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Parsing The 4th Circ. Stance In Campbell V. Hanover

by Jason W. Harbour and Tara L. Elgie, Hunton & Williams LLP

In Campbell v. Hanover Ins. Co. (In re ESA Envtl. Specialists Inc.), the Fourth Circuit recently confirmed the applicability of the earmarking doctrine within the Fourth Circuit.[1] In doing so, the Fourth Circuit clarified that the earmarking defense only applies if the transfer at issue was used to satisfy an antecedent debt.[2]

In ESA, the Fourth Circuit concluded that the transfer at issue did not satisfy an antecedent debt, and therefore the contemporaneous exchange for new value defense applied, not the earmarking doctrine.[3] The Fourth Circuit, however, did not expressly address how a transfer that fails to satisfy the earmarking defense's antecedent debt requirement satisfies the essential elements of a preferential transfer, which require that a preferential transfer be made for or on account of an antecedent debt.[4]

In addition, the dissent in ESA asserted that a debtor's receipt of contract rights may not be used to satisfy the contemporaneous exchange for new value defense. Although the majority disagreed, the issue of whether certain types of assets qualify for the contemporaneous exchange defense may arise in future proceedings.

Background

The debtor, ESA Environmental Specialists Inc., performed construction projects under contracts with the federal government.[5] As a condition precedent to an award of any contract in excess of $100,000, ESA had to obtain and furnish to the government surety bonds.[6]

In May 2007, ESA sought to obtain seven new contracts with the federal government and asked The Hanover Insurance Co. to issue surety bonds in connection with those contracts.[7] Hanover, concerned about ESA's financial condition, would not issue the bonds without a letter of credit in its favor in the amount of $1.375 million.[8] ESA obtained the letter of credit from SunTrust, which required ESA to secure the letter of credit with a certificate of deposit in the amount of $1.375 million.[9] The funds for this CD came from Prospect Capital Corp., which loaned ESA $1.575 million (the "Prospect loan").[10]

On May 17, 2007, ESA transferred $1.375 million of the Prospect loan proceeds to SunTrust to fund the CD.[11] On May 18, 2007, SunTrust issued the letter of credit, Hanover's agent issued the bonds, which ESA delivered to the appropriate government agencies, and ESA obtained final award of the contracts.[12] ESA filed bankruptcy on Aug. 1, 2007.[13]

The Bankruptcy Court Proceedings

The ESA bankruptcy trustee sued Hanover to avoid the $1.375 million transfer of the Prospect loan proceeds as a preference, arguing that Hanover was an indirect beneficiary of the transfer.[14] Hanover argued that the transfer should not be avoided and asserted the earmarking and contemporaneous exchange for new value defenses.

Generally, the earmarking doctrine operates as a defense to a preference claim "when a third person makes a loan to a debtor specifically to enable that debtor to satisfy the claim of a designated creditor."[15] The contemporaneous exchange for new value defense applies when the transferee provides the debtor with new value, in excess of the transfer sought to be avoided, in the form of money or money's worth in goods, services or new credit, or a release of property previously transferred in a transaction that is neither void nor voidable by the debtor.[16] While the earmarking defense arises from case law and the contemporaneous exchange defense arises from 11 U.S.C. § 547(c)(1), both defenses are premised on the principle that a transfer should not be avoidable if the transfer did not diminish the bankruptcy estate.

The bankruptcy court granted Hanover's motion for summary judgment, concluding that Hanover had complete defenses under both the earmarking doctrine and the contemporaneous exchange for new value defense.[17]

Relying on the Fourth Circuit's decision almost 50 years earlier in Decker, the bankruptcy court concluded that the earmarking defense applied because there was no diminution of ESA's estate and, therefore, no preferential treatment of Hanover to the detriment of other creditors.[18] The bankruptcy court concluded that the funds for the CD came solely from Prospect and were simply passed through ESA's bank account for payment to SunTrust.[19] The bankruptcy court reasoned that even if the proceeds became ESA's by virtue of the deposit into the account, ESA had no discretion over the use of funds — they were ESA's property solely for the purpose of payment into the CD.[20] Therefore, the bankruptcy court concluded that the Prospect loan did not benefit Hanover to the detriment of the other creditors.[21]

The bankruptcy court concluded that Hanover had a complete contemporaneous exchange for new value defense because the transfer at issue (1) was intended to be a contemporaneous exchange for new value based on the bonds and the government contracts that ESA obtained after receipt of the bonds, and (2) was in fact a substantially contemporaneous exchange because the letter of credit was provided to Hanover on May 18, 2007, the same date that Hanover gave ESA the bonds.[22] Hanover presented evidence that in exchange for the Prospect loan proceeds, ESA received bonds with a face amount of $7,889,350.86, plus the ability to proceed with the government contracts, which Hanover's evidence indicated would yield expected revenue to ESA in excess of the $1,375,000 transfer.[23] The trustee presented no contrary evidence on value.

The United States District Court for the Western District of North Carolina affirmed the bankruptcy court's summary judgment rulings concerning Hanover's earmarking and contemporaneous exchange for new value defenses.[24]

The Fourth Circuit Proceedings

The Fourth Circuit affirmed the award of summary judgment to Hanover holding that the transfer was a contemporaneous exchange for new value, but concluded that the earmarking defense did not apply. Notably, the Fourth Circuit observed that the earmarking defense and the contemporaneous exchange for new value defense are mutually exclusive in most circumstances.[25]

The Earmarking Defense

The Fourth Circuit reaffirmed the validity of the earmarking defense and acknowledged the uniform holding of other courts that "the earmarking defense applies whether the proceeds of the loan are transferred directly by the lender to the creditor or are paid to the debtor with the understanding that they will be paid to the creditor in satisfaction of his claim, so long as the proceeds are clearly earmarked."[26] The Fourth Circuit concluded, however, that the transfer at issue did not satisfy the earmarking defense because the transfer was not used to pay an antecedent debt.[27]

The Fourth Circuit stated that ESA borrowed money from Prospect (and in the process incurred new debt), then used the proceeds of that loan to collateralize both existing obligations to Hanover under the 2006 bonds and to obtain new bonds — a new debt not previously owed to any creditor.[28] The Fourth Circuit noted that instead of a transaction that simply substituted one creditor for another, ESA owed more money after the Prospect loan than it owed previously.[29] The Fourth Circuit concluded that the transfer diminished the value of the estate to the benefit of Hanover, which became a secured creditor, and thus did not satisfy the earmarking defense because the Prospect loan did not substitute one creditor (Prospect) for another, but rather gave rise to an entirely new obligation of ESA to Prospect.

Nevertheless, the Fourth Circuit's conclusion that the earmarking doctrine does not apply because the transfer was not used to satisfy an antecedent debt raises a question: if the transfer was not used to satisfy an antecedent debt, how could the transfer satisfy the prima facie elements of a preference claim? Under 11 U.S.C. § 547(b)(2), a transfer constitutes a preference only if the transfer is "for or on account of an antecedent debt owed by the debtor before such transfer was made."[30] The Fourth Circuit does not expressly address this potential inconsistency.

In the bankruptcy court, the trustee addressed this issue by arguing that (1) the transfer satisfied the preference claim "antecedent debt" requirement because some of the transfer secured old bonds previously issued by Hanover and (2) the transfer did not satisfy the earmarking defense "antecedent debt" requirement because there was no agreement that the transfer only pay such antecedent debt.[31] While this suggested resolution to the potential inconsistency may not be entirely satisfying, the Fourth Circuit's ruling clarifies that future litigants should be prepared to address the "satisfaction of an antecedent debt" requirement of the earmarking defense.

The Contemporaneous Exchange for New Value Defense

Notwithstanding its rejection of Hanover's earmarking defense, the Fourth Circuit affirmed the bankruptcy court's summary judgment ruling, concluding that Hanover had established the contemporaneous exchange for new value defense under 11 U.S.C. § 547(c)(1).

The trustee argued that Hanover failed to carry its burden because (1) it did not establish with the requisite specificity the exact measure of the new value received and therefore the bankruptcy court erred in concluding that the new contracts had a value in excess of the $1.375 million transfer, and (2) any value ESA received was not contemporaneously exchanged for its transfer to Hanover.[32]

In finding that the new contracts had value in excess of the $1.375 million transfer, the bankruptcy court relied on an affidavit presented by ESA's former CFO, stating that "the government contracts awarded to ESA had a face amount in excess of $3.9 million and the [bonds] provided ESA with the ability to proceed with the new government contracts and to earn revenues in excess of $1,375,000 — the face value of the Letter of Credit."[33] The trustee provided no evidence to contradict this affidavit or to establish any other measure of value for the contracts.[34]

The Fourth Circuit concluded that Hanover's uncontradicted evidence that ESA received new value in excess of the $1.375 million transfer was sufficient to prove that the bankruptcy estate was not diminished by the transfer, and that Hanover did not need to prove an exact figure beyond that amount.[35] The Fourth Circuit also rejected the trustee's second argument, concluding that although ESA did not receive revenue under the new contracts in exchange for the transfer, the new contracts "had a value in and of themselves in excess of $1.375 million based on the record in this case."[36]

In his dissent, Chief Judge Traxler concluded that the contemporaneous exchange for new value defense did not apply because the contracts ESA obtained were not "new value" as that term is defined in 11 U.S.C. 547(a)(2).[37] "New value" is defined under 11 U.S.C. § 547(a)(2) in pertinent part as "money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee."[38]

Judge Traxler stated that the government contracts ESA received did not constitute money, or money's worth in goods, services or new credit, or a release of property previously transferred.[39] Judge Traxler asserted that the new contracts were merely a conditional promise of future payment and not an exchange of new money contemporaneous with the transfer.[40] Judge Traxler reasoned that "[i]n a new value transaction, the debtor's payment does not reduce the size of the estate because the money paid by the debtor is replaced by [new] money ... of equivalent value,"[41] but here Hanover obtained $1,375,000 "from the estate without replacing it with equal value."[42]

In response, the majority noted that the trustee admitted that the new contracts, in and of themselves, were assets with an ascertainable value.[43] The majority also noted that the transfer of contracts "is a commonplace factor of commercial life" and that the new contracts were "a fungible commercial asset-and clearly 'new value' for § 547(c) purposes."[44] Here, the new contracts subsequently were assigned to an affiliate of Prospect as part of a bankruptcy-approved

sale of substantially all of ESA's assets to Prospect.[45] Interestingly, neither party appears to have referred to that transaction in valuing the assets.

Although the majority's holding confirms that the new contracts in ESA were "new value" for purposes of 11 U.S.C. § 547(c)(1), Judge Traxler's dissent serves to remind practitioners to consult the definition of "new value" in § 547(a)(2) when addressing contemporaneous exchange for new value defenses under § 547(c)(1).

Conclusion

Almost 50 years after its Decker decision, the Fourth Circuit in ESA reaffirmed the vitality of the earmarking defense. In doing so, the Fourth Circuit provided additional insight into the requirements for meeting the earmarking defense, including the requirement that the transfer at issue satisfy an antecedent debt. The Fourth Circuit also provided insight into the contemporaneous exchange for new value defense, including by discussing what assets might qualify as "new value" for purposes of 11 U.S.C. § 547(c)(1), and by clarifying that a defendant need not demonstrate the exact measure of value, but rather must only prove that the new value exceeds the value of the assets transferred.

Jason Harbour is a partner in the Richmond, Va., office of Hunton & Williams. His practice focuses on bankruptcy and creditor's rights, loan workouts, reorganizations and corporate recovery, and on insolvency-related structuring advice and legal opinions for complex transactions.

Tara Elgie is an associate in the firm's Richmond office. Her practice focuses on bankruptcy and creditors' rights.

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1 Campbell v. Hanover Ins. Co. (In re ESA Envtl. Specialists Inc.), No. 11-2150 (4th Cir. Mar. 1, 2013) ("ESA").
2 Id. at *4.
3 Id. at *8-9.
4 See 11 U.S.C. § 547(b)(2).
5 Id. at *1.
6 Id.
7 Id.
8 The letter of credit collateralized the bonds for the new contracts, as well as Hanover's existing guarantees and surety obligations on behalf of ESA under bonds issued in 2006 for eight prior government contracts. Id.
9 Id.
10 Id.
11 The remaining $200,000 was used to fund operations and are not at issue in the appeal. Id. at n3.
12 Campbell v. Hanover Ins. Co. (In re ESA Envtl. Specialists, Inc.), 457 B.R. 452, 455 (W.D.N.C. Sept. 22, 2011).
ESA, 2013 WL 765705 at *2.
14 Id.
15 Id. at *3 (citing 5 Collier on Bankruptcy ¶ 547.03[2][a] (16th ed. 2011), Va. Nat'l Bank v. Woodson (In re Decker), 329 F.2d 836, 839 (4th Cir. 1964)).
16 11 U.S.C. §§ 547(c)(1), 547(a)(2).
17 In addition, the bankruptcy court stated that it would be inequitable to require Hanover to return the funds at issue, when, as a result of ESA's bankruptcy and subsequent events, Hanover performed the work and paid the obligations under the government contracts secured by the bonds. Campbell v. Hanover Ins. Co. (In re ESA Envtl. Specialists, Inc.), 2010 WL 4622513, at*4 (Bankr. W.D.N.C. Nov. 3, 2010). The Fourth Circuit stated

that although it did not need to address this issue because it affirmed the contemporaneous exchange ruling, "neither this court nor any other has recognizes that such an equitable defense to a preference action exists." ESA, 2013 WL 765705 at *8, n. 12.

[18] ESA, 2010 WL 4622513 at *3 (citing Decker, 329 F.2d at 836).

[19] Id. *3.

[20] Id.

[21] Id.

[22] Id. (citing 11 U.S.C. § 547(c)(1)).

[23] Id.

[24] ESA, 457 B.R. at 452.

[25] ESA, 2013 WL 765705 at *5, n. 8.

[26] Id. at *4 (quoting 5 Collier on Bankruptcy ¶ 547.03[2][a]). The Fourth Circuit expressly stated that it need not answer who has the burden of proof as to the earmarking defense. Id. at *3, n. 6. The majority of Circuits, including the Third, Sixth and Ninth Circuits, have held that "once the trustee meets his burden of proving the avoidability of the transfer under § 547(b), the burden shifts to the defendant to show that the funds were earmarked." Id. (citing Schubert v. Lucent Tech. Inc. (In re Winstar Commc'ns, Inc.), 554 F.3d 382, 401 (3d Cir. 2009) (quoting Metcalf v. Golden (In re Adbox, Inc.), 488 F.3d 836, 842 (9th Cir. 2007)) (quotation marks omitted); see Chase Manhattan Mortg. Corp. v. Shapiro (In re Lee), 530 F.3d 458, 470 (6th Cir. 2008)). The Eighth Circuit, however, has held that the trustee has the burden of proving that the earmarking defense does not apply. Id. (citing Kaler v. Cmty. First Nat'l Bank (In re Heitkamp), 137 F.3d 1087, 1089 (8th Cir. 1998)).

[27] Id. at *4-5.

[28] Id. at *5.

[29] Id.

[30] 11 U.S.C. § 547(b)(2).

[31] Plaintiff's Supplemental Brief in Opposition to Defendant's Brief in Support of its Motion for Summary Judgment, at 12-13, Adv. Proc. No. 09-03143 (Bankr. W.D.N.C. Sept. 30, 2010).

[32] ESA, 2013 WL 765705 at *6-7, 8.

[33] Id. at *7 (quoting from the affidavit of ESA's former Chief Executive Officer).

[34] Id. at *7.

[35] Id.

[36] Id. at *8.

[37] Id. at *9-10.

[38] 11 U.S.C. § 547(a)(2).

[39] ESA, 2013 WL765705 at *9-10.

[40] Id. at *10 (citing In re Teligent, Inc., 315 B.R. 308, 317 (Bankr. S.D.N.Y. 2004) (a promise of future services does not constitute new value because such a promise does not "replenish" the bankruptcy estate and thereby negate the prejudicial effect of the preferential transfer.)

[41] Id.

[42] Id.

[43] Id. at *6, n. 10.

[44] Id.

[45] Id. at *2.