr. S.D.N.Y. 2013).

335. *Motors Liquidation*, 777 F.3d at 105–06 (2d Cir. 2015).

336. *Id.*

337. *Motors Liquidation*, 596 B.R. at 780–81. The order approving the debtor-in-possession financing provided for pay-off of the \$1.5 billion term loan, but also contained a proviso that allowed the Committee to seek to claw back that repayment if the court determined that the lenders were not properly secured. *Id.* at 779.

338. *Id.* at 781; cf. Carlson & Widen, *supra* note 88, at 602 n.63, maintaining that the earmarking concept simply does not fit in this context, and most courts agree. See generally Chase Manhattan Mortg. Corp. v. Shapiro (*In re Lee*), 530 F.3d 458 (6th Cir. 2007), discussed *supra* notes 325–28.

339. *Motors Liquidation*, 596 B.R. at 781. In this sense, the court was more receptive than the *Power* court to recognizing the earmarking doctrine beyond the traditional scenario of a new lender advancing funds to retire an old debt. See *supra* note 300 and text accompanying note 312; see also Campbell v. Hanover Ins. Co. (*In re ESA Env't'l Specialists, Inc.*), 709 F.3d 388, 396 (4th Cir. 2013) ("The earmarking doctrine applies only when the debtor borrows money from one creditor and the terms of that agreement require the debtor to use the loan proceeds to extinguish specific, designated, existing debt.")

340. *Motors Liquidation*, 596 B.R. at 782–84 ("It would be a perversion of the equitable earmarking doctrine to apply it in the circumstances of this case absent a clear statement in the Final DIP Order preserving the earmarking defense when DIP Loan proceeds were used to repay the Term Lenders subject to an express challenge provision.")

replaced with a secured loan (the DIP financing).³⁴¹ In sum, the court concluded that the banks' error in releasing the lien "should not be rewarded now by applying a judge-made equitable doctrine that has never been applied in circumstances such as those presented here."³⁴²

By contrast with the situations in *Power* and *Motors Liquidation*, when the earmarking doctrine is applied to shield a payment made with unsecured borrowed funds that were designated or intended for that purpose, there is no conflict with the terms of statute.³⁴³ Thus, the doctrine falls within the ambit of the bankruptcy courts' power to interpret Code provisions consistent with legislative intent.³⁴⁴ This is why courts that reject the earmarking doctrine in connection with late-perfected refinancing transactions have no difficulty in allowing it to be invoked in an effort to defeat the threshold requirements of § 547(b) in cases where the transaction entails a prearranged and intentional use of new loan proceeds to retire an old debt. The issue boils down to the question of how broadly, and under what circumstances, the doctrine can and should be applied; those are the questions this Article has attempted to address.

VIII. CONCLUSION

By definition, a preference involves the transfer of the debtor's property or of an interest therein. Simply stated, if the property transferred did not, in substance, belong to the debtor, then that debtor's creditors cannot rightfully be said to have been injured by the transfer. The earmarking doctrine is a means by which a preferential challenge that, in terms of actual economic substance, involves the transfer of third-party funds can be defeated on the basis that it did not disadvantage other creditors or interfere with the policy of ratable distribution. As a judicially-created equitable exception to the preference provisions of section 547(b), the determination of

341. *Motors Liquidation*, 596 B.R. at 785–86 (“The earmarking doctrine will only protect a transfer from avoidance to the extent it did not diminish the debtor’s estate.”) (citing *Cadle Co., D.A.N. Joint Venture, L.P. v. Mangan (In re Flanagan)*, 503 F.3d 171, 185 (2d Cir. 2007)).

342. *Motors Liquidation*, 596 B.R. at 787–88 (refusing to apply a judge-made doctrine to undermine equality of distribution, “one of the most fundamental tenets of bankruptcy law.”) (citing *Beiger v. I.R.S.*, 496 U.S. 53, 58 (1990)).

343. See *Flanagan*, 503 F.3d at 184 (“The earmarking doctrine ‘applies where a third party lends money to the debtor for the specific purpose of paying a selected creditor.’”) (citing *Glinka v. Bank of Vt. (In re Kelton Motors, Inc.)*, 97 F.3d 22, 28 (2d Cir. 1996)). This is because the loan funds that were “earmarked” to pay a particular creditor effectively never became part of the debtor’s assets. 5 COLLIER ON BANKRUPTCY, *supra* note 30 ¶ 547.03(2)[a] (“A widely accepted exception to section 547 holds that 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.”).

344. See *supra* notes 184–86 and accompanying text.

what constitutes “an interest of the debtor in property” for purposes of applying the doctrine does not necessarily have to coincide with the understanding of “property of the estate” for purposes of § 541(a).³⁴⁵

Even though this long-recognized exception to preference recovery originally arose in a Supreme Court case involving a guarantor,³⁴⁶ there was nothing about the holding in that case that could fairly be read to limit its precedential tail to codebtors.³⁴⁷ The line of authorities that urge confining the doctrine to codebtor cases do so based on a faulty rationale³⁴⁸ and one that overlooks potential inequity to non-codebtor lenders.³⁴⁹

Acceptance of a broader interpretation of the scope of the earmarking doctrine does not, however, end the inquiry. Even among the decisions that extend the earmarking exception to situations where the new creditor is an unrelated third party that merely loans new funds to the debtor for the purpose of enabling the debtor to pay the old creditor, there is nothing approaching consensus over the circumstances that might support application of the earmarking defense. Actually, there is not even agreement over the number and essential characteristics of the differing tests or standards that have been employed over the years by courts addressing the question.³⁵⁰ Finally, this disorder is amplified by the fact that, by and large, the concepts underlying most of these tests either provide marginally useful guidance³⁵¹ or are internally discordant.³⁵²

Given this muddled state of affairs, and guided by the twin goals of protecting the value of the estate from diminishment and protecting equality of distribution measured from 90 days prior to filing, this Article has attempted to put forth a framework for defining the scope of the earmarking doctrine that is relatively easy to apply, elevates substance over form, and more closely conforms to the purpose intended to be served by the preference law than the other standards that have been articulated in case law under the Code to date.

345. See *supra* Section VI.C.

346. Nat'l Bank of Newport, N.Y. v. Nat'l Herkimer Cty. Bank of Little Falls, 225 U.S. 178 (1912), discussed *supra* text accompanying notes 67–77.

347. See *supra* note 153.

348. *Supra* Section V.A.

349. See *supra* note 37.

350. See *supra* text accompanying notes 191–202.

351. The lack of any consensus over what constitutes impermissible control represents a good example of why many of the tests that have been employed are not overly helpful. See *supra* note 203.

352. *Supra* text accompanying note 167.

This standard requires that, in order to determine whether the earmarking doctrine will shield a transfer from avoidance as a preference, a court must look at the entire transaction in order to distill its substance, eschewing a purely mechanistic and formalistic approach.³⁵³ It incorporates both the concepts of intent and control, but also contains a bright-line test in relation to the latter to avoid the inherent imprecision entailed in attempting to define control in relation to possession, location, or authority over the funds; definitions that lack coherence and, further, carry the risk of riding roughshod over the actual effect of the transfer on the latter to-be-formed bankruptcy estate.

This approach, if endorsed, holds the potential to simultaneously better implement the goals of the bankruptcy system and reduce wasteful litigation over just whose money it is. More broadly, it would perhaps also serve as a welcome first step in moving us toward a more comprehensible and consistent understanding of the preference law writ large; one that happens to coincide with the equality objectives that should be the starting place for any more in-depth discussion of why we have a preference law in the first place.

353. *Cooper v. Centar Invs. (Asia), Ltd. (In re TriGem Am. Corp.)*, 431 B.R. 855, 862 (Bankr. C.D. Cal. 2010) (“In correctly evaluating earmarking cases, . . . it is necessary to look at the transactions as a whole.”).