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Tenth Circuit Addresses the Earmarking Doctrine in *Chuza Oil*

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The earmarking doctrine is a unique defense that is a "judicially created mechanism to determine whether the debtor had an interest in transferred property."[1] The defense usually arises in a situation where a new creditor transfers assets to a debtor on the condition that it would be paid to an old creditor. It always involves three parties: a new creditor, a debtor and an old creditor. The earmarking defense shields creditors from avoidance actions brought by trustees.

In a recent Tenth Circuit decision, *In re Chuza Oil Co.*,[2] the insider who was paid by the debtor from the funds loaned to the debtor during the reorganization raised the earmarking doctrine to the trustee's adversary proceeding. While the bankruptcy court sided with the insider and concluded that the transfers at issue were not avoidable, the Bankruptcy Appellate Panel (BAP) reversed the bankruptcy court's decision and sided with the trustee, thus allowing the clawback of the transferred funds. However, the insider successfully appealed the BAP's decision and persuaded the Tenth Circuit to affirm the bankruptcy court's decision.

Leading Up to the Tenth Circuit Court of Appeals

In *Chuza*, the debtor company filed a chapter 11 case in the U.S. Bankruptcy Court for the District of New Mexico. Prebankruptcy, the debtor had borrowed funds from an insider (hereinafter, the "insider creditor") under a promissory note.[3] The confirmed chapter 11 plan classified noninsider and insider unsecured creditors in classes where the insider claims were subordinate to the noninsider unsecured creditors.[4] Accordingly, the promissory note loaned by the insider creditor was to be paid only after the noninsider unsecured creditors had been paid in full.[5]

Post-confirmation, the company continued to be unprofitable, causing certain insiders to make additional loans to the debtor. At the direction of these insiders, the debtors used some of the funds to pay down the pre-petition insider-loaned promissory note, despite the distribution scheme under the confirmed plan requiring the debtor to make full payments to the noninsider unsecured creditors before making payments to the insiders.[6]

An involuntary chapter 7 petition was later filed against the debtor. The appointed chapter 7 trustee filed an adversary proceeding seeking to recover the payments made to the insider creditor as preferential and fraudulent transfers.[7] The insider creditor raised earmarking as a defense, contending that the transferred funds were loaned to the debtor on the condition that some of it will be paid on the pre-petition promissory note held by the insider creditor. Therefore, it was not a transfer of the estate's property.

The bankruptcy court ruled for the defendant and rejected the trustee's attempts to claw back the transfers, thus applying the earmarking doctrine to determine that the money paid was not "an interest of the debtor in property" because the funds directed payment on the promissory note.[8] Disagreeing with the bankruptcy court, the BAP held that the defendant's earmarking defense failed because the transfers diminished the debtor's estate as it replaced the subordinated debt with unsubordinated, unsecured debt, notwithstanding the debtor's lack of control over the conditionally loaned funds.[9] On appeal, the Tenth Circuit reversed and sided with the insider creditor, concluding that both the dominion/control test and diminution-of-the-estate test were met according to the facts of the case.[10]

Conditions on Funds Mean No Dominion/Control

Courts have used the dominion/control test to determine whether the debtor had an interest in the transferred property.[11] Debtors are deemed to have a lack of control over borrowed funds if the lender designates the subsequent transferee of the funds.

For example, in *Ogden*, the Tenth Circuit found that the debtor who used money from new investors

1 *Montoya v. Goldstein (In re Chuza Oil Co.)*, 88 F.4th 849, 857 (10th Cir. 2023); *see also In re Entringer Bakeries Inc.*, 548 F.3d 344, 347 n.3 (5th Cir. 2008) ("[T]he earmarking doctrine is 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.'").
2 *In re Chuza Oil Co.*, 639 B.R. 586 (B.A.P. 10th Cir. 2022), *rev'd in part*, 88 F.4th 849 (10th Cir. 2023)
3 *Id.* at 590.
4 *Id.*
5 *Id.*
6 *Id.* at 591.
7 *Id.* at 590.
8 *Id.* at 604.
9 *Id.* at 601.
10 *In re Chuza Oil Co.*, 88 F.4th 849.
11 *In re Marshall*, 550 F.3d 1251, 1255 (10th Cir. 2008); *see, e.g., McLemore v. Third Nat'l Bank in Nashville (In re Montgomery)*, 983 F.2d 1389, 1395 (6th Cir. 1993); *In re Smith*, 966 F.2d 1527, 1531 (7th Cir. 1992).

to pay back the initial investors had a property interest in the funds. Therefore, the transfers were avoidable, as there was "no indication that the new investors had designated the purpose of the investment as paying the prior investors."[12] Similarly in *Marshall*, the Tenth Circuit found that the debtors could avoid payments they made using their Capital One credit cards because the debtors controlled the funds without restriction, since "Capital One placed no condition on their use of funds."[13]

Citing the *Bankruptcy Desk Guide*, the Tenth Circuit in *Chuza* explained that "the lender must condition the funds on payment to a specific creditor, and the debtor must abide by that condition" to earmark funds.[14] The bankruptcy court in *Chuza* made a factual finding that the funds had a valid condition on the money when loaned to the debtor, and that the payments would go directly on the insider creditor's promissory note.[15] Looking at the "uncontradicted and plausible" testimony from the bankruptcy court, the Tenth Circuit agreed that the debtor did not have control or dominion over the funds.[16]

The court further noted its preceding decision in *Wagenknecht*, which highlighted the fact that the borrowed funds never passed through the debtor's account. In *Wagenknecht*, the Tenth Circuit found that the debtor, who received a loan under a promissory note, never had control because the lender only loaned the money on the condition that it be used to pay a specific creditor, the check was written from lender's bank account and delivered directly to the creditor, and the debtor did not have the ability to direct the distribution.[17]

However, the Tenth Circuit in *Chuza gave more significance to the fact that the debtor had full, unconditioned control than to the fact that the money never crossed the debtor's account*.[18] Although those funds passed through the debtor's account instead of being directly paid to the old creditor, the lender of the loan had placed a valid condition on the funds that were loaned to the debtor.

The Tenth Circuit also cited a Ninth Circuit ruling that stated that "the proper inquiry is not whether the funds entered the debtor's account, but whether the debtor had the right to disburse the funds to whomever it wished, or whether the disbursement was limited to a particular old creditor or creditors under the agreement with the new creditor."[19] In *Superior Stamp*, the debtor and a bank entered into a written agreement wherein the debtor had to submit monthly budgets to the bank for approval and could not pay its obligations to others without the bank's written approval.[20] The bank was to approve the payment and advance the necessary funds to cover the check presented to the bank after a "special review" process.[21]

12 *In re Ogden*, 314 F.3d 1190, 1196 (10th Cir. 2002).
13 *In re Marshall*, 550 F.3d at 1254.
14 *In re Chuza Oil Co.*, 88 F.4th at 855 (citing 2 *Bankruptcy Desk Guide* § 18:9 (March 2023 update) ("[E]xception to the general rule that the use of borrowed funds to discharge a debt constitutes the transfer of property of the debtor ... is where borrowed funds have been specifically earmarked by a lender for payment to a designated creditor.")).
15 *Id.* at 858.
16 *Id.* at 862; *see also In re Chuza Oil Co.*, 639 B.R. at 600 (insiders "testified unequivocally" about condition placed on loans).
17 *In re Wagenknecht*, 971 F.3d 1209 (10th Cir. 2020).
18 *In re Chuza Oil Co.*, 88 F.4th at 895.
19 *In re Superior Stamp & Coin Co.*, 223 F.3d 1004, 1009 (9th Cir. 2000).
20 *Id.* at 1006.
21 *Id.*

As opposed to the bankruptcy court's finding that the debtors controlled the funds because it requested the loan, thereby designating the specific creditor as the recipient of the payment, the Ninth Circuit held that "it is irrelevant whether the debtor or lender initiates discussions concerning a loan or proposes a particular creditor as the recipient of the funds, so long as the funds are advanced on the condition that they be used to pay that specific creditor."[22] When a third party lends money to a debtor for the specific purpose of paying the selected creditor, the earmarking doctrine applies.

Diminution-of-the-Estate Test Could Not Be Considered in Isolation from the Dominion/Control Test

Once the Tenth Circuit in *Chuza* found that the debtors did not control the funds under the dominion/control test, the court turned to the diminution test, which looks to whether the transfers diminished the bankruptcy estate.[23] The Tenth Circuit found that the bankruptcy court correctly concluded that the transfers did not diminish the debtor's estate and pointed out that the BAP erred in its analysis of the diminution of the estate by only focusing on the transfers at issue without considering the newly loaned funds into the debtor's bankruptcy estate.[24] The BAP's error was based on its previous erroneous conclusion that the debtor had control over how to spend the newly loaned funds.[25]

The Tenth Circuit emphasized that the newly loaned funds resulted in the debtor receiving significantly more money than what was paid to the insider creditor, allowing the debtor to stay afloat and pay at least something to noninsider creditors in the future.[26] The court concluded that the benefits of the newly loaned funds to the debtor for noninsider creditors outweighed the small amount transferred to the insider creditor. Therefore, the transfers did not diminish the debtor's estate.

The Tenth Circuit's reasoning shows that the dominion/control test will have a direct effect on the diminution-of-the-estate test. In general, for the preference to be voided under § 547, it is essential that the debtor have an interest in the property transferred so that the estate is thereby diminished.[27] For example, in *Marshall*, the Tenth Circuit's conclusion — that the transferred credit card loan proceeds diminished the debtor's estate and benefited only a preferred creditor — was based on its previous conclusion that the transferred loan proceeds were property of the estate and the debtor had direct control over how to use the loan proceeds from the credit card.[28]

After concluding in *Wagenknecht* that the personal loan proceeds were loaned on the condition that they would be paid to the specific creditor of the debtor and transferred directly to the creditor of the debtor by the debtor's mother, the Tenth Circuit found that the transferred funds did not

22 *Id.* at 1010.
23 *In re Chuza Oil Co.*, 88 F.4th at 859.
24 *Id.* at 860.
25 *Id.*
26 *Id.*
27 *Coral Petroleum Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1355-56 (5th Cir. 1986).
28 *In re Marshall* at 1258.

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diminish the debtor's estate, as these funds were never available to pay the claims of other creditors.[29] Thus, once the court concluded that the funds to be avoided were not part of the debtor's estate and the debtor was not in control of those funds, there could be no diminution of the estate, as the estate was not depleted when the third party directly transferred the funds to the old creditor or the debtor transferred the third-party funds to the old creditor.

The Fifth Circuit in *Entringer* has not discussed the diminution-of-the-estate test — even after finding that the debtor had control over the funds in question and concluded that the earmarking doctrine did not apply.[30] The court plainly held that control over the funds in a bank account, along with the debtor's discretionary power on what creditors to pay, is dispositive of the earmarking defense.[31]

29 *In re Wagenknecht* at 1214.
30 *In re Entringer Bakeries*, 548 F.3d at 351.
31 *Id.* at 350; *see also In re Magellan E & P Holdings Inc.*, 654 B.R. 98, 105 (Bankr. S.D. Tex. 2023).

Conclusion

As illustrated in these cases, the merits of the earmarking doctrine are highly fact-specific and require a full understanding of the relationship among the three parties involved in the transaction that allows the debtor to use funds received from a lender to pay an old creditor. For creditors, the earmarking doctrine serves as a vital safeguard for unwarranted preference claims, thus emphasizing the importance of discerning the specific circumstances surrounding the transfer in question.

As evidenced by the Tenth Circuit's decision, the more discretion that the debtor has with respect to its use of the funds, the more likely that a court is to find that the earmarking doctrine does not apply. To the extent that a lender places specific restrictions on the debtor's use of the funds, a court is more likely to find that the earmarking doctrine applies and the transfer cannot be avoided by a trustee. abi