UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF WISCONSIN

In re

FOX BAY ENTERTAINMENT, INC., Chapter 7

Debtor. Case No. 99-22637

JOHN M. SCAFFIDI, TRUSTEE,

Plaintiff,

v. Adversary No. 00-2149

BONNIE K. SMITH,

Defendant.

MEMORANDUM DECISION ON DEFENDANT'S MOTION TO DISMISS,
CONSTRUED AS A MOTION FOR SUMMARY JUDGMENT

The debtor filed a voluntary petition for chapter 11 relief on March 22, 1999, and the case was converted to chapter 7 on August 20, 1999. The chapter 7 trustee filed this adversary proceeding against the defendant, seeking to avoid an alleged preferential payment to an insider pursuant to 11 U.S.C. § 547(b). The defendant moved to dismiss the complaint for failure to state a claim upon which relief could be granted, which the court construed as a motion for summary judgment. The only issue raised at this time is whether the doctrine of earmarking applies to defeat avoidance by the trustee as a matter of law. The parties filed briefs and the court took the matter under advisement.

This court has jurisdiction under 28 U.S.C. § 1334(b), and this is a core proceeding under 28 U.S.C. § 157(b)(2)(F).

BACKGROUND

James Young was the president and majority shareholder of the debtor, Fox Bay Entertainment, Inc. He was also part owner, individually, of J.Y. Coffee Corp., doing business as Gloria Jeans. On May 7, 1998, the defendant Bonnie Smith, Mr. Young's mother-in-law, entered into an agreement with Mr. Young to loan Fox Bay $50,000 for a short time to help alleviate the cash flow problems Fox Bay was having during renovation of its place of business. The agreement provided that "[t]he full amount must be repaid in 90 days from the date of check or upon the closing of the sale of J.Y. Coffee Corp. (DBA - Gloria Jeans) or which ever is sooner." (Exhibit A to Defendant's Briefs) The agreement was signed by Mr. Young as the President of Fox Bay Entertainment.

On July 7, 1998, Mr. Young closed on the sale of Gloria Jeans and, from the proceeds of the sale, deposited $68,000 of his personal funds into the account of Fox Bay Entertainment. Also on July 7, 1998, Mr. Young wrote a check to Ms. Smith for $50,000 from Fox Bay's account, in full payment of the note. (Exhibit B to Defendant's Reply Brief) Ms. Smith endorsed and negotiated the check three days later – July 10, 1998.

ARGUMENTS

Ms. Smith contends that the transaction does not constitute a preferential transfer on account of the equitable doctrine of earmarking. Because the funds were earmarked, Ms. Smith claims that the trustee has not alleged a transfer of an interest of the debtor in property.

The trustee argues that earmarking is not applicable because Mr. Young, individually, did not control the funds once they were placed in Fox Bay's general account. The trustee also asserts that the payment to Ms. Smith diminished the estate. The transfer occurred within one year of filing, and the defendant is an “insider” of the debtor. 11 U.S.C. § 101(31)(B)(vi), (45).

Both parties reserve their rights with respect to other elements of a preference and any defenses thereto.

DISCUSSION

This case is appropriate for summary judgment with respect to the earmarking issue. Fed. R. Bankr. P. 7056. There are no material facts in dispute, only the interpretation of those facts. *See, e.g., United States v. Navistar Int'l Transp. Corp.*, 152 F.3d 702, 707 (7th Cir. 1998). Ms. Smith, as the party moving for summary judgment, bears the burden of showing the lack of evidence to support a necessary element of the trustee's case. *Celotex Corp. v. Catrett*, 477 U.S. 317, 323, 106 S.Ct. 2548, 2552-53 (1986).

The plaintiff submitted copies of depositions taken of James Young and Bonnie Smith, and their recollection of events leading up to the $50,000 loan and the payment two months later are largely consistent. Neither party had legal advice. Mrs. Smith had never made a loan of a commercial nature before; she merely considered this as a way to help her “children” (daughter and son-in-law) over a rough spot. She wanted her money back soon, and for this reason she told her son-in-law that the funds were coming from her IRA (the funds actually came from a line of credit secured by the equity in her home), and it was for a very short term. She thought her son-in-law was personally liable for the debt, but she knew the money was to be used for the debtor’s business. Mr. Young acknowledged that he signed the note as president of the debtor rather than

individually, a distinction that seemed to be meaningless to him, but there was no question how Mrs. Smith would be paid back – it was to come from the sale of Mr. Young's other business that had nothing to do with the debtor. Nevertheless, the note is unambiguous. The $50,000 was a loan to the corporation for corporate purposes and, aside from a moral obligation, Mr. Young and his other business were not personally liable.

One fact which is not so unambiguous is whether Mr. Young's deposit of $68,000 into the corporation account upon sale of Gloria Jeans was a loan to the corporation or a contribution of capital. Mr. Young stated in his deposition that his deposit was a contribution of capital, but his affidavit filed in response to the instant motion states that he loaned the money to the corporation. The debtor's schedules show that Mr. Young and his wife have made loans totaling $229,000 to the corporation, and it is unknown whether this $68,000 deposit is included in that number. It is axiomatic that a party cannot create a factual dispute by providing contradictory support for a premise, but this court is satisfied that the doctrine of earmarking can be applied whether the party contributing the funds becomes a creditor or not. Therefore, these differences are immaterial.

The trustee ultimately has the burden of proof to show by a preponderance of the evidence that each of the elements of an avoidable preference exist. 11 U.S.C. § 547(g). The central question relating to the doctrine of earmarking is whether an interest of the debtor in property has been transferred, which is the introductory element of 11 U.S.C. § 547(b). Thus, the trustee must prove the absence of earmarking as part of his burden of proof. *In re Libby Int'l, Inc.*, 247 B.R. 463, 467 (B.A.P. 8th Cir. 2000); *In re International Ventures, Inc.*, 214 B.R. 590, 594 (Bankr. E.D. Ark. 1997). While it usually is not necessary to prove a negative in the first

instance, it is logical to require the defendant to raise the matter as part of her burden of production of evidence, but to leave the final burden of proof of a transfer of the debtor's interest in property with the trustee.

The earmarking doctrine is a judicially created exception to § 547(b) deriving from the requirement that a transfer, in order to be preferential, must be "of an interest of the debtor in property." *In re Messamore*, 250 B.R. 913, 916 (Bankr. S.D. Ill. 2000). A transfer is preferential only if it diminishes the fund to which other creditors could have looked for payment of their debt had the transfer not been made. *Id*. (citing 5 *Collier on Bankruptcy* ¶ 547.03[2] (15th ed. Rev. 2000)).

There are three tests used, sometimes together, by courts to determine if funds are earmarked. One line of cases applies the earmarking doctrine if the debtor lacked "control" over the funds supplied by a new creditor. In determining control, courts will consider whether the new creditor restricted the use of the funds, whether the debtor had physical control over the funds, and whether the debtor had the ability to direct to whom the funds should be paid. *See, e.g., In re Superior Stamp & Coin Co.*, 223 F.3d 1004, 1008-09 (9th Cir. 2000); *In re Montgomery*, 983 F.2d 1389 (6th Cir. 1993); *Matter of Smith*, 966 F.2d 1527, 1531 (7th Cir. 1992); *In re Messamore*, 250 B.R. 913, 916-17 (Bankr. S.D. Ill. 2000). If the debtor had an obligation to transfer the funds to the creditor and to use them for no other purpose, the debtor lacked the necessary rights in the funds to make them property of the debtor. This obligation may take the form of an understanding, or it might be formalized.

Under a second line of cases, the "intent" of the new creditor and the debtor is analyzed. The following elements must be satisfied under this test: (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 and the transfer out to the old creditor) does not result in any diminution of the estate. *In re Bohlen Enters.*, 859 F.2d 561, 566 (8th Cir. 1988); *In re Kumar Bavishi & Assocs.*, 906 F.2d 942 (3rd Cir. 1990); *see also Matter of Smith*, 966 F.2d at 1533 (applying various aspects of "intent" test). Both parties must have intended that the funds be used for the purpose that they were actually used for; the debtor's intent alone is insufficient to invoke the doctrine.

A third line of cases simply applies a "diminution of the estate" test to determine if the transfer was earmarked. *E.g., In re Safe-T-Brake*, 162 B.R. 359, 366 (Bankr. S.D. Fla. 1993); *In re Kelton Motors, Inc.*, 153 B.R. 417, 428 (Bankr. D. Vt. 1993). If the creditors would have been able to recover from the funds but for the transfer, the estate was diminished.

The doctrine arose in situations whereby a co-obligor or guarantor paid off a creditor, and the trustee sought to bring that payment into the estate for the benefit of all creditors. If such a transfer could be avoided, the co-obligor or guarantor would end up paying twice – the first time to the creditor who had to turn the money over to the estate, and the second time to the same creditor on account of the personal obligation that sprang back. This was perceived as unfair. *See generally In re Moses*, 256 B.R. 641 (B.A.P. 10th Cir. 2000); *In re Kenosha Liquidation Corp.*, 158 B.R. 774 (Bankr. E.D. Wis. 1993). Later cases extended the doctrine to situations involving a new creditor, rather than a co-obligor or guarantor, who paid off the loan sought to be avoided. In these cases, the focus was on the estate rather than fairness to a particular creditor. The question then is whether the estate should be enhanced by the funds transferred, thus putting

the old creditor, who was paid off, and the new creditor, who provided the funds, in the same position as all other creditors. *Id.* Some courts have been unwilling to extend the doctrine beyond the co-obligor scenario. *See, e.g., In re Moses*, 256 B.R. 641.[1] If we may characterize this latter view, preference recovery puts old and new creditors in the same boat, notwithstanding any strings the new creditor placed on the use of funds or any agreement the debtor and creditor had for the use of the funds, but double payment is beyond the pale.

This court is satisfied that the focus of applying the doctrine should not be solely on fairness to the creditor who is also personally obligated with the debtor. After all, much of what occurs in the bankruptcy context is not particularly fair. The focus should also be on the estate; namely, whether the funds in the estate available for distribution to creditors are the same as would have been available but for the transfer. Property of the estate does not include funds held by the debtor in a fiduciary capacity and, when such assets exist, creditors do not receive a windfall by recovering from assets never intended for the debtor's general creditors or for other purposes the debtor might have. Earmarking applies, or extends, this general concept to particular situations in which the funds were designated for a specific purpose.

All of the cases cited by the parties or found by the court applying earmarking arise either because one creditor loans funds to the debtor to pay off another creditor or a co-obligor or guarantor pays off the creditor to which the guarantor is personally obligated, thereby becoming a

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[1]The court in *Moses* quoted with approval the Eighth Circuit decision in *In re Bohlen Enters.*, 859 F.2d 561 (8th Cir. 1988), which held that "the earmarking doctrine does not apply in this instance, where none of the money transferred to [the old creditor] was based on a guarantee or *similar obligation*." *Moses*, 256 B.R. at 647 (quoting *Bohlen*, 859 F.2d at 567; emphasis added). Whether a family obligation and the pressure that might be brought by family members constitutes a "similar obligation" need not be decided at this time.

creditor by subrogation (and avoiding double payment). The parties cited no cases dealing with earmarking a contribution to capital with no expectation of repayment by the contributor. If Mr. Young added this $50,000 transfer to the outstanding loans already owed him by the debtor, then this case comports with other cases allowing earmarking when one creditor merely replaces another. However, if the court looks to whether the estate has been diminished by the transfer, the distinction between a new earmarked loan and an earmarked contribution to capital is irrelevant, and the result is the same.

The transfer in this case meets all of the standards the courts have established for earmarking. First, the trustee argues that Mr. Young, the individual, lost control of the funds when they were placed in the corporate account. As the court stated in *Smith*, once the money was in the corporate account, the debtor could have paid creditors pro rata or purchased a 40 foot yacht. *Smith*, 966 F.2d at 1531. However, in *Smith*, the creditor allowed use of funds on a check that was ultimately dishonored, and the creditor did not direct how its provisional credit was to be used. Similarly, in *Moses*, the debtor announced his intention as to how the funds were to be used, but the creditor placed no condition on the loan that he comply with the stated purpose. Therefore, no effort to control the funds was exercised by those creditors.

In this case, the note shows that the funds coming from the sale of Gloria Jeans was to be used to pay Ms. Smith. The same Mr. Young who deposited the funds also determined what was paid out of the corporate account. While his mother, a 19% owner of the debtor, had signature powers on the account, she did not have the checkbook and was not directing the operations of the corporation. It defies logic to say that the contributor did not control the funds once he put on his corporate president's hat, especially when the corporation was obligated to pay the debt to

Ms. Smith when Gloria Jean's was sold, and that was the source of the funds. Control can take the form of an "understanding" between the source of the funds and the debtor as to the use of the funds; it is not necessary that there be a legal obligation for the use of the funds be in place. *Matter of Oliver's Stores, Inc.*, 112 B.R. 671, 677 (Bankr. D. N.J. 1989). Also, the fact that the funds went through the corporate account is not determinative as to control, as long as the direction of the contributor of the funds is clear. *Brown v. First Nat'l Bank of Little Rock*, 748 F.2d 490, 492 n. 6 (8th Cir. 1984); *In re Kenosha Liquidation Corp.*, 158 B.R. 774, 779-80 (Bankr. E.D. Wis. 1993). Thus, James Young, the individual and source of the funds, controlled the use of those funds.

Likewise, the intent of both the contributor and the corporation as to the use of the funds is clear, undisputed and identical. The funds were in fact used for the purpose of paying Ms. Smith's loan. The intent test is met.

The estate of the debtor was not diminished by payment of the debt to Ms. Smith because the money would never have come into the estate had it not been targeted for this particular debt. Actually, this payment may have enhanced the assets available to other creditors if Mr. Young made a contribution to capital, because there would be no substitution of creditors. In fact, a substantial claim may have been eliminated, thus increasing recovery for others.

The trustee has failed to meet his burden that there was a transfer of the debtor's interest in property to this creditor. Therefore, his claim for a preference must also fail. Summary

judgment in favor of the defendant will be granted, and the complaint will be dismissed. Each party will bear its own costs. A separate order will be entered accordingly.

Dated at Milwaukee, Wisconsin, February 15, 2001.

BY THE COURT

___/s/________________________
Honorable Margaret Dee McGarity
United States Bankruptcy Judge

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EASTERN DISTRICT OF WISCONSIN

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BONNIE K. SMITH,

Defendant.

ORDER DISMISSING ADVERSARY PROCEEDING

For the reasons set forth in the court's memorandum decision entered on this date, IT IS ORDERED that summary judgment is granted in favor of the defendant.

IT IS FURTHER ORDERED that the adversary proceeding is dismissed with prejudice and without costs to either party.

Dated at Milwaukee, Wisconsin, February 15, 2001.

BY THE COURT

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Honorable Margaret Dee McGarity
United States Bankruptcy Judge

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