IT IS ORDERED as set forth below:

Date: September 27, 2007

W. H. Drake
U.S. Bankruptcy Court Judge

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF GEORGIA
NEWNAN DIVISION

IN THE MATTER OF:	**CASE NUMBERS**
SUDCO, INC.,	BANKRUPTCY CASE NO. 04-17205-WHD
Debtor.	
JANET WATTS, Trustee,	
Plaintiff,	ADVERSARY PROCEEDING NO. 05-1134
v.	
PRIDE UTILITY CONSTR., INC.,	IN PROCEEDINGS UNDER CHAPTER 7 OF THE BANKRUPTCY CODE
Defendant.	

ORDER

Before the Court are cross Motions for Summary Judgment, filed by Janet Watts (hereinafter the "Trustee") and Pride Utility Construction Company (hereinafter the "Defendant"). The Motions arise in connection with a complaint to avoid and recover a preferential transfer. Accordingly, these matters constitute a core proceeding, over which this Court has subject matter jurisdiction. *See* 28 U.S.C. § 157(b)(2)(F).

FINDINGS OF FACT

At some point prior to July of 2003, the City of Manchester, Georgia (hereinafter the "City") contracted with Sudco, Inc. (hereinafter the "Debtor") to replace the City's steel gas pipes with plastic gas lines (hereinafter the "Project"). The Debtor then entered into a subcontract with the Defendant to perform the gas line work. Defendant's Statement of Material Facts, ¶ 1; Trustee's Response to Defendant's Statement of Material Facts, ¶ 1; Trustee's Statement of Material Facts, ¶ 12; Trustee's Statement of Material Facts, ¶ 14. The Defendant performed its work under its subcontract with the Debtor from July 2003 through October of 2003. Defendant's Statement of Material Facts, ¶ 2; Trustee's Response to Defendant's Statement of Material Facts, ¶ 2.

The Debtor received regular payments from the City for work performed on the Project. Defendant's Statement of Material Facts, ¶ 3; Trustee's Response to Defendant's Statement of Material Facts, ¶ 3. The Defendant completed the work under the subcontract on October 13, 2003 and sent the Debtor a final invoice for the amount of $4,016.25 on October 20, 2003. Defendant's Statement of Material Facts, ¶ 4; Trustee's Response to Defendant's Statement of Material Facts, ¶ 4; Trustee's

Statement of Material Facts, ¶ 20; Defendant's Response to Trustee's Statement of Material Fact, ¶ 20. During the Project, the Debtor invoiced the City for the Defendant's work as it was completed. Trustee's Statement of Material Facts, ¶ 21. The City made periodic payments to the Debtor for these invoices. Trustee's Statement of Material Facts, ¶ at 24.

As of December 1, 2003, the Debtor owed the Defendant $204,540.50. The Debtor made a payment to the Defendant on or about December 17, 2003, which reduced the outstanding balance to $194,540.50. Trustee's Response to Defendant's Statement of Material Facts, ¶ 5. This balance resulted from invoices from the Defendant to Debtor dated August 8, 2003 through October 20, 2003. Trustee's Statement of Material Facts, ¶ 26.

A payment bond was issued for the protection of subcontractors working on the Project. Defendant's Statement of Material Fact, ¶ 8; Trustee's Response to Defendant's Statement of Material Fact, ¶ 8; Trustee's Statement of Material Facts, ¶ 13. Two to three weeks prior to February 18, 2004, the Defendant informed the Debtor that, unless full payment of the outstanding balance was forthcoming, the Defendant would make a demand against the payment bond. Defendant's Statement of Material Facts, ¶ 9; Trustee's Response to Defendant's Statement of Material Facts, ¶ 9; Trustee's Statement of Material Facts, ¶ 35; Defendant's Response to Trustee's Statement of Material Fact, ¶ 35. The Debtor made final and full payment to the Defendant by check on February 17, 2004. Defendant's Statement of Material Fact, ¶ 12; Trustee's Response to Defendant's Statement of Material Fact, ¶ 12; Trustee's Statement of Material Facts, ¶ 3. The check cleared the Debtor's bank account on February 25, 2004. Trustee's Statement of Material Facts, ¶ 4.

Throughout the relevant time period, the Debtor maintained a checking account at Citizens Bank and Trust of West Georgia, which it used as a general operating account. The Debtor deposited all payments received from the City on account of the Project into this account. Trustee's Statement of Material Facts, ¶ 27; Affidavit of Michael Suddeth, ¶ 21. On November 21, 2003, the balance of the Debtor's general operating account was a negative $1,437.06. Trustee's Statement of Material Facts, ¶¶ 28, 30; Affidavit of Michael Suddeth, ¶ 24.[1]

The Debtor filed a voluntary petition under Chapter 7 of the Bankruptcy Code on April 8, 2004. The Trustee was appointed as the trustee of the Debtor's bankruptcy estate. On September 6, 2004, the Trustee filed a complaint seeking to avoid and recover the $194,540.50 payment made by the Debtor to the Defendant.

CONCLUSIONS OF LAW

The Trustee's complaint seeks to avoid the payment made by the Debtor to the Defendant in the amount of $194,540.50 and to recover this transfer for the benefit of the Debtor's unsecured creditors pursuant to sections 547 and 550 of the

---

[1] The Court notes that, in its response to the Trustee's Statement of Undisputed Facts, the Defendant did not specifically controvert paragraphs 27, 28, 29, and 30. The Defendant essentially stated that it has no reason to dispute these facts, but that the Trustee presumably has access to proof of these facts. These statements of fact are supported by the Affidavit of Michael Suddeth. At least with regard to this purpose, the Court declines the Defendant's request that the Court strike Suddeth's affidavit. Because the Defendant has cited no evidence to suggest that these statements of fact are in dispute, the Court finds these facts to have been established.

Bankruptcy Code. Both the Defendant and the Trustee seek summary judgment.

A. *Summary Judgment Standard*

In accordance with Rule 56 of the Federal Rules of Civil Procedure, made applicable to adversary proceedings by Rule 7056 of the Federal Rules of Bankruptcy Procedure, a party moving for summary judgment is entitled to prevail only if "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 judgment as a matter of law." *Celotex Corp. v. Catrett,* 477 U.S. 317, 322. The moving party bears the initial burden of establishing that no genuine factual issue exists. *See Celotex*, 477 U.S. at 323; *Clark v. Coats & Clark, Inc.,* 929 F.2d 604 (11th Cir.1991). The movant must point to the pleadings, discovery responses, or supporting affidavits which tend to show the absence of a genuine issue of material fact. *Celotex*, 477 U.S. at 323.

The Court must construe this evidence in the light most favorable to the non-moving party. *See Anderson v. Liberty Lobby, Inc*., 477 U.S. 242, 249 (1986); *Rollins v. TechSouth, Inc.,* 833 F.2d 1525 (11th Cir.1987). If the moving party satisfies its burden to show an absence of a genuine issue of material fact, no burden of going forward arises for the opposing party, and the non-moving party must designate "specific facts showing that there is a genuine issue for trial." *Clark,* 929 F.2d at 608; *Celotex,* 477 U.S. at 324.

B. *Section 547(b)*

One of the fundamental tenets of bankruptcy law is the equality of distribution of a debtor's usually limited assets. *See* H.R.Rep. No. 595, 95th Cong., 1st Sess. 177-78 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138 (noting the "prime bankruptcy policy of equality of distribution among creditors"). In furtherance of that policy, section 547 of the Bankruptcy Code authorizes the post-petition recovery of a debtor's pre-petition transfers that are deemed to be preferential in nature. In essence, the central purpose of section 547 is to discourage creditors "from racing to the courthouse to dismember the debtor during his slide into bankruptcy." *Id.*

The elements of a preference are set forth in section 547(b), which provision permits a trustee to avoid any pre-petition transfer of an interest of a debtor in property: 1) to or for the benefit of a creditor; 2) for or on account of an antecedent debt owed by the debtor before such transfer was made; 3) made while the debtor was insolvent; 4) made either on or within 90 days before the date of the filing of the petition, or between ninety days and one year before the date of the filing of the petition, if such creditor at the time was an insider; and 5) that enables such creditor to receive more than such creditor would receive if the case were a case under Chapter 7, the transfer had not been made, and the creditor received payment of its debt as provided by the Code. *See* 11 U.S.C. § 547(b). The Trustee bears the burden of proving each of the above elements. *See id*. § 547(g).

There is no factual dispute that the Debtor made a payment of $194,540.50 to the Defendant within 90 days of filing a bankruptcy petition. There is also no dispute that the payment was made for the benefit of the Defendant or that the payment was on account of a debt owed by the Debtor to the Defendant prior to the time the payment was made. The Trustee is entitled to a presumption that the Debtor was insolvent during the 90 days prior to the filing, *see* 11 U.S.C. § 547(f), and the Defendant has not presented any evidence to rebut the presumption or to call into question the Debtor's insolvency. Finally, there appears to be no question that the Debtor would not have been capable of satisfying this debt to the Defendant in full if the Defendant had not received payment from the Debtor prior to the filing.[2]

Therefore, the only element at issue here is the requirement that the Trustee prove that the Debtor transferred an interest in the Debtor's property to the Defendant. The Defendant asserts that the Debtor had no interest in the funds transferred to the Defendant because, under Georgia law, funds paid to a general contractor for a construction project are subject to a constructive trust in favor of unpaid subcontractors and, therefore, do not become the debtor's property. Additionally, the Defendant, subsequent to oral arguments on the motions, has argued that the funds did not become the Debtor's property because they were subject to an express trust created by the contract between the Debtor and the Defendant. Alternatively, the Defendant now asserts that the Debtor had no interest

[2] There is no dispute that, even if the Debtor had not made the payment to the Defendant, unsecured creditors would not have received a 100% dividend in this case. The fact that the Defendant could have received full payment by asserting a claim against the payment bond does not result in a finding that section 547(b)(5) has not been satisfied. *See In re Pameco Corp.*, 356 B.R. 327 (Bankr. S.D.N.Y. 2006) (the fact that the defendant's claim was fully secured by a lien on collateral that was not property of the debtor did not mean that the plaintiff could not satisfy section 547(b)(5)).

in approximately $190,000 of the funds used to pay the Defendant because they were loaned to the Debtor and were "earmarked" for payment to the Defendant.

The term "property of the debtor," as used in section 547(b), is not defined by the Bankruptcy Code. *See Begier v. Internal Revenue Service,* 496 U.S. 53, 58 (1990). However, the United States Supreme Court has stated that the "property" subject to avoidance under section 547(b) is "that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings." *Id.*; *see also Southmark Corp. v. Grosz (Matter of Southmark Corp.)*, 49 F.3d 1111, 1117 (5th Cir.1995); *Hansen v. MacDonald Meat Co. (In re Kemp Pac. Fisheries, Inc.)*, 16 F.3d 313, 316 (9th Cir.1994) ("[T]he transfer must diminish directly or indirectly the fund to which creditors of the same class can legally resort for the payment of their debts, to such an extent that it is impossible for other creditors of the same class to obtain as great a percentage as the favored one."). Accordingly, courts must look to section 541 to determine whether the property transferred became property of the bankruptcy estate upon the commencement of the case. *See Begier*, 496 U.S. at 58-59.

1. *Whether the Funds Used to Pay the Defendant were Trust Funds*

Under section 541, "property of the estate" includes "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). Specifically, section 541(d) states that "property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate under subsection (a) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold." *Id.*; *see also In re Vacuum Corp.*, 215 B.R. 277, 280 (Bankr. N.D. Ga. 1997) (Drake, J.). "Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not "'property of the estate'" and is also not "'property of the debtor' for purposes of § 547(b)." *Begier*, 496 U.S. at 59; *see also Vacuum Corp.,* 215 B.R. at 281 (funds held in trust by the debtor are not property of the estate for bankruptcy purposes); *In re McDowell*, 258 B.R. 296 (Bankr. M.D. Ga. 2001). Therefore, the question before the Court is whether the $194,540.50 transferred by the Debtor to the Defendant was previously held in trust for the Defendant's benefit.

"Be it expressed between the parties or implied from the circumstances, the existence of a trust relationship turns on applicable nonbankruptcy law." *Vacuum Corp.*, 215 B.R. at 281 (footnotes omitted). That being said, because "the generation of constructive trust substantially offends the Bankruptcy Code's general goal of equal distribution, courts generally will require that nonbankruptcy grounds for imposing a constructive trust '"be so clear, convincing, strong and unequivocal as to lead to but one conclusion.'" *Id*. at 281-82 (quoting *Amendola v. Bayer*, 907 F.2d 760 (7th Cir. 1990)). Accordingly, it is left to the bankruptcy court to determine whether impressing a constructive trust on estate assets would contravene bankruptcy policy. *See id*. at 282.

The Defendant first asserts that the funds used to pay the Defendant were subject to a constructive trust because the Debtor received the funds from the City and had the obligation to hold the funds in trust for the Defendant. Under Georgia law, a contractor, subcontractor, or materialman has the right to file a lien against real property when the contractor or materialman has improved the property and has not been paid for such work or provision of supplies. However, when the property is owned by a public entity, no such lien rights exist to protect the contractor or materialman from a payment default. *MacArthur Elec., Inc. v. Cobb County School District*, 281 Ga. 773 (2007). Consequently, the legislature deemed it necessary to enact a statute that requires a payment bond for "all public works construction contracts . . . with an estimated contract amount greater than $100,000." O.C.G.A. § 36-91-90. Under this statute, known as the "Georgia Little Miller Act," the unpaid contractor or materialman may assert a claim against the payment bond if the contractor or materialman has gone unpaid for 90 days after the last provision of labor or materials has been made or after the completion of the subcontract. *Id.* § 36-91-93. The time for bringing such an action is limited, however, to one year "from the completion of the project and the acceptance of the public works construction by the proper public authorities." *Id.* § 36-91-95.

Georgia federal courts have held that "Georgia law recognizes the constructive trust fund doctrine with respect to payments owed materialmen by their contractors for improvements made to a third party's realty." *Bethlehem Steel Corp. v. Tidwell*, 66 B.R. 932, 939-40 (M.D. Ga. 1986) (relying on *United Parcel Service v. Weben Indus., Inc.*, 794 F.2d 1005 (5th Cir. 1986)); *In re Amarlite Architectural Prods.,* *Inc.*, 178 B.R. 904 (Bankr. N.D. Ga. 1995) (Cotton, J.); *In re Rice*, 1999 Bankr. Lexis 1861 (Bankr. M.D. Ga. 1999) . The purpose of this so-called "construction trust fund doctrine" is to "ensure that those whose labor and materials earned the monies received their just compensation." *In re Boswell Elec. Contractors, Inc.*, 1991 WL 10007399 (Bankr. S.D. Ga. Jun. 27, 1991), *affirmed*, 1991 WL 11002441 (S.D. Ga. 1991) (funds paid by City of Augusta to debtor were held in constructive trust for benefit of unpaid materialmen). The doctrine also protects the paid subcontractor from losing the protection that the Georgia Assembly intended it would enjoy.

As recognized by the court in *Bethlehem Steel*, however, not all pre-petition payments made by the contractor to the subcontractor or materialman are affected by the constructive trust doctrine. Only persons who are entitled to file liens under the Georgia statute benefit from the doctrine. *See id; see also Amarlite Architectural Prods.,* 178 B.R. at 907 (supplier of subcontractor was not entitled to lien rights and, therefore, no constructive trust arose in favor of supplier). This limitation has been imposed because, if the unpaid subcontractor or materialman failed to take advantage of its ability to file a lien claim, the subcontractor or materialman should not later be entitled to prevail over general unsecured creditors. *See id.* at 940; *In re American Bldg. Consultants, Inc.*, 138 B.R. 1015, 1017 (Bankr. N.D. Ga. 1992) (Bihary, J.) (no constructive trust established over funds paid where materialman did not take steps to obtain a lien and time for doing so had lapsed prior to filing of bankruptcy petition).

The Court concludes that a constructive trust is created in favor of a subscontractor over funds paid by the owner of property to the contractor when the project is a public works project and the subcontractor enjoys no lien rights, but is entitled to file a claim against a payment bond in accordance with the Georgia Little Miller Act. The above-stated rationale for imposing a constructive trust in favor of lienholders on private construction projects also exists in the case of public construction projects. This rationale is illustrated by the instant case.

Here, prior to receiving payment from the Debtor, the Defendant had a right to make a claim against the payment bond in the event the Debtor failed to pay the Defendant for its work with funds received from the City, just as a subcontractor on a private construction project would be entitled to seek payment by exercising its lien rights on property of a third party. By receiving payment from the Debtor, the Defendant lost its right to seek payment from the bond, just as the subcontractor in the private construction case loses its right to seek satisfaction from the owner's property. The need for a constructive trust over funds received by the Debtor for payment to its subcontractors and materialmen exists in this case, just as it exists in cases in which the construction project is for a private entity. Accordingly, the Court finds no principled reason not to extend the construction trust fund doctrine to cover funds received by a debtor for work on a public construction project. *See, e.g.*, *In re Inca Materials, Inc.*, 81 B.R. 728 (Bankr. N.D. Ga. 1988) (Bihary, J.), *affirmed* 880 F.2d 1307 (11th Cir. 1989) (holding that funds received by a subcontractor-debtor from its general contractor, for work performed on public project subject to the Maryland Little Miller Act, did not become property of the subcontractor-debtor's estate because the funds were impressed with a constructive trust in favor of the debtor's subcontractor). Further, the limitations placed on the doctrine by the court in *Bethlehem Steel* do not apply in this case, as, at the time the Debtor paid the Defendant, the Defendant continued to have the right to seek payment against the bond.

To the extent that the construction trust fund doctrine prevents the funds received by the Debtor from the City from becoming the Debtor's property, these funds were not property of the debtor within the meaning of section 547(b). *Bethlehem Steel*, 66 B.R. at 941. The Trustee would be unable to avoid or recover the transfer of those funds.[3] *Id*. However, there remains a question as to whether the actual funds received by the Defendant were in fact trust funds.

In order to protect the goal of equal distribution, a party who seeks to exclude property from the estate on the basis that the property is subject to a trust must identify the property. *First Federal of Michigan v. Barrow*, 878 F.2d 912 (6th Cir. 1989); *see also In re Financial Federated Title and Trust, Inc.*, 347 F.3d 880 (11th Cir. 2003) ("If the original *res* no longer remains, but is transformed into a different form, it is the burden of the party seeking to impress a constructive trust to trace the

---

[3] The Court notes, however, that, in the event the funds are found to be trust funds, if the Trustee presents evidence that other creditors of the estate have claims against these funds arising from the Project, avoidance may, nonetheless, be appropriate. *See Bethlehem Steel Corp. v. Tidwell*, 66 B.R. 932 (M.D. Ga. 1986) (leaving open the possibility that a payment made with trust funds may not be protected from avoidance if the trust funds are claimed by more than the recipient of the transfer); *In re Rice*, 1999 Bankr. Lexis 1861 (Bankr. M.D. Ga. 1999) ("A number of courts have held that the constructive trust doctrine is not applicable when the constructive trust fund is not sufficient to satisfy all similarly situated creditors.").

property to specific funds before it can prevail."); *In re Kennedy & Cohen, Inc.,* 612 F.2d 963, 966 (5th Cir. 1980), cert. den. 449 U.S. 833 (1980) (question of whether a constructive trust, which cannot be traced to specific funds, may attach to general assets of a bankruptcy estate is a question of federal law, which requires that the party seeking imposition of a trust trace their funds to identifiable funds in the hands of the trustee; to the extent that "state law is to the contrary, it must yield to federal policy"); *Rosenberg v. Collins*, 624 F.2d 659 (5th Cir. 1980) ("To establish a trust relationship that excludes property from the bankruptcy estate, a claimant must: (1) prove the existence of the trust; and (2) trace the identity of his property."); *Cunningham v. Brown*, 265 U.S. 1 (1924) (where funds supposedly held in trust have been commingled and cannot be traced to funds repaid, defrauded lender "becomes merely a creditor to the extent of his loss and a payment to him by the bankrupt within the prescribed period of four months is a preference").

Federal courts most often apply the lowest intermediate balance rule in order to aid trust beneficiaries in tracing trust funds. *See* Restatement (Second) of Trusts § 202 (Comment J). This rule presumes that the trustee of the trust dissipates his own funds first, such that any remaining funds in the account are trust funds. *See id.*; *In re Hecker*, 316 B.R. 375 (Bankr. S.D. Fla. 2004). "However, if the account is depleted after the trust fund has been deposited, the trust fund is treated as lost." *In re MJK Clearing, Inc.*, 371 F.3d 397 (8th Cir. 2004); *see also In re Dameron,* 155 F.3d 718 (4th Cir. 1998) ("In no case is the trust permitted to be replenished by deposits made subsequent to the lowest intermediate balance."); *First Federal of*

Michigan v. Barrow, 878 F.2d 912 (6th Cir. 1989); *In re Columbia Gas Systems, Inc.*, 997 F.2d 1039 (3d Cir. 1993) ("[T]rust beneficiary also loses property rights in a commingled account to the extent that the account drops below the amount held in trust."); *In re Whitacre Sunbelt, Inc.*, 211 B.R. 411 (Bankr. N.D. Ga. 1997) (Bihary, J.).

Courts have recognized, however, that replenished funds can regain their trust status under certain circumstances. *See In re Gottfried Baking Co.*, 312 F. Supp. 643 (D.C.N.Y. 1970) (noting that it is well established under New York law that the "deposit of personal funds by a debtor in a dissipated bank account in which he had wrongfully commingled trust funds with his personal funds restores the trust fund if that was the intention of the debtor"); *In re Cannon,* 277 F.3d 838 (6th Cir. 2002); *In re California Trade Technical Schools, Inc.,* 923 F.2d 641 (9th Cir. 1991); *County of Oakland v. Vista Disposal, Inc.*, 900 F. Supp. 879 (E.D. Mich. 1995); *Bethlehem Steel Corp. v. Tidwell*, 66 B.R. 932, 939-40 (M.D. Ga. 1986) (a presumption exists that funds replaced into a commingled account regain their status as trust funds).

It appears to the Court that the presumption that the replenished funds are trust funds applies only when the restored funds are deposited into a segregated trust account.[4] *See* Bogerts TRUSTS AND TRUSTEES, § 929 (2006) ("If, however, the bank

---

[4] The Court recognizes that the *Bethlehem Steel* court utilized a presumption under facts similar to this case and did not require evidence that the debtor intended to restore the trust funds. However, the decision relied upon by the court in *Bethlehem Steel*, *In re Mahan & Rowsey, Inc.*, 35 B.R. 898 (Bankr. Okla. 1983), was subsequently reversed. *See In re Mahan & Rowsey, Inc*, 62 B.R. 46 (W.D. Okla. 1985) (lowest intermediate balance rule applies in bankruptcy case in order to protect general creditors' recoveries), *affirmed* 817 F.2d 682 (10th Cir. 1987). On this point, the Court is of the opinion that the correct

account is labeled as a trust account but contains personal funds of the trustee as well as trust funds, and the trustee misappropriates part of the fund and later deposits his own money in the account, without express statement as to whether he intends a restoration or not, it is generally held that an implied intent to make a restoration is to be found."); *In re Cannon,* 277 F.3d 838 (6th Cir. 2002) (presumption applies that lawyer is replacing misappropriated client funds when he deposits personal funds into client trust fund); *In re California Trade Technical Schools, Inc.,* 923 F.2d 641 (9th Cir. 1991). If the funds are deposited into the debtor's individual account in which he has commingled trust funds and personal funds, the restored funds are only treated as trust funds if the evidence shows that the debtor intended to make restitution. *See* Restatement (Second) of Trusts § 202 (Comment J) ("Where the trustee deposits trust funds in his individual account in a bank, and makes withdrawals from the deposit and dissipates the money so withdrawn, and subsequently makes additional deposits of his individual funds in the account, manifesting an intention to make restitution of the trust funds withdrawn, the beneficiary's lien upon the deposit is not limited to the lowest intermediate balance."); Bogerts TRUSTS AND TRUSTEES, § 929 (2006) ("[T]he deposit accrues to the benefit of the trustee personally and does not constitute a restoration of the trust funds, unless the trustee expressly shows an intent that there be a restoration or there is an implication of such intent, as where the deposit is exactly the same in amount as the trustee's debt to the trust."). Accordingly, if evidence is presented that

view of the law is that no presumption exists.

the trustee returned funds to an individual account with the intent to make restitution for the dissipated funds, the replenished funds will regain their trust status.

Here, there is no dispute that the Debtor deposited the funds paid by the City on account of the Project into its general operating account. There is also no dispute that, after the last payment made by the City, that account had a negative balance. Accordingly, the trust funds were completely dissipated. Under the lowest intermediate balance rule, the Defendant would be unable to trace its trust funds in this case.

The Defendant asserts that the Debtor deposited new funds into its commingled account with the specific intent to restore the Defendant's trust funds. This fact, however, may not provide the Defendant relief from a finding of a preference. The transformation of the funds from unrestricted funds available to all creditors to funds impressed with a trust may itself be an avoidable preference. *See In re California Trade Technical Schools, Inc.,* 923 F.2d 641 (9th Cir. 1991) (deposit of funds into a segregated trust account 89 days prior to the petition date constituted an avoidable transfer). As the parties have not had an opportunity to brief this particular legal question, the Court will reserve its final ruling as to whether the funds regained their trust fund status.[5]

---

[5] It should be noted that, although the burden is on the Trustee to establish that the funds were property of the Debtor, *see* 11 U.S.C. § 547(g), the Trustee has satisfied this burden by proving that the payment was made to the Defendant with funds in the Debtor's general operating account. *See* Trustee's Statement of Material Facts, ¶ 27; Affidavit of Michael Suddeth, ¶ ¶21, 32, Exhibit E. Accordingly, the burden of proving that the funds were trust funds will rest with the Defendant. *See In re R.W. Leet Electric, Inc*., 2007 WL 2052184 (6th Cir. B.A.P. Jul. 19, 2007) (unpublished) (the trustee met the burden of

2. *Whether the Funds Used to Pay the Defendant were "Earmarked"*

The Defendant next contends that evidence in this case supports a finding that the Debtor borrowed the funds used to pay the Defendant from a third party, that this loan was made to the Debtor for the express purpose of permitting the Debtor to pay the debt owed to the Defendant, and that the Debtor in fact used these borrowed funds to pay the Defendant. Accordingly, the Defendant argues that, under the "earmarking doctrine," the Debtor never obtained an interest in these funds within the meaning of section 547(b).

The earmarking doctrine is an "equitable doctrine which provides that when a new lender makes a loan to enable a debtor to pay a specified former lender, those funds are 'earmarked' for that creditor" and, because "the debtor has no control over the disposition of the earmarked funds, the funds do not become part of the debtor's estate, and no preference occurs." *In re Whitacre Sunbelt, Inc.*, 206 B.R. 1010 (Bankr. N.D. Ga. 1997) (Bihary, J.). The factors for consideration as to whether an earmarking transaction has occurred include: "(1) the existence of an agreement between the new lender and the debtor that the new funds will be used to pay a specified antecedent debt; (2) performance of that agreement according to its terms; and (3) the transaction viewed as a whole (including the transfer in of the new funds

---

establishing that payments constituted an interest in the debtor's property when she proved that the payments were made from the debtor's commingled general account, which had not been designated as a trust account; thereafter, the burden shifted to the defendant to prove that the debtor had only legal title to the funds); *In re Carrozzella & Richardson*, 247 B.R. 595, 602 (2d Cir. B.A.P. 2000) (preference defendant had burden of establishing funds received were trust property).

and the transfer out to the old creditor) does not result in any diminution of the estate." *See id.* at 1020 (citing *In re Bohlen Enterprises, Ltd.,* 859 F.2d 561 (8th Cir. 1988); *see also In re McDowell*, 258 B.R. 296 (Bankr. M.D. Ga. 2001); *In re Safe-T-Brake of South Florida, Inc*., 162 B.R. 359 (Bankr. S.D. Fla. 1993)) (to find that funds have been earmarked, the court must find a clear agreement between the new creditor and the debtor that the property transferred is to be used by the debtor to pay one or more of its creditors, and the property was in fact so used); *In re Werner*, 365 B.R. 283 (Bankr. M.D. Ga. 2007) (earmarking doctrine did not apply when debtor paid an unsecured creditor with his credit card because there was no agreement between the credit card company and the debtor that the funds would be used to pay only the defendant). Additionally, other courts have considered whether the debtor had any "dispositive control" over the funds. *See Whitacre Sunbelt*, 206 B.R. at 1020-21; *In re Hardwood P-G, Inc.*, 2007 WL 1728653 (Bankr. W.D. Tex. Jun. 12, 2007) (citing *Coral Petroloeum, Inc. v. Banque Paribas-London*, 797 F.2d 1351 (5th Cir. 1986)).

Although the trustee bears the initial burden of establishing that a transfer involved an interest in the debtor's property, she may satisfy that burden by demonstrating that funds were transferred "from one of the debtor's accounts over which the debtor ordinarily exercised total control." *In re Adbox, Inc*., 488 F.3d 836, 842 (9th Cir. 2007). At that point, the burden shifts to the defendant "to show that the funds were earmarked." *Id*.

The Defendant contends that James Pitts, an insider of the Debtor, borrowed

$190,000 from Robert Carden on February 17, 2004. The Defendant contends that Pitts borrowed these funds in his individual capacity and loaned the funds to the Debtor to enable the Debtor to pay its debt to the Defendant. The motivation to do so, the Defendant submits, was the fact that, if the Defendant made a claim on the payment bond, Pitts would have been individually liable to the surety, the surety would have sued Pitts, and Pitts' mortgage business would have been impacted. According to the Defendant, this argument is supported by Pitts' deposition testimony. The Defendant also points to the undisputed facts – the proximity of the time the Debtor borrowed the funds to the time the payment was made to the Defendant, as well as the fact that the amount borrowed was roughly equivalent to the amount paid to the Defendant – to establish that the Debtor borrowed the funds with the specific intent to pay the Defendant.

As the Trustee points out, in order to establish that the borrowed funds did not become the Debtor's property, the Defendant must establish that the Debtor had no control over the funds. In this regard, courts applying the "earmarking doctrine" require the existence of an agreement between the new lender and the debtor that the borrowed funds will be used to pay the specific debt. The Defendant has pointed to no evidence that Carden and the Debtor agreed that the Debtor would use these funds to pay the Defendant, and Carden's deposition testimony, as well as his affidavit, establishes that Carden did not have any intention with regard to the loaned funds. Nonetheless, as noted above, the Defendant asserts that Pitts, rather than the Debtor, borrowed the funds from Carden in his personal capacity and loaned the funds to the

Debtor for the express purpose of paying the Defendant. If this is the case, the transaction would appear to fall within the ambit of the earliest earmarking cases. *See In re Bohlen Enterprises, Ltd.*, 859 F.2d 561, 565 (8th Cir. 1988) ("The earliest enunciation of the doctrine occurred in cases where the new creditor providing new funds to pay off the old creditor, was himself also obligated to pay that prior debt. In other words, the new creditor was a guarantor of the debtor's obligation, such as a surety, a subsequent endorser or a straight contractual guarantor. Where such a guarantor paid the debtor's obligation directly to the old creditor, the courts rejected the claim that such payment was a voidable preference.").

It is unclear whether there is any evidence to support this theory. The Defendant filed the affidavit of James Pitts, which is dated April 2, 2007. In that affidavit, Pitts stated that he borrowed the funds in his personal capacity and that he loaned them to the Debtor for the "express purpose" of paying the Defendant. The Trustee, however, has filed another affidavit of Pitts, which is dated May 11, 2007. In that affidavit, Pitts appears to correct his earlier averment by stating that the Debtor borrowed the funds from Carden and that he and Suddeth personally guaranteed the loan. Not only are the affidavits inconsistent, but the testimony given by Pitts and Carden in their respective depositions is not entirely clear as to the identity of the borrower of the $190,000 from Carden. As the Defendant points out, the timing and the amount of the loan support the inference that the funds were borrowed with the express intent to make payment to the Defendant. The issue that remains to be addressed at trial is whether the Debtor had any control over the funds such that the Debtor could have used the funds for some other purpose. Under the unique circumstances of this case, the Court believes that this matter should not be resolved until the parties have had an opportunity to present these witnesses subject to cross examination and the Court has an opportunity to assess their credibility.

The Defendant appears to make the additional argument that, even if the evidence establishes that the Debtor borrowed the funds directly from Carden on an unrestricted basis, as a practical matter, the Debtor had no dispositive control over the funds because the Debtor would not have been able to borrow the funds without Pitts, and Pitts and Suddeth would not have permitted the Debtor to use the borrowed funds for any purpose other than paying the Defendant. The Court is not persuaded that a corporate debtor's principal's control over the corporation's decision regarding which creditor to pay precludes a finding that the borrowed funds were the corporation's property. In such a situation, the Court is inclined to hold that the corporation had a legal right to use the funds in any way, including the payment of any of its creditors. The fact that the corporation, acting through its officers, as a corporation must, chose to pay one creditor over another, should not support the finding that the corporation lacked dispositive control over the funds. Nonetheless, the Court will permit the parties an additional opportunity to address the issue.

C. *Section 547(c)*

The Defendant has asserted that, even if the Trustee could establish all of the elements of a preferential transfer, the transfer at issue is protected from avoidance by two affirmative defenses: the "new value" defense and the "ordinary course of business" defense. Section 547(c) provides several affirmative defenses to avoidance of a preferential transfer. The defendant bears the burden of proving, by a preponderance of the evidence, that such a defense applies. *See* 11 U.S.C. § 547(g); *In re Arrow Air Inc.*, 940 F.2d 1463 (11th Cir. 1991); *In re Jet Florida Systems, Inc.*, 861 F.2d 1555, 1558 (11th Cir. 1988); *In re General Time Corp.*, 328 B.R. 243, 247 (Bankr. N.D. Ga. 2005) (Mullins, J.).

1. *The "Contemporaneous Exchange for New Value" Defense*

The Defendant asserts that the transfer falls within the "new value" exception to avoidance found in section 547(c)(1). Section 547(c)(1) provides that the trustee may not avoid a preferential transfer "to the extent that such transfer was . . . intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and . . . in fact a substantially contemporaneous exchange." 11 U.S.C. § 547(c)(1); *see also In re Arrow Air, Inc.*, 940 F.2d 1463 (11th Cir. 1991). The Defendant argues that this transaction satisfies all three requirements of section 547(c)(1) because, upon receipt of the payment, the Defendant "released" its right to make a claim against the payment bond, the release provided new value to the Debtor, and the exchange of the payment for the release was substantially contemporaneous.

It remains unclear whether the facts of this transaction fall within the bounds of section 547(c)(1). The Defendant asserts that the release (or perhaps the "elimination") of its right to proceed against the bond provided new value to the Debtor. The Code defines "new value" as "money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation." 11 U.S.C. § 547(a)(2). Additionally, the "Eleventh Circuit has determined that forbearance, or the act of refraining from enforcing a right, obligation, or debt by a creditor, cannot be treated as 'new value' under section 547." *In re General Time Corp*., 328 B.R. 243, 247 (Bankr. N.D. Ga. 2005) (Mullins, J.).

The Defendant relies on *In re E.R. Fegert, Inc*., 88 B.R. 258 (9th Cir. B.A.P. 1988), *affirmed*, 887 F.2d 955 (9th Cir. 1989), for the proposition that the release of the right to assert a claim against a payment bond in exchange for payment from the debtor provides the debtor with new value within the meaning of section 547(c)(1). In *Fegert*, the debtor was a general contractor on a federal construction project. As required by the Miller Act, the debtor had obtained a payment bond from Seaboard Surety Company. The debtor failed to pay two subcontractors, and the subcontractors filed suit against the debtor and Seaboard. The debtor, the two subcontractors, and Seaboard reached a settlement of the suit, under which the debtor and Seaboard agreed to pay the subcontractors, and the subcontractors agreed to dismiss the suit and "release" all claims against Seaboard. The court found that the transaction was a contemporaneous exchange for new value because, once the subcontractors received payment, they released their claims against Seaboard, which meant that Seaboard was no longer entitled to assert a claim against funds owing to the debtor from the federal government. The court opined that, under the United States Supreme Court's holding in *Pearlman v. Reliance Ins. Co*., 371 U.S. 132 (1962), the surety would have been entitled to an equitable lien on the funds, which would have been superior to the claim of the bankruptcy estate. Accordingly, the payment by the debtor resulted in the "freeing up" of the funds remaining to be paid to the debtor on the contract. Because those funds became available to the bankruptcy estate and its general unsecured creditors, the court found that the transaction resulted in the provision of new value to the debtor.

The holding of *Fegert* is limited to the situation in which the debtor holds, at the time of the preferential payment, a right to receive contract proceeds. *Newbery Corp. v. Fireman's Fund Ins.,* 106 B.R. 186 (D. Ariz. 1989) (to the extent that payments exceeded the amount of contract proceeds that could have been released from an equitable lien, the payments resulted in only the release of unsecured claims against the debtor and, therefore, did not result in new value). Absent the existence of such a right, a finding that the release of claims against the surety provides new value to the debtor would do violence to the purpose of section 547.

Without the existence of a superior, equitable lien in favor of the surety against the debtor's account receivable, the fact that the debtor paid the defendant instead of the surety provides nothing of value to the debtor or its other creditors. It is simply the release of a contingent, unsecured claim. *See In re Pameco Corp*., 356 B.R. 327

(Bankr. S.D.N.Y. 2006) (the fact that third parties might not have been able to file hypothetical claims against the debtor did not constitute "new value"). Reliance on the avoidance of such claims as "new value" constitutes "a circular and ill-founded evasion of the policy against preferential transfers." *In re Chase and Sanborn Corp.*, 904 F.2d 588 (11th Cir. 1990) (criticizing the reasoning of lower court decisions holding that a payment made to a subcontractor in exchange for the release of a lien against non-debtor property provides new value because it avoids the assertion of an unsecured indemnification claim against the debtor). The purpose of the contemporaneous exchange for new value exception is to encourage vendors and suppliers to continue doing business with a financially distressed business. *See In re Pameco Corp*. 356 B.R. 327 (Bankr. S.D.N.Y. 2006). Unless superior lien rights are involved, a creditor's acceptance of a payment from the debtor, rather than a surety, provides nothing of value to the debtor and its other creditors, does not enhance the estate, and was not intended to be protected by section 547(c)(1).

As the Trustee has pointed out, in the *Fegert* case, the trustee did not dispute that the estate received "post-petition more than the total paid to both subcontractors from the [contract]." *Fegert*, 88 B.R. at 260. In this case, the Defendant has pointed to no evidence to suggest that, at the time the Debtor made the payment to the Defendant, the City owed the Debtor any amounts under the contract. The Defendant does point to the fact that the Debtor listed on its Schedule B an account receivable of $250,000 arising from the Project and a certificate of deposit of $100,000 "pledged as security for payment of indemnity obligations to bonding company on" the Project. The Court has been directed to no evidence that would support a finding that the Debtor received a payment from the City after the Debtor paid the Defendant. If fact, the evidence suggests that the Defendant had completed its work on the Project, the Debtor had invoiced the City for all work done, and the City had made its final payment to the Debtor before the Debtor paid the Defendant. However, because the Court must consider evidence as to whether the funds transferred were in fact property of the Debtor, the Court will permit the Defendant a further opportunity to present evidence that the surety had any right to payment from the Debtor's property that would have been superior to the right of the Trustee.

2. *The "Ordinary Course of Business" Defense*

Next, the Defendant submits that it is entitled to an "ordinary course of business" defense. Under section 547(c)(2), the trustee may not avoid a preferential transfer "to the extent such transfer was: "in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; . . . made in the ordinary course of business or financial affairs of the debtor and the transferee; and . . . made according to ordinary business terms." 11 U.S.C. § 547(c)(2).[2] To prevail, the Defendant must prove all three elements of the defense.

---

[2] The payment at issue in this case occurred in February 2003, the Debtor filed its voluntary petition on April 8, 2004, and the Trustee filed the instant adversary proceeding on September 6, 2005. Accordingly, the Court applies section 547(c)(2) as it existed prior to the amendments made by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. *See* Pub. L. 109-8, Apr. 20, 2005, 119 Stat. 23 ("BAPCPA"); *In re Globe Holdings,* 366 B.R. 186 (Bankr. N.D. Ala. 2007).

See *In re Globe Holdings,* 366 B.R. 186 (Bankr. N.D. Ala. 2007).

The Defendant has recognized that the Court has been presented with "conflicting evidence" as to whether the ordinary course of business exception applies. The Court concurs with this assessment and finds that summary judgment is not warranted on the basis of this defense.

CONCLUSION

For the reasons stated above, the Court finds that the Motions for Summary Judgment filed by the Trustee and the Defendant should be, and hereby are, **DENIED**.

END OF DOCUMENT