



# Is a Debtor's Credit Card Payment a Preference? The U.S. Tenth Circuit Court of Appeals Speaks

A debate has raged over whether a debtor's payment by credit card, such as through a balance transfer from a credit card account, is a transfer of an interest of the debtor in property that would give rise to a preference claim. The United States Court of Appeals for the Tenth Circuit, in *In re Marshall*, recently ruled that the debtors' credit card balance transfers from one credit card issuer to pay down their credit card debt owing to another credit card issuer is a transfer of the debtors' property interest and, as such, is a recoverable preference. Interestingly, the Tenth Circuit's reversal and rejection of the only lower court opinions, that support the contrary and more trade creditor friendly view that credit card payments are not transfers of the debtor's interest in property, has undercut the trade's ability to assert a credit card payment as a defense to preference exposure.



#### Bruce will be speaking on these topics:

- 17041.** Practical Bankruptcy Knowledge for Survival in Today's Troubled Economic Climate
- 17057.** Hot and Emerging Legal Issues
- 17068.** Creditors' Rights Forum

In the *Marshall* case, the court considered whether a debtor's payment by credit card, through a transfer of balances from one credit card company to pay off the debtor's indebtedness to another credit card issuer, is a transfer of an interest in the debtor in property.

#### Elements of a Preference Claim

Section 547(b) of the Bankruptcy Code permits a trustee or debtor-in-possession to recover a preference by satisfying all of the following requirements:

- (a) The debtor transferred its interest in property to or for the benefit of a creditor (section 547(b)(1)). In the *Marshall* case, the court considered whether a debtor's payment by credit card, through a transfer of balances from one credit card company to pay off the debtor's indebtedness to another credit card issuer, is a transfer of an interest in the debtor in property;
- (b) The transfer was on account of antecedent or existing indebtedness that the debtor owed the creditor (section 547(b)(2));

- (c) The transfer was made when the debtor was insolvent (section 547(b)(3)). The debtor's insolvency is based on a balance sheet definition: the debtor's liabilities exceed its assets. The debtor's insolvency is also presumed during the 90-day preference period, which makes it easier for the trustee to prove insolvency;
- (d) The transfer was made within 90 days of the debtor's bankruptcy filing, in the case of transfers to non-insider creditors, and within one year of bankruptcy for transfers to insiders of the debtor, such as the debtor's officers, directors, controlling shareholders and affiliated companies (section 547(b)(4)); and
- (e) The creditor received more from the transfer than the creditor would have recovered in a Chapter 7 liquidation of the debtor (section 547(b)(5)). This preference requirement is always satisfied; unless the creditor is fully secured by the debtor's assets, the creditor is paid from its collateral or the debtor has sufficient assets to pay 100% of its claims.

#### *In re Marshall*

The Debtors, Brian and Julie Marshall, had two credit card accounts with MBNA under account numbers 6264 and 7781. The Debtors also had two credit card accounts with Capital One, a Platinum MasterCard account with a \$30,000 line of credit and a Platinum Visa account with a \$25,000 line of credit. On July 27, 2005 the Debtors directed Capital One to pay \$17,000 through a balance transfer from the Debtors' Capital One Platinum MasterCard account to MBNA in reduc-

tion of MBNA's account number 6264 owing by the Debtors. That same day, the Debtors directed Capital One to pay \$21,000 through a balance transfer from their Capital One Platinum Visa account to MBNA in reduction of MBNA's account number 7781 owing by the Debtors. These payments did not increase the Debtors' net credit card indebtedness; they merely increased the Debtors' indebtedness to Capital One by the same amount as the corresponding reduction of their indebtedness to MBNA.

On October 13, 2005, the Debtors filed a Chapter 7 bankruptcy petition. The Debtors filed their Chapter 7 case within 90 days of their use of \$38,000 of their Capital One credit card balances to pay down their indebtedness to MBNA. The Chapter 7 trustee appointed in the Debtors' case commenced a lawsuit against MBNA for the recovery of the Debtors' credit card balance transfers totaling \$38,000 to MBNA as preferences.

The issue in the case is whether Capital One's payments to MBNA were transfers of the Marshalls' interest in property, which is one of the prerequisites for the trustee's preference claim. The trustee claimed that the payments to MBNA were preferences because they were transfers of funds that the Marshalls had borrowed from Capital One to pay down MBNA's claim and were, therefore, property of the Debtors. MBNA denied the payments were preferences because they a) were paid by Capital One, not the Marshalls, to MBNA; b) merely substituted one creditor, Capital One, for another, MBNA;

and c) did not result in any diminution of the assets of the Marshalls' bankruptcy estate.

The Kansas Bankruptcy Court ruled that the Marshalls' direction to Capital One to transfer balances from their credit card accounts to pay down their indebtedness to MBNA was not a transfer of an interest of the Marshalls in property and, therefore, was not a preference. The court did not regard the Marshalls' ability to draw on their credit card line with Capital One to pay a creditor, such as MBNA, as an asset that could satisfy creditors' claims. In the event the Debtors had not

---

The bankruptcy court did not regard the Marshalls' ability to draw on their credit card line with Capital One to pay a creditor, such as MBNA, as an asset that could satisfy creditors' claims.

---

drawn on their Capital One credit card line to pay down MBNA by their bankruptcy filing date, the Capital One credit card line would have yielded no value to the Debtors' estate. The bankruptcy court also noted that the payments to MBNA did not diminish the property available to pay the Marshalls' other creditors. There was no diminution of the Marshalls' assets, nor any increase in their liabilities, as a result of Capital

One's balance transfers to pay down MBNA. There was just a substitution of creditors: before the payment, the Marshalls were indebted to MBNA, and following the payment, the Marshalls' indebtedness to MBNA was reduced and their liability to Capital One increased by a like amount.

The trustee appealed the bankruptcy court's ruling. The United States District Court in Kansas also held that credit card payments are not property of the Debtors and, therefore, are not recoverable as preferences. The District Court reached its decision by relying on the earmarking defense to preference claims. The earmarking doctrine exempts from preference exposure a debtor's use of borrowed funds that the debtor's lender or other creditor had designated for payment to an identified creditor. Generally, courts require satisfaction of the following three-tier test as a prerequisite for a valid ear-

---

## The earmarking doctrine exempts from preference exposure a debtor's use of borrowed funds that the debtor's lender or other creditor had designated for payment to an identified creditor.

---

marking defense to a preference claim: (a) the existence of an agreement between the debtor and its lender or other creditor that identifies the claim to be paid with the borrowed funds; (b) performance of the agreement in accordance with its terms; and (c) the absence of any diminution of the debtor's estate or reduction in recoveries to unsecured creditors resulting from such agreement. The rationale for the earmarking defense is that the use of borrowed funds to pay a particular creditor's claim is not a transfer of an interest in the debtor's property because the debtor did not have any control over the disposition of the funds and the payment did not diminish either the value of the property of the debtor's estate or the recoveries to the debtor's creditors.

The District Court concluded that the earmarking defense was available to defeat the trustee's preference claim because Capital One had chosen to make payments on the Debtors' behalf, by transferring credit card balances to pay down MBNA's claim. Capital One thereby substituted itself for MBNA as a creditor of the Debtor pursuant to the terms of Capital One's balance transfer agreement with the Debtors. The court noted that the Debtors had lacked the requisite control over these payments for them to be considered the Debtors' property. In substance, the transaction was a bank to bank transfer, and a transfer of credit, not assets, that resulted in a substitution of creditors and did not diminish either the Debtors' bankruptcy estate or any recovery for its creditors.

The trustee filed another appeal to the United States Court of Appeals for the Tenth Circuit. The Tenth Circuit reversed the lower court holdings in ruling that the Debtors' use of

their credit card balances with Capital One to pay down their indebtedness to MBNA was a transfer of an interest of the Debtors in property and, therefore, was recoverable as a preference.

While the Bankruptcy Code does not define "an interest of the debtor in property," the United States Supreme Court, in *Beiger v. IRS*, observed that property of the debtor is "... property that would have been part of the estate had it not been transferred before the commencement of the bankruptcy proceedings." The Supreme Court looked to Bankruptcy Code section 541(a)(1), which states that property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case," wherever located or by whomever held.

The Tenth Circuit regarded "property of the estate" as sufficiently broad to include even novel and contingent property interests. That includes property the debtor has the right to use and over which the debtor otherwise exercises "dominion and control."

The Tenth Circuit relies on the emerging majority view, recently reaffirmed by two recent Sixth Circuit Bankruptcy Appellate Panel Decisions, *In re Wells* and *In re Dilworth*, and numerous lower court decisions, that a debtor's payment by

---

## Treating the payments to MBNA as preferential transfers also furthered section 547(b)'s policy of equality of distribution among all unsecured creditors by allowing them to share in any recovery, instead of preferring a single creditor.

---

credit card is an interest of the debtor in property. Critical to these courts' holdings is the discretion afforded to the debtors in deciding on the disposition of the available funds on their credit card lines. These courts also concluded that the debtors' credit card payments diminished their bankruptcy estates by paying and preferring a single creditor, instead of retaining the payments for the benefit of all of their creditors.

Likewise, the Tenth Circuit concluded that the Debtors had exercised control over their credit card balances with Capital One through their ability to direct the disbursement of these funds to MBNA. The Debtors drew on their credit card line with Capital One, converted available credit into a loan and directed Capital One to use the loan proceeds to pay down MBNA. Capital One complied with the Debtors' payment instructions and could not have stopped the payments to MBNA once Capital One honored the Debtors' draw. This

was no different than if the Debtors had drawn down on their Capital One credit line, deposited the proceeds into their bank account and then wrote a check to pay down their indebtedness to MBNA, which clearly would have been a preference.

The Tenth Circuit also found that the Debtors' use of their credit card balances with Capital One to pay MBNA had depleted their bankruptcy estate. The Debtors' conversion of their credit line with Capital One into a loan and use of the proceeds to pay another creditor, MBNA, precluded their use of these proceeds to pay other creditors.

The Tenth Circuit also rejected the applicability of the earmarking defense to the preference claim. The court noted that earmarking would have applied only if the lender, Capital One, had opted to use the Debtors' credit line to pay the Debtors' indebtedness to MBNA. That just was not the case here. Capital One honored the Debtors' instruction to use their credit line with Capital One to pay MBNA and placed no condition on the Debtors' use of the funds. Earmarking also did not apply because the Debtors' transfer of the Capital One proceeds to MBNA had diminished the Debtors' bankruptcy estate. The proceeds would have been part of the Debtors' estate if they had not been transferred to MBNA prior to the commencement of the Debtors' bankruptcy case. The proceeds were, therefore, an asset of the Debtors' estate for at least the moment before they were transferred to MBNA, when they would have been available for distribution to all of the Debtors' creditors.

The Tenth Circuit rejected the lower court holdings, that the Debtors' credit card payments are not property of the Debtors, as mistakenly characterizing credit card payments as untapped credit that was not available to pay creditors' claims. The court viewed Capital One's balance transfers to MBNA as a transfer of loan proceeds that diminished the Debtors' estate. Treating the payments to MBNA as preferential transfers also furthered section 547(b)'s policy of equality of distribution among all unsecured creditors by allowing them to share in any recovery, instead of preferring a single creditor.

### Conclusion

The courts appear to be reaching a consensus on whether a debtor's payment by credit card is a recoverable preference. The Tenth Circuit Court of Appeals, in *In re Marshall*, has adopted the majority view that a debtor's payment through a balance transfer from its credit card account can be a recoverable preference because it is a transfer of an interest of the debtor in property. The Tenth Circuit's reversal and rejection of the only reported lower court decisions that a debtor's credit card payment is not a transfer of property of the debtor and, therefore, is not a preference, raises doubts about the continued legitimacy of this view. The decision has undercut the trade's ability to assert a credit card payment as a defense to preference exposure. ●

*Bruce Nathan, Esq. is a partner in the New York City office of the law firm of Lowenstein Sandler PC. He is a member of NACM and is on the Board of Directors of the American Bankruptcy Institute and is a former co-chair of ABI's Unsecured Trade Creditors Committee. He can be reached at [bnathan@lowenstein.com](mailto:bnathan@lowenstein.com).*