Is A Debtor’s Credit Card Payment to You a Preferential Transfer?

It All Depends on Who You Ask

by

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When making credit arrangements with a struggling debtor, a creditor should give special consideration to receiving payment by credit card. As determined by the Kansas bankruptcy court in the recent decision of *In re Bryan K. Marshall*, a transfer by a debtor’s credit card company may not be considered a preferential transfer in the event the debtor files bankruptcy.

In *In re Bryan K. Marshall,* the Chapter 7 trustee brought an adversary proceeding to set aside alleged preferential transfers occurring when the debtors took advantage of offer by one credit card company to transfer balances from the debtors' other credit card accounts. The creditor defended on basis that, when balance was paid by the credit card company, no interest of the debtors in the property was transferred as required under the bankruptcy preference laws.

Before the payments by the credit card company to the creditor, the debtors had available pursuant to their agreements with the credit card company two substantial lines of credit. Pursuant to the debtors' request, the credit card company transferred funds to the creditor and posted as balances due from the debtors to the credit card company in the amounts paid to the creditor. Before the transactions, the debtors owed the creditor, and after the transactions, the debtors' obligation to the creditor was reduced and their liability to the credit card company increased by the same amount. In effect, there was a substitution of creditors.

As a result, the primary issue before the *Marshall* court was whether the transactions constituted a transfer of an interest of the debtors in the property. The court defined a preferential transfer as property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings, and found that the fundamental inquiry is whether the debtor had a legal or equitable interest in the property transferred such that the transfer at issue diminished or depleted the debtor's estate. The court reasoned that the recovery of interests in property of the debtor serves the purpose of protecting against the dismemberment of the debtor and promotes equality of distribution to creditors. Based on this rationale, the *Marshall* court found by drawing on the line of credit with the credit card company, the Debtor merely substituted one creditor for another and did not diminish property available to their creditors.

The *Marshall* court recognized, however, that its opinion is the minority view. The court acknowledged a number of cases whereby courts considered whether the creditor had an earmarking defense to the action. "Earmarking" is a judicially-created doctrine said to apply when a new creditor pays a debtor's existing debt to an old creditor. However, most courts limit the earmarking doctrine to cases where the new creditor has control over disposition of the loan proceeds. In the *Marshall* case, the debtor had control over the disposition of the loan proceeds and the earmarking doctrine would therefore not apply.

In the recent case of *In re Warner* from the Middle District of Georgia, the bankruptcy court similarly found that if the debtor decides which creditor is paid, the proceeds are not earmarked by the new lender for repayment of the existing loan, and thus, the proceeds constitute an interest of the debtor in property avoidable under the preference law. In *Warner,* the debtor could have distributed the funds among of his creditors, but he instead transferred them to one select creditor. The court found that the debtor initiated and directed the transfer of funds from his credit card account to the creditor, which he could not have done if he had no interest in the funds. Accordingly, the court found that there was no reason to distinguish this scenario from one in which a debtor obtains a cash advance and uses the advance to pay one of many creditors. Consequently, the court concluded the transfer was of an interest of the debtor in property.

In examining the majority view, the Marshall court found that theoretical possibility that a debtor can draw upon a line of credit for any purpose is not sufficient to find the debtor has a property interest in credit proceeds that at debtor's direction are paid directly to a specific creditor. In the end, the *Marshall* court found that a debtor's line of credit is not an asset available to increase the property available for the payment to creditors, and the reasoning for the majority decisions wrongfully focuses on what the debtor could have done rather than what he did do.