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**The Earmarking Doctrine:
Can it be Used to Protect Late-Recorded Mortgages in Preference Action?**

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Introduction

Borrowers often seek to refinance their home loan mortgages in order to attain more favorable interest rates and other terms. Essentially, in these refinancing transactions, “the parties are looking simply to exchange one more expensive secured loan for another less expensive secured loan.”¹ Typically, as part of the transaction, a refinancing lender will discharge the original mortgage and record a new mortgage. It is not uncommon for a delay to occur such that the new mortgage is recorded over thirty days after the lender transferred the funds to pay off the original loan. In such a case, if the borrower files for bankruptcy within ninety days of the date on which the new mortgage was recorded the bankruptcy trustee will often seek to avoid the new mortgage as a preference.

The Bankruptcy Code provides lenders with statutory defenses to preference actions. Most notable, section 547(e)(2) provides lenders with a grace period of thirty days to perfect

¹ Kevin M. Baum, Note, *Apparently, "No Good Deed Goes Unpunished": The Earmarking Doctrine, Equitable Subrogation, and Inquiry Notice Are Necessary Protections When Refinancing Consumer Mortgages in an Uncertain Credit Market*, 83 ST. JOHN'S L. REV. 1361, 1382 (2009) (“the parties to home refinancing agreements intend that these loans be secured by a mortgage.”).

their security interest.² Thus, “[i]f the security interest is perfected within this grace period, for the purposes of the bankruptcy proceeding, the date of the transfer of the security interest will relate back to when the lender issued credit to the debtor.”³ In addition to statutory defenses, refinancing lenders can also assert various common law defenses, including the earmarking doctrine.

Although the use of the earmarking doctrine has been the topic of much debate, it is generally accepted that the judicially-created doctrine is a valid defense to preference actions.⁴ Effectively, the earmarking doctrine posits that a transaction is not a preference “[w]hen new funds are provided by [a] new creditor to or for the benefit of [a] debtor for the purpose of paying the obligation owed to the old creditor.”⁵ While most courts generally accept the basic framework of the earmarking doctrine,⁶ a circuit split currently exists over whether a new lender may successfully use the doctrine as a defense in a preference action to protect a late-recorded, but otherwise valid, mortgage granted in connection with a home loan refinancing.⁷

² See generally 11 U.S.C. § 547(e)(2).

³ See Baum, *supra* note 3 at 1365 (“[r]ealizing that a secured creditor may face potential problems if it did not record the security deed instantaneously, which may be impossible because of bureaucratic delays at the states’ real-property recoding offices, Congress enacted a grace period.”).

⁴ See *McCuskey v. Nat’l Bank of Waterloo (In re Bohlen Enterprises, Ltd.)*, 859 F.2d 561, 565 (8th Cir. 1988) (“[t]he earmarking doctrine is entirely a court-made interpretation of the statutory requirement that a voidable preference must involve a ‘transfer of an interest of the debtor in property’”. Equivalent language has existed in the Bankruptcy Act for many decades.”); see also Baum, *supra* note 5 at 1374–75 (“courts have created a common law preference action defense, beyond the statutory protections of § 547, for third parties who refinance an antecedent debt owed by the debtor.”); see also Lisa G. Beckerman and Robert J. Stark, *Structuring Workout Settlements Premised on the “Earmarking Doctrine,”* 26 Cal. Bankr. J. 105, 113 (2002) (“Historically, earmarking doctrine cases involved a third-party paying an obligation of the debtor that the third-party itself was also obligated to pay, as a surety, subsequent endorser, or guarantor.”).

⁵ *In re Bohlen Enterprises, Ltd.*, 859 F.2d 561, 565 (8th Cir. 1988); see *In re Flannery*, 513 B.R. 1, 5 (Bankr. D. Mass. 2014) ([t]he earmarking doctrine applies ‘where a third party lends money to the debtor for the specific purpose of paying a selected creditor.’”).

⁶ See Beckerman and Stark, *Supra* note 6 at 112 (“the prevailing view is that the doctrine has been extended “to encompass any situation where a subsequent loan was made on the condition that it be used to repay an existing loan”).

⁷ See Baum, *Supra* note 6 at 1366–67 (“Circuits are currently divided over whether to apply a bright-line approach, requiring that the transaction occur within the thirty-day grace period found in § 547(e) or whether to take a flexible approach and look at the totality of the circumstances.”).

Courts have adopted two approaches when applying the earmarking doctrine to home-loan refinancing transactions: (1) the multiple transactions approach and (2) the unitary approach.⁸ Under the multiple transactions approach, courts view the process to refinance a home loan as having two distinct transactions: (1) the new lender transferring funds and (2) the borrower granting the new lender a mortgage. As such, if the mortgage is recorded more than thirty days after the funds are transferred and within ninety days of the debtor filing for bankruptcy, the earmarking doctrine will not bar the bankruptcy trustee from avoiding the mortgage as a preference.⁹ The unitary approach is premised on the presumption that the process to refinance a home loan consists of one transaction involving multiple different steps. Consequently, the date a security interest is recorded is of no consequence when deciding whether a transaction is an avoidable preference.¹⁰

This Article will discuss the different approaches courts have taken when applying the earmarking doctrine within the context of late-perfected mortgages granted in connection with a home loan refinancing. Part I discusses the earmarking doctrine generally and then examine the current state of the law as it pertains to both the unitary approach as well as the multiple transaction approach. And Part II discusses practical implications that the multiple transaction approach will have on creditors and trustees, should it continue to be the dominant theory with respect to the earmarking doctrine.

I. The Earmarking Doctrine

To successfully assert the earmarking doctrine, a new creditor (i.e. the refinancing party) must prove that: (1) an agreement exists between the new creditor and the debtor, which

⁸ See *Id.* at 1376; see also Paul A. Rogers et al., *Applicability of the Earmarking Defense to a Preference Action*, Am. Bankr. Inst. J., 20 (2006).

⁹ See *Id.* at 1378.

¹⁰ See Baum, *Supra* note 9.

stipulates that new funds will be used to pay a particular antecedent debt; (2) the agreement was fulfilled according to its terms; and (3) the transaction, when taken in its entirety, did not result in a diminution of the estate in question.¹¹

Essentially, the earmarking doctrine rests on the premise that these sorts of transactions cause no diminution to the bankruptcy estate because the funds in question were used for the sole purpose of paying antecedent debts and thus merely “pass[ed] through the debtor’s hands.”¹² Simply put, “courts view the funds as transferred by the guarantor to the creditor through, *but not* by, the debtor.”¹³

A. The Multiple Transaction Approach – The Majority Approach

Most prominently demonstrated by the First and Sixth Circuits,¹⁴ the majority of courts have rejected the earmarking doctrine as defense to preference actions seeking to avoid late-recorded mortgages granted in connection with home loan refinancing.¹⁵ Essentially, adherents

¹¹ See *Id.* at 566; See also Baum, *Supra* note 12 at 1375 (explaining the use of the earmarking doctrine as a defense in preference actions); See Beckerman and Stark *Supra* note 10 ([i]n order to avail itself of the “earmarking” defense regardless of where the debtor’s bankruptcy case might be filed, the creditor should ensure that the structure of the settlement satisfies...the *Bohlen* [test]).

¹² *Collins v. Greater Atl. Corp. (In re Lazarus)*, 478 F.3d 12, 15 (1st Cir. 2007) (“the earmarking doctrine relies on a conceptual view that the payment passing through the debtor’s hands is not his and that he is merely a kind of bailee.”)

¹³ *Id.* (“If the earmarked funds were treated as those of the debtor, the guarantor’s payment could often be recaptured from the original creditor as an avoidable preference and the guarantor would then have to pay twice.”).

¹⁴ See *In re Lazarus*, 478 F.3d 12. The First Circuit held that a trustee could not use the earmarking doctrine to avoid a mortgage granted by two sisters to a new lender when refinancing their residential mortgage loan. *Id.* There, when refinancing their mortgage, the two sisters executed a promissory note, which was secured by a granting the new lender a mortgage on their property. *Id.* at 13. Subsequently, per the terms of the promissory note, the new lender paid the antecedent debt. The refinancing mortgage, however, was recorded 15 days later, which was within 90 days of the sisters filing for bankruptcy. *Id.* Holding that the earmarking doctrine did not protect the new mortgage, the *Lazarus* court explained that refinancing in question was composed of multiple transactions involving the debtor, a new creditor and an old creditor. *Id.* at 15. In effect, the *Lazarus* court was not persuaded by the new lender’s argument that the sisters merely transferred the initial mortgage to them from the old lender. *Id.* at 16. See also *Chase Manhattan Mortg. Corp. v. Shapiro (In re Lee)*, 530 F.3d 458, 469 (6th Cir. 2008). Here, a debtor sought to refinance his mortgage with the initial lender six months before filing for bankruptcy. *Id.* at 461. Per the terms of the refinance agreement, the debtor obtained a loan to pay off the antecedent mortgage and granted the initial lender a new mortgage on different terms. *Id.* However, the lender failed to record the new mortgage for 72 days. Shortly thereafter, only 77 days after the new mortgage was recorded, the debtor filed for bankruptcy. *Id.*

¹⁵ See Baum, *Supra* note 13 at 1389 (nothing that the multiple transaction approach has been adopted by numerous circuits); see also *In re Lazarus* 478 F.3d at 16; see also *In re Lee*, 530 F.3d at 469.

of the multiple transaction approach advocate a mechanical interpretation of section 547.¹⁶ As an initial matter, they reason that two independent transactions take place when debtors refinance their home loans. The first transaction occurs when a new creditor pays a debtor's antecedent debt, while the second transaction takes place once the new creditor has perfected the refinanced mortgage.¹⁷ Consequently, under the multiple transaction theory, it follows that if the second of those transactions occurs within ninety days of a debtor filing for bankruptcy, then it is an avoidable preference so long as no other defense applies.¹⁸ In essence, the majority rule, as stipulated by the First Circuit, applies a strict construction of section 547 and concludes that, "the earmarking concept does not provide...an escape from the plain language of section 547(b) in the case of a belatedly-perfected transfer of a security interest."¹⁹

Furthermore, those courts adhering to the multi-transactional approach reason that the unitary approach leads to a diminution of the estate in question,²⁰ thus violating one of the necessary preconditions for the earmarking doctrine to apply.²¹ Under the multiple transaction approach, courts reason that once the first transaction (i.e. paying off the antecedent home loan) occurs, the property in question is no longer subject to any liens. However, the second transaction (i.e. the granting of the new mortgage) causes a diminution because the new lender,

¹⁶ See Baum, *Supra* note 17 at 1379. Explaining that Circuits adopting the multiple transaction approach choose to focus their attention "on the form of the refinancing transaction instead of its substance."

¹⁷ See 11 U.S.C. § 547(e)(2)(b); see also *In re Lazarus*, 478 F.3d at 15–6 ("in refinancing there are multiple transactions, including a new loan to the debtor, a mortgage back from the debtor to the new lender, a pre-arranged use of the proceeds of the loan to pay off the old loan and the release of the old mortgage.").

¹⁸ See Baum, *Supra* note 18 at 1378; see also Rogers, *Supra* note 10.

¹⁹ *In re Lazarus*, 478 F.3d at 16. The court reasons that by not following the multiple transaction theory, courts are essentially "ignoring the statutory language." In its decision, the court wrote: "It is one thing to impose a gloss on the statute, such as the earmarking doctrine, that achieves formal compliance with the statute to rescue a transaction where no prejudice occurred. It is another to make lack of prejudice itself a *substitute* for formal compliance." See Rogers, *Supra* note 20. (explaining that the multiple transaction approach argues that "the earmarking doctrine does not apply to insulate a refinancing creditor from preference recovery that belatedly perfects its security interest during the preference period.")

²⁰ See *Id.* at 472.

²¹ See *In re Bohlen Enterprises, Ltd.*, 859 F.2d at 565 (outlining the necessary conditions for the earmarking doctrine to be applicable).

by taking a security interest to protect his loan, is in fact taking property out of the bankruptcy estate. Moreover, courts explain that not following the multiple transactions approach would lead to “secret liens” on properties, and thus diminish the value of the estate in question because “non-exempt equity in the [p]roperty that otherwise would have been available for distribution [becomes] encumbered, and unavailable to [other] creditors.”²² Also, courts adhering to the multiple transaction approach have opined that, for the elements of the earmarking doctrine to be satisfied, the refinancing agreement must be between a debtor and a new lender. Thus, a creditor is not permitted to act simultaneously as both a new and old lender.²³

B. The Unitary Approach – The Minority View

On the other side of the circuit split, courts, with the adoption of the unitary approach, have held that the earmarking doctrine is an appropriate defense for a creditor involved in a preference action arising from late perfected refinanced home loans. Courts adopting the unitary approach, most notably the Eighth Circuit,²⁴ reason that the process to refinance mortgages should be considered a “single [unitary] transaction, consisting of multiple steps.”²⁵ Therefore, under the unitary approach, the mere fact that last aspect of the transaction occurs within ninety

²² *In re Lee*, 530 F.3d at 472.

²³ *Id.* at 461. The Sixth Circuit held that the earmarking doctrine could not be used to protect a late-perfected mortgage granted in connection with a home loan refinancing when the new lender and old lender are the same bank. *Id.* at 461. In *Lee*, the court held that “[b]ecause [the bank] refinanced its own loan with the Debtor, it cannot establish this preliminary element of the earmarking defense.” *Id.* at 470.

²⁴ See *Kaler v. Cmty. First Nat'l Bank (In re Heitkamp)*, 137 F.3d 1087 (8th Cir. 1998); see also Baum, *Supra* note 20 at 1376 (“When the Eighth Circuit adopted the unitary approach, it went in a “new direction,” allowing a refinancing lender to successfully assert the earmarking doctrine when the lender failed to perfect within the statutory period of § 547(e).”).

²⁵ Baum, *Supra* note 26 (“[c]ourts treat the payment to the creditor for the antecedent debt and the granting of the security interest as “two sides of the same coin.”); see also *Lindquist v. Dorholt (In re Dorholt, Inc.)*, 224 F.3d 871, 873 (8th Cir. 2000) (“a transaction is *not* a preferential transfer, even if made on the eve of bankruptcy, if the creditor provides new value in exchange for the debtor's contemporaneous transfer of, for example, a security interest.”).

days of a debtor filing for bankruptcy does not create any preference issues if the first step taken to refinance the home loan was taken prior to the beginning of the preference period.²⁶

Under the unitary approach, all three of the earmarking doctrine's requirements are met in cases involving home loan refinancing. First, an agreement between the debtor and a new lender would exist. Under this agreement, the new lender would be required to pay-off the antecedent home loan. By its very nature, in a refinancing transaction a new lender is agreeing to pay off the old lender. Therefore, to ensure that an old lender no longer has a lien on the refinanced property, a new lender will undoubtedly take control of the situation and directly pay off the antecedent debt. Consequently, the second requirement of the earmarking doctrine would be met. And finally, unlike the majority view, the minority, like the Eighth Circuit, concludes that invoking the earmarking doctrine in these scenarios does not in any way diminish the bankruptcy estate.²⁷ As stated by the Eighth Circuit, the reasoning behind this is that, in the end, the bankruptcy estate is left with the same net assets and liabilities that it would have regardless of whether the transaction in question took place.²⁸ Thus, in the case of home loan refinancing agreements, before and after the transaction, the estate is left with a house encumbered by a lien. Therefore, by accepting the unitary theory, courts have held that in scenarios involving refinanced mortgages all three elements of the earmarking doctrine are satisfied.²⁹

²⁶ See Rogers, *Supra* note 21 (“These courts are willing to apply the earmarking doctrine as a defense even where there is a substantial delay in the perfection of the new refinanced security interest within the time required” by the Code).

²⁷ See, e.g. *In re Heitkamp*, 137 F.3d at 1089 (the new lender only recorded the mortgage 5 months after the transaction occurred); see also Baum, *Supra* note 27 at 1377.

²⁸ *In re Heitkamp*, 137 F.3d at 1089. The court here reasoned that the bankruptcy estate's “assets and net obligations remained the same.” Furthermore, the Eighth Circuit explained that “[b]ecause the transfer of the mortgage interest to the bank merely replaced the [old lender]’s security interest, there was no transfer of the [debtor]’s property interest avoidable under [section] 547(b).” *Id.* at 1089.

²⁹ *Id.* at 1088. Here, The Eighth Circuit held that the earmarking doctrine applied to a transaction involving a late perfected mortgage granted in connection with a home loan refinancing. *Id.* In *Heitkamp*, a couple had incurred a mechanics lien from a number of subcontractors because of an outstanding \$40,000 debt. *Id.* Unable to meet their financial obligations, the debtors obtained a loan for the outstanding amount, which was secured by granting the bank a second mortgage on their home. *Id.* Instead of giving the couple the money, however, the bank, pursuant to [American Bankruptcy Institute Law Review](#) | St. John's School of Law, 8000 Utopia Parkway, Queens, NY 7
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II. Implications of the Multiple Transaction Approach on Creditors and Trustees as Well as How Refinancing Creditors Can Protect themselves and Work Around the Multiple Transaction Approach

A. Practical Implications for Secured Creditors

The multiple transaction approach should be a cause of concern for new lenders involved in home loan refinances. The primary reason for this is that under the multiple transaction approach, the refinancing lender becomes an unsecured creditor. This point was particularly emphasized by the *Lazarus* court, which unsympathetically remarked that:

[I]f the transaction is deemed an avoidable preference, [the refinancing lender] will still hold the unpaid note but... will lose its status as a secured creditor... vis a vis the other creditors. This may, or may not, be as bad as a guarantor having to pay twice; but it is certainly a penalty. But the penalty is not without a general benefit--pour encourager les autres--and is easily avoided by recording within [30] days as the statute directed.³⁰

Consequently, it has been speculated that the multiple transaction approach could potentially lead creditors to become more skeptical when refinancing mortgages, and ultimately offer debtors less favorable terms when refinancing their homes.³¹

Although not optimal, the reality is that the multiple transaction approach does not drastically reduce the amount a refinancing lender would receive on his claim should he become

the terms of the loan, directly paid the subcontractors. *Id.* Further, as part of the refinancing, the couple obtained waivers from the subcontractors for the mechanic liens held against their house. *Id.* However, due to an oversight, the bank failed to record the mortgage for three months. *Id.* A mere three days after the bank perfected the mortgage, the couple filed a Chapter 7 bankruptcy petition and the trustee filed a preference action against the bank. *Id.*

³⁰ 2007 Comm. Fin. News. 09

³¹ See Baum, *Supra* note 29 at 1381. “The Eighth Circuit's unitary transaction approach allows the bankruptcy courts to encourage lending, while still working within the constraints of the Bankruptcy Code.” See also *id.* at 1389. “These refinancing agreements lowered the debtors' monthly payments, thus leaving more money for the debtors to pay their unsecured creditors...bankruptcy courts should adopt a policy that helps keep people out of their courtrooms. By removing the risk that the refinancing lender's security interests will be avoided, the courts will act to encourage the banks to reduce the debtor's monthly payments through refinancing, thus allowing the debtor to pay his other debts.”

an unsecured creditor. This is because, as a practical matter, a refinancing bank will get the vast majority of the proceeds generated from the property.³²

However, even if the majority of courts do not adopt the unitary approach, refinancing lenders still have options available to them. For example, to limit “the number of transactions,” lenders should consider taking the following steps. First, new lenders should simply assign the original mortgage to themselves from the old lenders directly. And second, once the mortgage has been assigned, the new lender and the debtor can amend the initial terms to make them more favorable. Although such a scenario has yet to be litigated, taking these steps should satisfy the multiple transaction approach advanced by the First Circuit because the “debtor would be acting as bailee when passing the mortgage from one creditor to another.”³³

Furthermore, should this approach not work, it is clear that the vast majority of courts deem a late-perfected mortgage to be a preferential transfer within the meaning of section 547. Thus, lenders should take extra efforts to be diligent about recording their mortgages as soon as possible.³⁴ Doing so would automatically decrease the likelihood that perfection of the mortgage took place within the preference period outlined in the Bankruptcy Code. Finally, it should be noted that the earmarking doctrine is only one of three common law defenses to preference actions. Thus, instead of using the earmarking doctrine to overcome a preference action, lenders may be able to successfully invoke the doctrine of equitable subrogation³⁵ or the doctrine of inquiry notice.³⁶

B. Practical Implications for Bankruptcy Trustees

³² See Baum, *supra* note 33 at 1390 (“in reality “[n]o unsecured creditor ever had the slightest basis to believe that he would be entitled to recover his debt from mortgage proceeds.””) (Quoting *In re Lee*, 530 F.3d at 475).

³³ Baum, *Supra* note 34 at 1384. “Arguably, the refinancing lender may be able to avoid this technical problem by actually taking over the old creditor’s security interest.”

³⁴ See *In re Flannery*, 513 B.R. at 7 (commenting that the issue of belatedly perfected refinancing mortgages is frequent issue addressed in preference actions).

³⁵ Baum, *Supra* note 35 at 1391.

³⁶ See *Id.* at 1396–97.

This circuit split is of particular importance for bankruptcy trustees because it will determine their ability to avoid a mortgage on real property that has recently been refinanced. In turn, this will directly effect a trustee's compensation. Pursuant to section 326 of the Bankruptcy Code, Chapter 7 trustees are compensated with a percentage of the value of the bankruptcy estate's assets.³⁷ In the event a trustee discovers a late perfected security interest granted in connection with a home loan refinancing, he or she would, in the majority of circuits, increase the value of the assets available for distribution to creditors. Consequently, a trustee's compensation would increase in cases involving late perfected refinancing mortgages. Thus, under the multiple transaction approach, trustees should be financially motivated to take extra steps in checking the date that a mortgage granted in connection with a home loan refinancing was recorded by a new lender. Furthermore, a bankruptcy trustee has a fiduciary duty to unsecured creditors to maximize the value of the bankruptcy estate.³⁸

C. Practical Implications for Unsecured Creditors

Currently, a majority of courts are determined to continue implementing the multiple transaction approach, which brings with it a number of implications that directly effect unsecured creditors. The multiple transaction approach does seemingly have benefits for the claims of unsecured creditors. The multiple transaction approach works under the premise that a new mortgage granted in a home loan refinancing "elevate[s] [the new lender] from unsecured to secured status, resulting in fewer assets of the Debtor's estate for other unsecured creditors."³⁹ A

³⁷ See generally 11 U.S.C. §326.

³⁸ Steven Rhodes, *The Fiduciary and Institutional Obligations of a Chapter 7 Bankruptcy Trustee*, 80 AM. BANKR. L.J. 147, 161 ("a trustee may pursue a personal interest in earning a professional fee for services performed for the estate if it will serve the estate's interest in maximizing the distribution.").

³⁹ *In re Lee*, 530 F.3d at 462; But see Baum, *Supra* note 38 ("even the First Circuit recognized that in these situations, there is no prejudice to the unsecured creditors. In reality, "[n]o unsecured creditor ever had the slightest basis to believe that he would be entitled to recover his debt from mortgage proceeds."").

direct consequence of the multiple transaction approach is that the value of a debtor's home will be included in his or her estate during bankruptcy proceedings. Thus, under this approach, when a refinanced mortgage granted in connection with a home loan refinancing is belatedly perfected, unsecured creditors will find themselves more likely to have a higher portion of their claims honored.

Conclusion

Although generally accepted by the majority of courts, the earmarking doctrine as it pertains to late perfected mortgages granted in connection with home loan refinancing remains a source of controversy. Circuits are split between two theories for applying the earmarking doctrine: (1) the multiple transaction approach; and (2) the unitary approach. Although the unitary approach has its benefits, the multiple transaction approach has been adopted by an overwhelming majority of circuits. While this current trend, at least at first glance, benefits unsecured creditors, it is important for creditors to take extra steps to protect their interests when refinancing home loans.