

IN THE UNITED STATES BANKRUPTCY COURT FOR
THE MIDDLE DISTRICT OF TENNESSEE
NASHVILLE DIVISION

IN RE:

WASHINGTON MANUFACTURING
COMPANY, ET AL.,

Debtors.

Nos. 388-01467-WHB
388-01469
388-01468

NATIONAL UNION FIRE INSURANCE
COMPANY OF PITTSBURGH,
PENNSYLVANIA,

Plaintiff,

Chapter 11
Jointly Administered
Judge William H. Brown

v.

THORNTON, HARWELL AGENCY, INC.,
and TIMOTHY F. FINLEY, Trustee
in Bankruptcy for Washington
Manufacturing Company,

Defendants.

Adversary Proceeding
No. 389-0376

**MEMORANDUM OPINION AND ORDER
ON MOTIONS FOR SUMMARY JUDGMENT**

This adversary proceeding began as a complaint for interpleader filed by National Union Fire Insurance Company seeking to determine ownership and right to possession of a pro rata return of a premium in the amount of \$23,482.00, on a cancelled insurance policy. Each defendant consented to the jurisdiction of this Court, and the proceeding is core pursuant to 28 U.S.C. §157(b)(2)(A), (O). The following constitutes findings of fact and conclusions of law pursuant to Bankruptcy Rule 7052.

POSITIONS OF PARTIES

The parties involved in the events leading to this dispute and their roles relevant thereto are as follows: The original plaintiff, National Union Fire Insurance Company of Pittsburgh, Pennsylvania, (hereinafter "Insuror") is a corporation which sells certain insurance coverage and issued the coverage for which the disputed premium was paid. Bowes & Company, Inc. of Tennessee, (hereinafter "Broker") is an insurance coverage broker which is an authorized agent of Insuror and procured the issuance of the debtor's coverage. Defendant, Thornton and Harwell Agency, Inc. (hereinafter "Agency") is a licensed Tennessee insurance agency which holds an agency agreement with Broker whereby Agency can place or effect insurance coverage for its customers through Broker. (Exhibit 1 to Agency Memorandum) It is Agency which acted upon the debtor's request for insurance coverage and obtained the coverage through Broker. Defendant Timothy F. Finley (hereinafter "Trustee") is the duly appointed bankruptcy Trustee¹ for the jointly administered Chapter 11 debtors, Washington Manufacturing Company, Washington Industries, Inc. and KSA, Inc.

National Union has interpleaded the return premium and has no further interest in these proceedings. Thus, the issue to be decided is who, as between the Trustee and the insurance agency, Thornton and Harwell Agency, Inc., is entitled to the return premium. It is the Agency's position that because it "advanced" the premium payment on the debtor's behalf prepetition, it is entitled to the return premium. Thornton and Harwell also seeks sanctions against the Trustee for his position in this matter, which is that the premium advance was merely a loan to the prepetition debtor for which the Agency holds an unsecured claim against the estate.

¹ The Trustee asserts that the policy at issue insured Haywood Male/Washington Industries, Inc. (See, Exhibit 2, Agency Memorandum) However, that is of no substantive concern because he acts as Trustee for Washington Industries as well as Washington Manufacturing.

MOTIONS FOR SUMMARY JUDGMENT

Both Agency and the Trustee have filed motions for summary judgment, supported by various documents, pleadings, memoranda, and excellent and extensive oral argument. The adversary proceeding is set for trial; however, because of the dispositive nature of this Memorandum Opinion and Order, further trial in this Court will not be necessary. The Court should grant summary judgment only when

. . . the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.

Bankruptcy Rule 7056(c). The Court will grant the Agency's motion for summary judgment.

FACTUAL FINDINGS

From the documents, pleadings and memoranda in file, it is uncontroverted that the parties and their positions relevant to this matter, are as they are described above. Also, uncontroverted are the following pertinent events which gave rise to this proceeding:

On September 30, 1986, Agency entered into an agency agreement with Broker. (Exhibit 1 to Agency Memorandum) As discussed above, under this agreement, Agency could place insurance policies through Broker, and in return, Agency would pay net premiums (less Agency's commission) to Broker within thirty days of Broker's demand. Agency was so obligated irrespective of whether Agency received the premium from its customer.

At the request of one of the Washington entities in 1986, Agency obtained the insurance coverage at issue through Broker, which in turn obtained the policy issuance from Insuror. In December, 1987, a Washington entity requested renewal of the coverage and Agency obtained the renewal through the same process. Pursuant to its agency agreement, Agency paid Broker the net renewal premium (\$33,953.95) on December 30, 1987. (Exhibits 4, 6 & 7 Agency Memorandum) On December 28, 1987, Agency invoiced

Washington for the renewal premium. (Exhibit 8 Agency Memorandum) However, it is conceded that Washington never paid the renewal invoice. These events occurred prebankruptcy.

The policy provides under its general conditions that no cancellation is permitted by the insured and that Insuror could cancel only for nonpayment of premiums. (Exhibit 2, Agency Memorandum, pp. 6-7)

After Washington filed its Chapter 11 petitions on March 1, 1988, Agency requested that Insuror cancel the policy due to Washington's nonpayment of the premium invoice.² (See Exhibit 10, Agency Memorandum) Subsequently, on April 21, 1988, the Trustee requested cancellation of the policy by letter to Agency. (Exhibit 11, Agency Memorandum) Initially, Insuror refused to cancel the policy and to refund any pro rata premium. As a result, Agency filed suit against Insuror in the Davidson County, Tennessee Chancery Court. (Exhibit 12, Agency Memorandum) After communication with the Trustee (see Exhibits 13, 14, & 15, Agency Memorandum), Agency moved for relief from the automatic stay in order to proceed with the Chancery suit. However, before that motion could be heard, the present interpleader complaint was filed in this Court and the Chancery suit was nonsuited.

As discussed above, from these facts, Agency argues that it is entitled to the return premium, primarily because it paid the premium under the requirements of its agency agreement with Broker. On the other hand, the Trustee contends that Agency's payment of the premium constitutes a loan for which Agency merely holds an unsecured claim.

LEGAL CONCLUSIONS

² Trustee contends that this attempted cancellation was a violation of the automatic stay. That appears to be correct; however, no damages resulted and the Insuror, at that point, did not cancel the policy.

Agency has asserted several legal theories upon which it bases its argument that it is entitled to the return premium as a matter of law. These theories include recoupment³, setoff⁴, earmarking, constructive trust, and that the estate has no legal or equitable interest in the funds. The Trustee refutes each of these assertions, contending that they are inapplicable to the instant facts and that the broad interpretation given to §541(a)'s⁵ inclusion of all legal and equitable interests of the debtor, at the time of the petition, in the bankruptcy estate establishes that the return premium is property of the estate as a matter of law.

As set forth above, the Court agrees that this issue may be resolved as a matter of law; therefore, it is the Court's conclusion that the issue may be resolved through analogy to the earmarking rule. Although the earmarking rule is customarily found only in the §547(b) preferential transfer context, it has been applied there to answer the question of whether the property interest sought to be recovered by the debtor or trustee as

³ "Recoupment is the setting up of a demand arising from the same transaction as the plaintiff's claim or cause of action, strictly for the purpose of abatement or reduction of such claim." 4 King, COLLIER ON BANKRUPTCY (15th Ed. 1990) ¶553.03 at 553-13. Thus, recoupment may apply between the Agency and the Broker or the Insuror, but not between the Agency and this bankruptcy estate. The Trustee holds no funds from which recoupment may be effected.

⁴ Setoff requires mutuality. "When the debt to be setoff arose between the parties acting in differing capacities the requisite 'mutuality of debt' does not exist." In re Revco D.S. Inc., 111 B.R. 631, 639 (Bankr. N.D. Ohio 1990). Here, the debt to the Agency arose prebankruptcy while any debt to the Trustee arose postbankruptcy. There is no mutual prebankruptcy debt nor is there mutuality of parties. Setoff therefore does not apply.

⁵ §541(a) provides in pertinent part: "The commencement of a case . . . creates an estate. Such estate is comprised of all of the following property, wherever located and by whomever held: (1) . . . all legal or equitable interest of the debtor in property as of the commencement of the case."

the subject of a preferential transfer may be said to be property of the estate. See, In re Hartley, 825 F. 2d 1067 (6th Cir. 1987). Hartley was "concerned with the first element [of §547(b)], whether there has been a transfer of the debtor's property." Id. at 1069. Given that the issue here involves whether the premium payment may be said to be property of the estate, it follows that the earmarking concept may be dispositive of that issue.

According to the Sixth Circuit Court of Appeals,

[w]hen a third person loans money to a debtor specifically to enable him to satisfy the claim of a designated creditor, the general rule is that the proceeds are not property of the debtor . . . [t]his is sometimes called the "earmark" rule - funds loaned to the debtor that are "earmarked" for a particular creditor do not belong to the debtor because he does not control them.

Id., at pp. 1069, 1070, citing Grubb v. General Contract Purchase Corp., 94 F. 2d 70 (2d Cir. 1938); 4 King, Collier on Bankruptcy, ¶547.03, at 547-25 (15th Ed. 1987). See also In re T & B Scottsdale Contractors, Inc. v. U.S., 866 F. 2d 1372 (11th Cir. 1989), cert. denied, _____ U.S. _____, 110 S. Ct. 139, 107 L. Ed. 2d 98 (1989); In re Air Conditioning, Inc. of Stuart, 845 F. 2d 293, 297 (11th Cir. 1988). cert. denied, _____ U.S. _____, 109 S. Ct. 557, 102 L. Ed. 2d 584 (1988); New York City Shoes, Inc. v. Best Shoe Corp., 106 B.R. 58 (E.D. Pa. 1989); In re Perdido Motel Group, Inc., 108 B.R. 316 (Bankr. N.D. Ala. 1989).

In the case sub judice, the Court is presented with a third party (Agency) who directly paid a creditor (Broker/Insuror) of the debtor for the debtor's benefit without the funds ever passing to or from the debtor. The Trustee in fact argued that the Agency had made a loan for the benefit of the debtor, thereby reducing the Agency to the status of an unsecured creditor. The Agency, on the other hand, argues it did not extend a loan, but rather an "involuntary advance" of the renewal premium. For the purposes of the Court's analysis, there is little, if any, difference between a loan and an advance. Thus, even from the Trustee's position, it is clear that the basic elements of earmarking are present here. The payment was made specifically to satisfy the claim of a designated creditor without the debtor having any control over the funds. Consequently, the Court concludes that these funds constituted no legal or equitable interest of the debtor and thus, are not property of

the estate. Moreover, the advance of the premium by the Agency did not deplete any of the debtor's assets, and it would be a windfall to allow the Chapter 11 Trustee to obtain these funds when they were never drawn from the debtor.

In the alternative, if the Court adopted the Agency's theory that the transaction was not a loan at all but an "advance" of premium which the Agency was contractually obligated to advance, the Trustee still fails to recover the premium return. There is no suggestion of evidence that the prebankruptcy debtor requested the Agency to advance the premium nor that the debtor was aware of the advances. Certainly, the debtor did not request a loan from the Agency. The Trustee argues that the Agency was not compelled to obtain the insurance coverage; therefore, the premium advance was a voluntary act. However, the fact is that coverage was obtained for the debtor's benefit, and the undisputed proof shows that the Agency was contractually obligated to pay Bowes, the Broker, for the net premium charge. At that point in time, the debtor had the benefit of insurance coverage for which the debtor never paid.

The insurance coverage was still in effect when the bankruptcy was filed and thus became property of the estate, as the Trustee contends. However, the Court disagrees with the Trustee's argument that the cancellation of the policy was a change in form only and that the pro rated premium refund remained property of the estate. The bankruptcy estate's interest in the insurance coverage ceased when the coverage was cancelled, partially at the Trustee's request. Had the prebankruptcy debtor paid the premium, certainly the estate would have an interest in the premium refund, but the Trustee ignores the hurdle that the Agency paid the premium.

Use of earmarking concepts is not farfetched. Its use merely recognizes the reality that the bankruptcy estate has no legal nor equitable claim to the premium refund. The funds used to pay the premium charge were derived from an advance of credit from the Agency. Thereafter, in the analysis, "[a] fundamental inquiry [is] determining whether the transfer in question has diminished the debtor's estate." In re Funding Systems Asset Management Corp., 111 B.R. 500, 514 (Bankr. W.D. Pa. 1990). When the Agency paid the premium and thereby advanced credit to the debtor, without any transfer of security from the debtor, the

debtor's assets were not diminished and other creditors were not adversely affected. The debtor, at that point, owed for the premium but it makes no difference whether the debtor owed the Agency, the Broker or the Insuror. The debtor merely had a liability which is being reduced by the refunded premium passing to the party who paid it.

AGENCY'S REQUEST FOR SANCTIONS

As to the Agency's request for sanctions, it is grounded upon the Agency's theory that the Trustee ignored "overwhelming legal precedent" contrary to the Trustee's position, "all in violation of Rule 9011." (Agency Memorandum, p. 20) The legal precedent argued to the Court were six bankruptcy court decisions, all from other jurisdictions. The precedent was by no means overwhelmingly against the Trustee's position. More important, this Court, sitting in the Middle District of Tennessee, is not bound by the decisions of other bankruptcy courts. Rather, this Court is bound only by its own decisions, those decisions of the United States District Court for this District, those of the Court of Appeals for the Sixth Circuit and, obviously, the Supreme Court. This Court cannot say that the Trustee's position was groundless under Rule 9011. In fact, there is merit to the Trustee's legal position. The Court simply finds more compelling logic and merit to the Agency's legal position. The request for sanctions will be denied.

CONCLUSION

Based on the foregoing, the Court concludes that the premium refund interpleaded by the Insuror is not property of the bankruptcy estate, and that the Agency's Motion for Summary Judgment is **GRANTED**. The Trustee's Motion for Summary Judgment is **DENIED**. The Agency's request for sanctions is **DENIED**. The interpleader funds are property of Thornton, Harwell Agency, Inc. and shall be paid, with any accrued interest, to that agency.

IT IS SO ORDERED this the 15th day of June, 1990.

WILLIAM HOUSTON BROWN
UNITED STATES BANKRUPTCY JUDGE
BY DESIGNATION

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