ALERTS

Ninth Circuit Holds Bank Liable for Preference, Applying Hypothetical Liquidation Analysis

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"[C]ourts may account for hypothetical preference actions within a hypothetical [C]hapter 7 liquidation" to hold a defendant bank ("Bank") liable for a payment it received within 90 days of a debtor's bankruptcy, held the U.S. Court of Appeals for the Ninth Circuit on March 7, 2017. *In re Tenderloin Health*, 2017 U.S. App. LEXIS 4008, *4 (9th Cir. March 7, 2017). According to the court, the hypothetical "inquiry [must be] factually warranted, [be] supported by appropriate evidence, and … not contravene an independent statutory provision." *Id.* Applying Bankruptcy Code ("Code") §547(b)(5) (the "greater amount test"), the court reasoned that the Bank "received a greater amount than it would have if the [debt repayment] had not been made and there had been a hypothetical [C]hapter 7 liquidation as of the petition date." *Id.* at*7 quoting *In re Smith's Home Furnishings*, Inc., 265 F. 3d 959, 963 (9th Cir. 2001).

The Bank had received $190,000 from the debtor (i.e., fully satisfying the debtor's outstanding loan obligations to the Bank) within 90 days of the debtor's bankruptcy, but the lower courts found that the Bank was fully secured with a setoff right against $526,000 on deposit in the debtor's account at the Bank as of the date of bankruptcy. Because it was fully secured, the Bank had not received more than it would have received in a hypothetical Chapter 7 case; therefore, it had no preference liability, reasoned the lower courts. Reversing the district court's affirmance of the bankruptcy court's summary judgment dismissing the complaint, the Ninth Circuit explained that, in the hypothetical required by Code §547(b)(5), the debtor's later $526,000 deposit "would be voidable, leaving less

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than $190,[000] in [the debtor's account]" as of the petition date. 2017 U.S. App. LEXIS 4008, at*4. Significantly, the concurring judge noted the "strained boundaries of [the majority's] hypothetical analysis" *Id.* at*36. As shown below, the Ninth Circuit's reasoning is not only murky, but also questionable.

Facts

The Bank had made a loan to the debtor three years prior to its Chapter 7 bankruptcy filing, secured by the debtor's personal property, including its deposit accounts with the Bank. Ninety days prior to bankruptcy, the debtor had roughly $173,000 on deposit with the Bank and owed it about $190,000. Five weeks before bankruptcy, the debtor satisfied "fully its outstanding loan obligations," *id.* at*5, from the escrowed proceeds of a sale of unencumbered assets. On the "same day," it deposited "the rest of its net sales proceeds" — $526,000 — with the Bank. *Id.* The Bank thus received, according to the Ninth Circuit, "two transfers simultaneously within 90 days of [the debtor's] bankruptcy" — the $190,000 payment from a sale escrow and the $526,000 deposit. *Id.* at *28-*29. The Bank later voluntarily turned over the net balance (more than $500,000) in the debtor's account to the Trustee, never having set off anything. *Id.* at *20n.6.

The Trustee sued to recover the debtor's $190,000 payment to the Bank. The district court affirmed the bankruptcy court's granting of the Bank's motion for summary judgment dismissing the complaint. *Id.* at *6.

Relevance

"This case," said the concurring judge in *Tenderloin*, "raises the important question of how to measure the preferential impact of commonplace bank deposits, which will often turn on the permissible extent of a hypothetical post-petition setoff" *Id.* at *35, n.3.

Code §553(b) contains its own preference provision with respect to setoffs —an "improvement in position" test. Specifically, §553(b) permits a trustee to recover from a creditor any improvement in that creditor's position resulting from a setoff of its claim during the 90-day period preceding bankruptcy. The section applies only to pre-bankruptcy setoffs. If, for example, the creditor's claim against the debtor (e.g., the outstanding balance of a loan) exceeds the debtor's claim against the creditor (e.g., the amount on deposit with the bank), there is an "insufficiency." Code §553(b)(2). If the earlier insufficiency exceeds the

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insufficiency on the day of the actual setoff, the creditor (i.e., the Bank) has improved its position, and the trustee is permitted to recover the difference between the two amounts. As the concurring opinion in *Tenderloin* stressed, Section §553(b) provided a simpler, more "straightforward" way to dispose of this appeal, rather than the "strained" hypothetical preference analysis used by the majority. *Id.* at *37. But even the concurring judge's reasoning is questionable, for the Bank never set off its claim against the debtor's funds.

The Ninth Circuit's Majority Analysis

The premise of the majority's opinion was the voidability of the debtor's $526,000 deposit. The majority "assum[ed] in a hypothetical liquidation, that the hypothetical trustee would sue to recover the $526,[000] deposit," consistent with the Code's preference provision, §547(b). *Id.* at *20. Although the Bank argued against "permitting the hypothetical trustee to do something the actual trustee did not do," the majority stressed the "Trustee had no incentive to challenge the deposit," for the Bank had already voluntarily turned the funds over to the Trustee, "preclud[ing] any subsequent claim of setoff … ." *Id.* at *20n.6.

Had the Bank not waived its setoff right, reasoned the majority, the Bank would still have received more as a result of the debtor's $190,000 payment than "it would have received in a hypothetical [C]hapter 7 liquidation." *Id.* at *21. According to the majority, the Bank's setoff right also "improved … between the 90th day before [bankruptcy when the debtor had $173,000 on deposit] and the date of the bankruptcy [when it had $526,000 on deposit]." *Id.* at *21n.8. Under Code §553(b), the Bank's improvement in position during the critical 90-day period would have enabled the trustee to recover more than $17,000 from the Bank if the Bank had set off its $190,000 claim prior to bankruptcy, which it did not do. *Id.* Because the Bank actually received a direct $190,000 payment, said the majority, that was more than the Bank would have received ($173,000) in a hypothetical Chapter 7 liquidation. *Id.*

The majority also reasoned the Bank's $190,000 claim would not have been allowed under Code §502(d) until the bankruptcy court had "decide[d] the Trustee's hypothetical preference action … ." *Id.* at *22. To find a preference, the majority focused on the "greater amount test" of Code §547(b)(5) and applied it to the facts. "In the hypothetical liquidation where the debt payment had not been made, [the Bank] would still be a creditor because it would be owed the [$190,000] it loaned to [the

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debtor]." *Id.* at *22-*23. The debtor's deposit of $526,000, made during the 90-day period preceding bankruptcy, said the Ninth Circuit (though noting it was a closer question), "would be for or on account of antecedent debt," an essential element of a preference under Code §547(b)(2). *Id.* at *23. Although the debtor paid the Bank $190,000 before making its $526,000 deposit, the preference provision, reasoned the majority, would make "the deposit [effectively] diminish … the funds available to [the debtor's] creditors [by] increas[ing] the size of [the Bank's] secured claim against the bankruptcy estate. The deposit would also constitute a 'transfer' under the … Code. It would subject the funds to [the Bank's] security interest, give [the Bank] title to the funds, and deplete the assets available for distribution to [the debtor's] creditors." *Id.* at*23-*24.

The majority stressed that the $526,000 deposit effectively "deplete[d] the estate's assets." *Id.* at *26-*27n.13. "Through the deposit… one creditor — [the Bank] — gained a beneficial interest in the funds … and … increased its right to exercise a setoff for the full amount of its loan. The deposit… represents the kind of pre-[bankruptcy] 'transfer' that the preference provisions target." *Id.* at *27 "[They] 'created an actual or potential diminution of the estate by subjecting the funds to the [Bank's] power under [its] credit agreement.'" *Id.* at *27-*28, quoting *Ivey v. First Citizens Bank & Trust Co.*, 539 B.R. 77, 87n.14 (M.D. N.C. 2015).

The majority reasoned that the Trustee's "hypothetical preference challenge to the [$526,000] deposit would still be successful" had the Bank sought to set off after bankruptcy. *Id.* at *28. Therefore, said the majority, the debtor's "account functionally would contain $37,713… on the petition date, a sum far less than the $190,[000] … [the Bank] received, even allowing for its right of setoff." *Id.* On these "hypothetical facts," said the majority, the Trustee satisfied the "greater amount test" of Code §547(b)(5) and "can prove each required element of its claim." *Id.* at *29.

The Concurring Opinion

The concurring judge agreed with the ultimate result, but disagreed "that the entirety of the $526,000 deposit was itself a preferential transfer subject to clawback under" Code §547. *Id.* at *30. Noting that the "circuits are divided on" the question of whether a bank deposit is a "transfer" under the Code, he argued that Code §553 "is an entirely separate provision that subjects setoffs, exclusively, to different rules than those applicable to the recovery of preferences generally." *Id.* at *32-*34, n. 1, citing *New York County Nat'l Bank v. Massey*, 192 U.S. 138 (1904) and *In re*

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Dillard Ford, Inc., 940 F.2d 1507, 1512 (11th Cir. 1991). Moreover, "to hold that the creation of a setoff right that the Code preserves under the terms of §553 may be preferential under §547 would, as in *Massey*, 'enlarge the scope of the statute defining preferences so as to prevent [the exercise of] set-off in cases coming within the terms of [§553].'" *Id.* at *33. "Because *Massey*'s reasoning applies with the same force today as it did in 1904," the concurring judge refused "to join in the majority's holding that the $526,000 deposit was a preference subject to attack under §547." *Id.* at *35. Because of the Code §553(b) limitation on the creditor's right to set off after it has improved its position, the concurring judge would have enabled the Trustee to recover only "the $17,580.50 difference" received by the Bank. Like the majority, the concurring judge "would reverse the judgment below and send the case back to the bankruptcy court for further proceedings … to consider … [the Bank's] affirmative defenses … ." *Id.* at *37.

Comment

The concurring judge's "straightforward" analysis clearly is a more effective way of preventing "an offsetting creditor" from improving its position, consistent with Code §553(b). But, critically, the Bank in *Tenderloin* never set off. Although the majority, too, noted the Bank's improvement in position by $17,580, *Id.* at *21n.8, it went too far in treating the debtor's $526,000 deposit as a transfer for preference purposes under §547(b), for there was no transfer, as shown below.

The majority's strained preference analysis ignores both longstanding and recent precedent, is practically unworkable, and is at least questionable, if not simply wrong. The Bank should petition for rehearing en banc.

According to the leading bankruptcy treatise, "a debtor's deposit of a nonexempt check into a non-exempt bank account… is not a transfer from the debtor to [it]self … — so classifying such transactions would be akin to holding that a debtor's moving of money from one pocket to another is a transfer. The debtor's interest in the property has not substantively changed, and at all times the debtor's interest was exposed to creditors." 2 Collier, *Bankruptcy* ¶ 101.54, at 101-216 (16th ed. 2011), rejecting legislative history (S. Rep. No. 989, 95th Cong., 2d Sess. 27 (1978). Accord, *In re Whitley*, 848 F.3d 205, 210 (4th Cir. 2017) ("… when a debtor deposits … funds into his own unrestricted checking account in the regular course of business, he has not transferred those funds to the bank that operates the account."), citing *Massey*, 192 U.S. at 145; *Citizens Nat'l Bank v.*

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Lineberger, 45 F. 2d 522, 527-28 (4th Cir. 1930); *In re Prescott*, 805 F. 2d 719, 729 (7th Cir. 1986); *Katz v. First Nat'l Bank of Glen Head*, 568 F. 2d 964, 969 (2d Cir. 1977). Incredibly, the Ninth Circuit also ignored the Sixth Circuit's Feb. 8, 2017 decision in *Meoli v. Huntington Nat'l Bank*, 2017 U.S. App. LEXIS 2248, *16. (6th Cir. Feb 8, 2017) ("banks are not 'transferees' with respect to ordinary bank deposits" because they lack "dominion and control over them.") citing *In re Hurtado*, 342 F. 3d 528-533 (6th Cir. 2003) and *Bonded Fin. Servs., Inc. v. European Am. Bank*, 838 F. 2d 890, 893-94 (7th Cir. 1988).

Nor did the Bank's security interest in the debtor's account give it "dominion and control" over the debtor's $526,000 deposit in *Tenderloin*, for "a security interest cannot grant dominion" over anything in excess of "the underlying debt." *Meoli*, 21017 U.S. App. LEXIS 2248, *22. Further, in *Tenderloin*, the debtor owed the Bank nothing when it made the $526,000 deposit. The deposit, accordingly, was not on account of an antecedent debt, an essential element of a preference under Code §547(b)(2). In sum, the $526,000 deposit was neither a transfer nor a preference.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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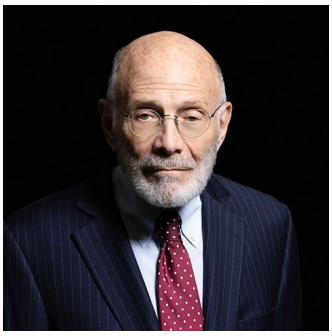

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