UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In re

LAUGHLIN SERVICES, INC. Case No. 97-17261 K
d/b/a Hook Towing & Rigging

Debtor

MARK S. WALLACH, Trustee

Plaintiff

-vs- AP No. 99-1267 K

AI CREDIT CORP. d/b/a AICCO; AICCO
INC. d/b/a AICCO and Reliance National
Insurance Company

Defendant

The question presented is why rebated insurance premiums are properly paid to the premium-financing lender regardless of whether the premium financing was a prepetition arrangement or a postpetition arrangement and regardless of whether the lender did or did not perfect a lien thereupon under the U.C.C.

Borrowing a totally-different part of bankruptcy law, we find that the reason is very much akin to the reasoning of the "earmarking doctrine." The earmarking doctrine is a "court-made interpretation of the statutory requirement that a voidable preference must involve a 'transfer of an interest of the debtor in property.'" *McCuskey v. Nat'l. Bank of Waterloo (In re Bohlen Enterprises, Ltd.)*, 859 F.2d 561, 565 (8th Cir. 1988). The earmarking doctrine is a defense against what might otherwise be a preference claim under 11 U.S.C. § 547.

For instance, "[w]hen a third party makes a loan to the debtor specifically to enable that debtor to satisfy the claim of a designated creditor, the proceeds never become assets of the debtor." 5 *Collier on Bankruptcy* § 547.03[2] at 547-25 (15 ed. 2000). The earmarking doctrine is viewed as a valid defense against preference claims in part because the "assets from the third party were never in control of the debtor and therefore payment of these assets to a creditor in no way diminishes the debtor's estate." *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1356 (5th Cir. 1986).

The doctrine initially arose in situations where "the new creditor was a guarantor of the debtor's obligation, such as a surety, a subsequent endorser or a straight contractual guarantor." *In re Bohlen* at 565. The doctrine has been expanded over time to include instances "where the new creditor is not a guarantor but merely loans funds to the debtor for the purpose of enabling the debtor to pay the old creditor." *Id* at 566. In some cases, the courts have focused "not on the relationship of the creditor advancing the funds, but rather on the degree of control the debtor possesses over the disputed funds." *Geremia v. Fordson Associates (In re International Club Enterprises, Inc.)*, 109 B.R. 562, 566. The courts have found that the earmarking doctrine applied "where the new lender entrusts the funds to the debtor with instructions to use them to pay the old creditor." *In re Bohlen* at 566. *See also, In re Sun Railings, Inc.*, 5 B.R. 538 (S.D. Fla. 1980).

As to insurance premium financing, the pre- or post-petition debtor is at no time negotiating for a loan of money to be used at the debtor's discretion. Rather, the debtor is negotiating for insurance coverage on a pay-as-you-go basis. The form of the transaction is

"whatever works."

From the debtor's perspective it makes no difference how the transaction is "papered" so long as the debtor (1) gets the insurance coverage, and (2) can have no liability to either the insurance company or any "lender" if the debtor were to cancel the policy or let it lapse.

In other words, there never is a "debt," but rather there is only a month-to-month purchase of contemporaneous insurance coverage. So long as that is the result in fact, the "structure" of the transaction is irrelevant, and Bankruptcy Code provisions that would otherwise apply to "debts" arising out of the same "structure" have no application.

Here is a close analogy. Someone who is a member of an HMO with prescription coverage goes into a pharmacy and "buys" a prescription medication. There can be no doubt that in the mind of that person, she has simply "bought" her medication by paying her $5 (or $10 or $25) "co-pay" and signing a form. And if she were to file bankruptcy later that same day, no creditor would disagree that she "bought" her prescription that day. The fact is that that is not what happened, given the "structure" of the relationship among the HMO, the member, and the pharmacy. By her signature on the form she empowered the pharmacy to make a claim against her HMO to be paid by the HMO with its money, and to be charged against whatever limitations and conditions apply to her membership, which membership she has either paid for, or is obliged to pay for, in the ordinary course.

Neither she nor her creditors give a hoot or a holler about what that structure is, so long as it has no negative impact on her bankruptcy. Consequently, her trustee too should not

care.

Resort to theories like "recoupment" or "set off" might be thought necessary because those are useful analytic tools when tinkering with such parts of the "structure" as installment notes, pledges, etc. But they are irrelevant because from the debtor's perspective, all it is doing is buying insurance coverage on a pay-as-you-go basis, just as if its insurer agreed to sell it coverage on that basis.

To reach that result, the structure selected in the case at Bar was that of a loan fully secured by any premium rebates. Other possible structures might involve the creation of a trust to own the insurance policy and the right to any rebate; or (if the insurer is willing) a guaranty or a bond by AICCO to secure the insured's promise to pay premiums to the insurer on a monthly basis; and so forth.

In a completely different context, Justice Cardozo once was confronted with technical arguments as to whether a particular fact pattern fell under the doctrine of waiver or the doctrine of estoppel (or both or neither) and he said "We need not go into the accuracy of the description. The truth is we are facing a principle more nearly ultimate than either waiver or estoppel, one with roots in yet larger principle that no one shall be permitted to found any claim upon his own inequity or take advantage of his own wrong." (Concurring opinion in *Imperator Realty Co. v. Tull*, 228 N.Y. 447, 127 N.E. 263 (1920) (internal citation omitted)).

Here he might say that we need not decide how various provisions of the Bankruptcy Code might operate on the various components of the structure used here, for we are dealing with a more ultimate truth, that nothing in the Bankruptcy Code ever affects the purchase

of (and essentially-contemporaneous payment for) ordinary and necessary goods and services in the ordinary course of a Chapter 11 Debtor in Possession. This is true of utilities such as phones, electricity and water, and it is true of maintaining insurance coverage in whatever form "works," so long as no debt can be created that can be asserted against the estate if the policy is cancelled or allowed to lapse.

Just as the "earmarking doctrine" in preference law deems the loan proceeds never to be property of the debtor, the above analysis establishes why the premium rebates go back to the financier and not to the Chapter 7 estate.

The Trustee's Motion is denied. The Cross Motion is granted. The Adversary Proceeding is dismissed. The parties are to bear their own costs.

SO ORDERED.

Dated: Buffalo, New York
February 12, 2001

/s/ Michael J. Kaplan
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U.S.B.J.