UNPUBLISHED OPINION

255

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF UTAH

In re	)	Bankruptcy Case No. 87B-02669
	)	
MEGABAR CORPORATION, Megabar Explosive Corporation Coraco, Inc.,	)	Chapter 11
	)	
Debtor.	)	
	)	
MEGABAR CORPORATION,	)	
	)	
Plaintiff,	)	Civil Proceeding No. 87PB-0772
	)	
vs.	)	
	)	
FIRST SECURITY BANK OF UTAH, N.A.,	)	
	)	
Defendant.	)	MEMORANDUM OPINION

Appearances: Danny C. Kelly and M. Catherine Caldwell of Van Cott, Bagley, Cornwall & McCarthy, for Megabar Corporation; Steven H. Gunn and Rick L. Rose of Ray, Quinney & Nebeker, for First Security Bank of Utah; and Henry S. Nygaard of Nygaard, Coke & Vincent, for Aerojet General Corporation.

This adversary proceeding comes before the Court upon cross motions for summary judgment filed by Megabar Corporation ("Megabar"), the debtor herein, and by First Security Bank of Utah, N.A. ("the Bank"). It is an action by Megabar, as a Chapter 11 debtor in possession, to recover from the Bank an

alleged preferential payment made by Aerojet General Corporation ("Aerojet") to the Bank. For the reasons set forth herein, the Court concludes that the payment by Aerojet did not involve a transfer of property of the debtor, and, therefore, the Bank's motion will be granted and Megabar's motion will be denied.[1]

FACTUAL BACKGROUND

In August 1984, Megabar entered into a License Agreement with Aerojet, whereby Megabar authorized Aerojet to use certain technology involving energetic materials having military and aerospace applications and authorized Aerojet to sell products which embodied this technology. The license was exclusive to Aerojet although Aerojet retained an option of converting to a non-exclusive license. An exclusive licensee, Aerojet was obligated to make minimum royalty payments ranging from $150,000.00 during the first year of the agreement to $400,000.00 during the fifth and subsequent years. Were Aerojet to exercise its option to convert this to a non-exclusive license, it would only be obligated to make royalty payments based on actual sales.

On or about September 25, 1986, Megabar borrowed $150,000.00 from the Bank and executed a Non-Revolving Note ("Note") in that amount. Under the terms of the Note, interest was payable quarterly, with the principal balance due and payable in full on

---

[1]However, see note 2, infra.

March 14, 1987. Upon request from Megabar and in order to assure that Megabar would have adequate working capitol, Aerojet agreed to guarantee the payment of Megabar's indebtedness under the Note. In addition, Aerojet knew that should it be required by the Bank to honor the guaranty, Aerojet would be able to set off any amount paid to the Bank against the minimum royalties due Megabar, which would always be in excess of the principal of the Note.

In the summer of 1986, the parties commenced discussions concerning Aerojet's desire to exercise its option to convert the license to non-exclusive. There had been no sales by Aerojet incorporating the licensed technology, nor did it then anticipate any. On September 25, 1986, Aerojet sent notice to Megabar of its intention to convert the license. Subsequent to that notice, the parties again had discussions relative to their relationship. Aerojet had become concerned about its outstanding obligation pursuant to the guaranty. It wanted to be assured that the $150,000.00 indebtedness would be paid before the license became non-exclusive, since if a minimum royalty payment were not owing, Aerojet would have no ability to protect itself by offsetting against the royalty payment. The parties subsequently agreed that Aerojet would pay $100,000.00 to Megabar as a prepayment against the minimum royalties due under the License Agreement and that the balance of the minimum royalties due would be paid to

the Bank to retire the Note. Thereupon Aerojet issued a check payable to Megabar and the Bank in the amount of $148,455.83, dated March 20, 1987, to retire the Note with the Bank.[2] The Bank was never aware of the License Agreement, nor the related transactions between Megabar and Aerojet.

Megabar filed its Chapter 11 petition on May 29, 1987 and then commenced this proceeding against the Bank to recover the payments made to it as preferential transfers pursuant to § 547 of the Code.

DISCUSSION

The preference provisions in § 547 of the Bankruptcy Code, according to the Legislative History, are designed (1) to deter "the race of the diligent" in dismembering the debtor's assets, and (2) to "facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor." H.R. Rep. No. 595, 94th Cong., 1st Sess. 177-178 (1977), reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 6138. The trustee or debtor in possession may avoid a transfer under § 547(b) if it can

---

[2]Megabar's memorandum in support of its motion, as well as the affidavit of Jay W. Butler, state that Megabar directly paid the Bank the sum of $2,325.05. That contention is nowhere refuted by the Bank. In fact the Bank admits in its answer to the complaint that the total amount of $150,780.88 was paid to it. Therefore, as to the $2,325.05 payment, Megabar's motion for summary judgment will be granted.

demonstrate the following elements by preponderance of the evidence:

> (1) a transfer of an interest of the debtor in property;
> (2) to or for the benefit of a creditor;
> (3) for or an account of an antecedent debt owed by the debtor;
> (4) made while the debtor was insolvent;
> (5) made on or within ninety days before the filing of the petition;
> (6) which enables the creditor to receive more than it would have received if the case had been a chapter 7 liquidation, the transfer had not been made, and the creditor had received payment as permitted under chapter 7.

See, Kenan v. Forth Worth Pipe Co. (In re Rodman), 792 F.2d 125 (10th Cir. 1986).

The issue involved in this case concerns the first element--whether the transfer at issue involved a payment of property of the debtor. Megabar's position is that the payment from Aerojet to the Bank was an indirect transfer of Megabar's property, which diminished the bankruptcy estate. The Bank, on the other hand, takes the position that Aerojet made the payment pursuant to its independent obligation to the Bank as guarantor of Megabar's Note.

A payment of the debtor's obligation by a guarantor with its own funds is generally not preferential. First National Bank of Danville v. Phalen, 62 F.2d 21 (7th Cir. 1932); Bank of America National Trust & Savings Association v. Small (In re Zaferis Brothers & Co.), 67 F.2d 140 (9th Cir. 1933) ("[The] guarantor

[is] necessarily protecting himself as well as the bankrupt by the payment."); Brown v. First National Bank of Little Rock, Arkansas, 748 F.2d 490 (8th Cir. 1984); Peyton v. First American Bank (In re Quest Inc. of Virginia), 17 B.R. 359, 361 n.3 (Bkrtcy. E.D. Va. 1982) ("This is so even if the guarantor takes a mortgage or other security interest in the bankrupt's property as consideration for the payment."); Boldt v. Alpha Beta Co. (In re Price Chopper Supermarkets, Inc.), 40 B.R. 816, 819 (Bkrtcy. S.D. Cal. 1984); In re M.J. Sales & Distributing Co., Inc., 25 B.R. 608, 614 (Bkrtcy. S.D. N.Y. 1982) ("There is no preference to the holder of a guaranty when paid by the guarantor, notwithstanding the bankruptcy of the obligor whose performance was guaranteed. . . . This is so because no preference occurs when the payment depletes the assets of the guarantor and not those of the debtor."). See also, 4 COLLIER ON BANKRUPTCY ¶547.03 at 547-22 to 547-23 (15th ed. 1986) ("Generally, a transfer of money or property by a third person to a creditor of a debtor that does not issue from the property of the debtor is not a preference. Thus payments made by an indorser, surety or guarantor do not effect a preference because there is no transfer of an interest of the debtor in property.").[3]

---

[3]The policy supporting this doctrine is similar to that justifying the so-called "earmarking doctrine." Pursuant to that judicial doctrine, a loan made to the debtor or property transferred to the debtor (or directly to the debtor's creditor) by a third party solely for the purpose of paying a specific

However, in this case Megabar contends that the general rule does not apply because Aerojet did not pay the Bank qua guarantor, but rather, merely transferred to the Bank a payment which it owed to the debtor. The debtor's assets were depleted thereby and, therefore, the Bank was preferred over other general unsecured creditors. The Bank, on the other hand, contends that Aerojet paid the obligation as a guarantor and there was no depletion of the debtor's assets, but (by virtue of Aerojet's subrogation to the position of the Bank) simply the substitution of one creditor for another.

The parties have correctly agreed in their respective memoranda that the fundamental inquiry in this case must be

---

creditor is not preferential. Mandross v. Peoples Banking Co. (In re Hartley), 825 F.2d 1067 (6th Cir. 1987) ("When a third person loans money to a debtor specifically to enable him to satisfy the claim of a specified creditor, the general rule is that the proceeds are not the property of the debtor, and therefore the transfer of the proceeds to the creditor is not preferential."); Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351, rehearing denied en banc, 801 F.2d 398 (5th Cir. 1986) ("If all that occurs in a 'transfer' is the substitution of one creditor for another, no preference is created because the debtor has not transferred property of his estate; he still owes the same sum to a creditor, only the identity of the creditor has changed."); Grubb v. General Contract Purchase Corp., 94 F.2d 70 (2nd Cir. 1938). See also, 4 COLLIER ON BANKRUPTCY ¶ 547.25 at 547-101 to 547-102 (15th ed. 1986) ("In cases where a third person makes a loan to a debtor specifically to enable him to satisfy the claim of a designated creditor, the proceeds never become part of the debtor's assets, and therefore no preference is created. The rule is the same regardless of 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 such proceeds are clearly 'earmarked'.").

whether the transfer diminished or depleted the Megabar estate. If there was no diminution in the debtor's assets as a result of the transfer, it is undeniable that Aerojet made the transfer either voluntarily or pursuant to an independent obligation. As noted in the memoranda, there has emerged over the years a now well-recognized principle of preference law that a third-party transfer which does not deplete the value of the debtor's estate cannot be an avoidable preference. National Bank of Newport, New York v. National Herkimer County Bank of Little Falls, 225 U.S. 178 (1972); Wind Power Systems, Inc. v. Cannon Financial Group, Inc. (In re Wind Power Systems, Inc.), 841 F.2d 288, 292 (9th Cir. 1988); Mandross v. Peoples Banking Co. (In re Hartley), 825 F.2d 1067, 1070 (6th Cir. 1987) ("where there is a question as to the debtor's ownership of the money, the Court must determine whether the debtor had such an interest in the funds such that a transfer thereof would result in a diminution of the estate."); Brown v. First National Bank of Little Rock Arkansas, 748 F.2d 490, 491 (8th Cir. 1984); Abramson v. St. Regis Paper Co., 715 F.2d 934, 938 (5th Cir. 1983) ("even though not expressly provided by the statute, it is implicit from the language used that the transfer must result in a diminution of the bankrupt estate."); Nicholson v. First Investment Co., 705 F.2d 410, 413 (11th Cir. 1983); Kapela v. Newman, 649 F.2d 887 (1st Cir. 1981); In re Columbus Malleable, Inc., 459 F.2d 118, 120 (6th Cir.

1972); First National Bank of Danville v. Phalen, 62 F.2d 21 (7th Cir. 1932). It should be noted that the asset depletion test is not intended to be an element of a preference action in addition to those set forth in § 547(b). In re Hartley, 55 B.R. 770, 775-776 (Bkrtcy. N.D. Ohio 1985) rev'd on other grounds, 825 F.2d 1067 (6th Cir. 1987). Rather, the test is designed to assist the Court in determining whether third-party transfers effected a transfer of property of the debtor, or simply a transfer of the third party's own assets.

In a general sense, no preferential transfer ever depletes the estate or net financial condition of the debtor since the reduction in assets by virtue of the transfer will be offset by an accompanying reduction in the debtor's liabilities. Therefore, assuming an arms-length transaction, the transfer will have no effect on the debtor's equity or insolvency. However, preferential analysis is designed to remedy the depletion of the debtor's assets in favor of one creditor over all others. Therefore, the Court believes it must analyze whether the transfer resulted in the depletion of an asset of the debtor, regardless of whether the debtor's financial condition remained unchanged.

Megabar argues that the transfer herein resulted in the loss of its account receivable from Aerojet. Prior to the transfer it was owed the minimum royalty and following the transfer Megabar

had no account receivable and the Bank had been paid. However, the nature of that asset leads the Court to conclude that the payment to the Bank resulted in no depletion, but only the substitution of one creditor for another. This transaction must be viewed in its entire context. Aerojet was originally willing to guarantee Megabar's obligation to the Bank because it knew it could always protect itself by offset were it ever required to pay on that obligation, since the minimum royalty payments would always be greater than the Note obligation. However, when Aerojet decided to exercise its option to convert the license to non-exclusive, it became concerned about its exposure on the Note and wanted to assure itself that the Note would be paid before the license became non-exclusive. It was in that posture that Aerojet entered into an agreement with the debtor to prepay its minimum royalty obligation (with certain discounts), provided the obligation to the Bank was thereby satisfied. Aerojet did not make payment to the Bank solely as an accommodation to Megabar, nor did it simply pay the Bank at Megabar's direction. It acted to protect its own interest and to extinguish its exposure under the guaranty. Since Aerojet was necessarily acting to protect its own interest and to limit its exposure under the guaranty, the Court cannot conclude that the payment was made independent

of its guaranty obligation.[4] See, Boldt v. Alpha Beta Co. (In re Price Chopper Supermarkets Inc.), 40 B.R. 816 (Bkrtcy. S.D. Cal. 1984) (Payment by bank on standby letter of credit was not preferential even though the letter of credit was not called since the bank volunteered the payment to reduce its own exposure.); Bank of America National Trust & Savings Association v. Small (In re Zaferis Brothers & Co.), 67 F.2d 140 (9th Cir.

---

[4]Megabar argues in its memorandum that the payment was not made pursuant to the guaranty but according to an agreement to use the receivable to pay off the Note. It relies on a letter from Aerojet, dated January 29, 1987, which reads, in part:

> Please find attached as Enclosure (1) a check in the amount of $100,000. As previously discussed, this check is a prepayment against the total minimum royalties due under our License Agreement for the third year, and is being made with the following understandings:
>
> 1. The balance of the minimum royalty payment will be used to retire the Megabar bank loan from First Security Bank currently guaranteed by Aerojet General.

It may well have been the intention of the parties to use the funds which would have been paid to Megabar on the minimum royalty obligation to retire the Note. Of course, the debtor's or creditor's motive or intention is generally irrelevant in determining whether there has been a preference under § 547. See, e.g., Hertz v. Credit Corp. (In re Repro-Technics, Inc.), 8 B.R. 225, 226 (Bkrtcy. D. Maine 1981); In re Acme-Dunham Inc., 50 B.R. 734, 738 (D. Maine 1985); 4 COLLIER ON BANKRUPTCY ¶ 547.01 at 547-13 (15th ed. 1985). More importantly, however, this arrangement was devised to relieve Aerojet of its liability under the guaranty. It would be superficial to conclude that the payment was made entirely independent of its liability as a guarantor. It was specifically because of the guaranty that the parties entered into the agreement.

1933) (Payment by guarantor was not preferential since "he was necessarily protecting himself as well as [the debtor]" by the payment to the bank.).

In order to ascertain whether an asset of the debtor was the subject of a transfer (thereby resulting in a diminution of the debtor's estate), a fundamental inquiry is whether the debtor exercised, or had the ability to exercise control over the transferred funds. In re Hudson Valley Quality Meats, Inc., 29 B.R. 67, 78 (Bkrtcy. N.D. N.Y. 1982) ("If property belongs to and is transferred by a debtor who may exert such control over it as to specify which creditor shall become the transferee, the estate has been diminished."). See also, In re Van Huffel Tube Corp., 74 B.R. 579, 585 (Bkrtcy. N.D. Ohio 1987) ("In order for the earmarking doctrine to apply . . . it must be shown that the debtor had a lack of dispositive control over the funds in question."); Coral Petroleum Inc. v. Banque Paribas-London, 797 F.2d 1351, 1356 (5th Cir. 1986) ("The earmarking doctrine is widely accepted in the bankruptcy courts as a valid defense against a preference claim, primarily because the assets from the third party were never in the control of the debtor and therefore payment of these assets to a creditor in no way diminishes the debtor's estate."); Mandross v. Peoples Banking Co. (In re Hartley), 825 F.2d 1067 (6th Cir. 1987). There is no evidence upon which the Court can rely that Megabar possessed dispositive

control over the funds which were paid to the Bank. The debtor could have assigned its account receivable to the Bank and allowed the Bank to collect it. That was not done. The funds which were actually paid to the Bank were Aerojet funds. They were paid pursuant to an agreement which required that the funds be paid to the Bank. The check was drawn payable to Megabar and the Bank. At no time did Megabar have the power to divert these funds to its own account for some other purpose.

However, Megabar argues that the situation is no different than it would have been had it allowed Aerojet to make its minimum royalty payments and then paid those amounts to the Bank, which clearly would have been preferential. Of course, those are not the facts. Moreover, it is unlikely that that ever would have happened. Absent the agreement the minimum royalty payments would not have been prepaid. Aerojet was concerned about is exposure under the guaranty and had expressed its intention to assure itself that the Note was paid before its License became non-exclusive. It could have easily effectuated its intention by paying the Note and then offsetting its minimum royalty obligation with its then subrogated position. The parties would then have been in precisely the same position as they are now. Therefore, because of the unique nature of the asset here involved and the particular legal relationships of

these parties, the Court concludes that Aerojet's payment to the Bank resulted in no diminution in Megabar's estate.

Finally, Megabar argues that it is not inequitable to require the Bank to return the payment because if it is determined that the payment was preferential, the Bank would be entitled to recover the amount of the judgment from Aerojet on the guaranty. Perhaps it would not be inequitable to the Bank, but if the Bank's theory on its third party complaint is correct, it would clearly be inequitable to Aerojet who made the payment. Aerojet paid the obligation to the Bank pursuant to an agreement which was based on its ability to offset the obligation under the guaranty against its minimum royalty obligation. If this Court were to conclude that the payment was not made pursuant to the guaranty, the Bank could then collect from Aerojet as guarantor. Aerojet would then find itself as a general unsecured creditor of this estate with no right of set off. Consequently, it would have been required to make a double payment. That is not a result which this Court believes is mandated by § 547 of the Code.

CONCLUSION

Based on the foregoing, the Court concludes: (1) Aerojet paid the Bank $148,455.83 to extinguish its liability or exposure under the guaranty and Note; (2) Because of the unique nature of

the transactions and legal relationships between these parties, there was nonetheless no diminution of the debtor's estate by virtue of the payment to the Bank; and (3) The debtor is entitled to recover $2,325.05 from the Bank which represents the amount which was paid to it directly from Megabar. Therefore, except as to the $2,325.05 payment, the Bank's motion for summary judgment will be granted, and as to the $2,325.05 payment, the debtor's motion will be granted.

DATED this 21 day of July, 1988.

BY THE COURT:

GLEN E. CLARK, CHIEF JUDGE
UNITED STATES BANKRUPTCY COURT