IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF ILLINOIS

In re:

LWMcK CORPORATION, d/b/a
National Building Systems,

Debtor.

DONALD HOAGLAND, Trustee

Appellant,

vs.

DENK & ROCHE BUILDERS, INC.

Appellee.

Case No. 96-4264-JLF

Bk No. 95-30157

Adv. No. 96-3036

MEMORANDUM AND ORDER

FOREMAN, District Judge:

Before the Court is an appeal by Donald Hoagland, Trustee of Debtor's estate, from the judgment of the Bankruptcy Court for the Southern District of Illinois. The matter came before the bankruptcy court on the cross-motions for summary judgment made by Defendant-Appellee, Denk & Roche ("D&R") and Trustee, respectively, in an adversary proceeding initiated by Trustee. After a hearing, the bankruptcy court granted summary judgment and entered final judgment in favor of D&R. Thus, this Court has jurisdiction pursuant to 28 U.S.C. § 158(a)(1). The Trustee filed a timely notice of appeal. The matter has been fully briefed on appeal and oral arguments have been heard. For the reasons set forth herein, the Court **REVERSES** the judgment of the bankruptcy court and **REMANDS** this case for further proceedings consistent with this order.

BACKGROUND

The facts of this case are taken from the bankruptcy court's Findings of Fact and Conclusions of Law. (Doc. 32). There are four actors involved in this case: Trustee, Cambridge Properties ("Cambridge"), LWMcK Corporation ("Debtor"), and D&R. Cambridge was the owner-developer of two separate real estate developments in Lake County, Illinois, known as Fox Chase and College Trail ("the properties"). In 1993, Cambridge contracted with Debtor for the construction of residential housing on the properties. Both contracts were memorialized in separate written agreements. Debtor proceeded to enter into subcontracts with D&R for the material and labor for certain carpentry work at the projects.

In the fall of 1994, the construction neared the midway point, but Debtor had paid very little money to D&R for the work it had performed up to that point. Cambridge was also aware of the nonpayment of D&R. The contracts entered into between Cambridge and Debtor contained specific provisions concerning the rights of the parties regarding unpaid subcontract work. Specifically, paragraph 13(a) of the contracts between Cambridge ("CONTRACTOR") and Debtor ("SUBCONTRACTOR") provided:

> . . . If at any time there shall be evidence of any lien of [sic] claim by a SUBCONTRACTOR or materialman or any other person claiming by or through SUBCONTRACTOR for which, if established, CONTRACTOR might become liable or to which Project or property on which Project is located might be subject, or which should, in any event, be charged to SUBCONTRACTOR, CONTRACTOR shall have the right to retain out of any payment due or thereafter to become due SUBCONTRACTOR, an amount sufficient to indemnify CONTRACTOR against such lien or claim ....

A meeting was held in November 1994 among Cambridge, Debtor, and D&R.[1] As a result of this meeting, they entered into a three-way agreement. D&R agreed to assume all warranty work previously warranted by Debtor and to forebear the exercise of its lien rights as to the projects for the unpaid work it performed. In return, Cambridge agreed to pay D&R for the outstanding invoices that remained unpaid by Debtor, and Debtor agreed to transfer its right to payment, under the contract with Cambridge, to D&R.

Various letters were sent among Cambridge, Debtor, and D&R, which memorialized the

---

[1]The record does not provide the exact date of this meeting. The bankruptcy court's findings of fact only provide that the meeting was held in November 1994. (Doc. 32, ¶ 9, at 3).

agreement. On November 28, 1994, Debtor sent a letter to Cambridge which stated that it authorized the issuance of any checks by Cambridge for monies it owed Debtor to D&R. On November 29, 1994, D&R sent two letters to Cambridge. The contents of the letters were virtually identical. They differed only in that one pertained to the Fox Chase property and the other pertained to the College Trail property. Each letter set forth the warranty work that D&R was assuming on the respective projects. D&R further stated that Debtor was released from any further warranty obligation. D&R stated that its assumption of the warranty work was to commence on November 30, 1994. From and after November 30, 1994, D&R proceeded to perform carpentry services directly for Cambridge. On March 20, 1995, Cambridge issued two checks to D&R for its services totalling $241,582.24. The Debtor had discontinued its services on the projects.

Approximately one month prior to Cambridge's $241,582.24 payment to D&R, on February 16, 1995, Debtor petitioned for bankruptcy. Trustee then filed, and subsequently amended, a two-count complaint. In Count I, Trustee sought to avoid the March 20, 1995 transfers made by Cambridge to D&R pursuant to11 U.S.C. § 549. In Count II, Trustee sought to avoid these transfers under 11 U.S.C. § 547 (preferences), asserting that these checks were transferred pursuant to an agreement made within 90 days of the entry of the Order of Relief in the bankruptcy proceeding.[2]

The premise of Trustee's complaint was that the money transferred by Cambridge to D&R was actually the property of the Debtor's estate. The bankruptcy court found that "Debtor agreed to transfer its right to payment, under the contract[s] with Cambridge, to D&R" (Doc. 32, ¶ 9, at 3), but concluded that by virtue of paragraph 13(a) of the respective project agreements between Cambridge and Debtor, the money paid to D&R on March 20, 1995, did not constitute property of the estate as defined by II U.S.C. § 541. (Doc. 32, ¶ 20, at 5). Accordingly, the bankruptcy court held that Cambridge's payments to D&R were neither a transfer of an interest of the Debtor in property under § 547 nor a transfer of the

[2]The amount of money at issue in this case is not equal to the total amount of money paid to D&R by Cambridge. Trustee has conceded that the payment of $20,536.06 from Cambridge to D&R was not avoidable by the Trustee, as it was made pursuant to an independent obligation owed from Cambridge to D&R. It is the remaining $221,046.64 ($241, 582.24 - $20,536.06 = 221,046.64) which is at issue in this case. (Doc. 32, ¶ 13, at 4).

property of the estate under § 549. (Doc. 32, ¶¶ 22 & 23, at 5).

DISCUSSION

The Court reviews factual findings of the bankruptcy court under a clearly erroneous standard and reviews conclusions of law *de novo*. Bankruptcy R. 8013; *see also In re Bonnett,* 895 F.2d 1155, 1157 (7th Cir. 1989).

Trustee raises four issues on appeal: (1) whether the March 20, 1995 transfer of funds from Cambridge to D&R was avoidable pursuant to 11 U.S.C. § 549; (2) whether Debtor's pre-petition transfer of its right to payment from Cambridge to D&R constituted a preferential transfer pursuant 11 U.S.C. § 547; (3) whether the funds at issue are either property of the estate under § 549 or an interest of the Debtor in property under § 547; and (4) whether paragraph 13(a) of the original contract between Cambridge and Debtor prevented the funds at issue from constituting either property of the estate or an interest of the debtor in property. *See* Appellant's Br. at 2 (emphasis added). Despite Appellant raising four issues, both parties agree that the general issue before the Court is whether the transfer of the funds constituted either a transfer of the property of the estate under § 549 or an interest of the Debtor in property under § 547. *See* Appellant's Br. at 20; Appellee's Br. at 1, 11.

1. § **547(b) Analysis**

Section 547(b) provides that the trustee may avoid a transfer of an interest of the 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–
>   (A) on or within 90 days before the date of filing of the petition; or
>   (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
> (5) that enables such creditor to receive more than such creditor would receive if–
>   (A) the case were a case under chapter 7 of [Title 11];
>   (B) the transfer had not been made; and
>   (C) such creditor received payment of such debt to the extent provided by the provisions of [Title 11].

Before a court can determine whether the five elements of § 547(b) are present, the threshold issue of whether the transfer of the property at issue was "an interest of the debtor in property" must be addressed.

The Bankruptcy Code does not provide a presumptive definition of the phrase "interest of the debtor in property." It does, however, define the phrase "property of the estate" as "all legal or equitable interest of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). The Supreme Court of the United States has stated that the phrase "interest of the debtor in property," as used in § 547, is coextensive with the phrase "property of the estate," as used in § *549. Bergier v. Internal Revenue Serv.,* 496 U.S. 53, 58-59 & n.3 (1990). Hence, the definition of "property of the estate" found in § 541 (a)(1) guides this Court's analysis under § *547. See Id.* at 59 n.3.

In *In re Yonikus,* 996 F.2d 866, 869 (7th Cir. 1993), the Seventh Circuit stated that the scope of § 541 (a)(1) is broad:

> The term "property" [in § 541 (a)(1)] has been construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed. . . . In fact, *every conceivable interest of the debtor,* future, nonpossessory, contingent, speculative, and derivative, *is within the reach of § 541.*

(emphasis added) (quotations and citations omitted). Furthermore, the Second Circuit has stated that the property of the estate includes a debtor's rights to collect accounts receivable. *See In re Crysen,* 902 F.2d 1098, 1101 (2d Cir. 1990). The broad definition of the word "property" is consistent with what the Supreme Court has indicated as the purpose behind the avoidance provision: "to preserve the property includable within the bankruptcy estate--the property available for distribution to creditors . . . ." *Bergier,* 496 U.S. at 58.

Based on § 541's definition of "property of the estate" and the principles stated in *Yonikus,* the November 1994 three-way agreement appears to include a transfer of funds due to Debtor by Cambridge. This conclusion is further buttressed by the bankruptcy court's explicit finding in its order that via the November 28, 1994 letter, debtor "transferred to D&R its right to payment under its contract with Cambridge" (B.R. Doc. 32, p.3, para. 10). D&R, however, argues otherwise under the theories of independent obligation, the earmarking doctrine, and constructive trust.

A. Independent Obligation Issue.

D&R proposes several arguments in support of its position that Cambridge had an independent obligation to pay D&R for the work D&R had performed under its subcontract with Debtor. D&R first argues that Cambridge had an independent obligation to pay D&R as a result of the November 1994 agreement between itself and Cambridge. *See* Appellee's Br. at 14-18. D&R asserts that the agreement created an independent obligation because "Cambridge undertook an independent obligation to pay D&R in consideration of [D&R] providing certain warranties, standing behind the projects, in addition to [D&R]'s agreements to complete the project and forebear from asserting any liens." Appellee's Br. at 16.

Undoubtedly there was an independent obligation between Cambridge and D&R regarding the work performed *after* the formation of the November 1994 agreement, which resulted in Debtor assuming some of the contractual obligations previously placed on Debtor. Nevertheless, only $20,536.06 of the $241,582.24 aggregate sum paid to D&R was based on the work done by D&R subsequent to the November 1994 agreement. *See supra* note 2. The remaining $221,046.64 paid to D&R by Cambridge was based on work completed *prior to* the November 1994 three-way agreement. *See supra* note 2. Prior to this agreement, however, there was no privity of contract between D&R and Cambridge. There was only privity of contract between Cambridge and Debtor, and privity of contract between Debtor and D&R. In other words, prior to the November 1994 agreement, it was Debtor's responsibility to pay D&R, not Cambridge's.

D&R, however, argues that the November 1994 agreement between itself and Cambridge was sufficient to remove the funds at issue from the interest of the debtor in property. To support its argument, D&R relies upon *In re Flooring Concepts, Inc.*, 7 B.R. 957 (Bankr. App. 9th Cir. 1984). *In Flooring Concepts*, the trustee for a debtor-subcontractor brought an adversary proceeding to recover from a materialman certain transfers made pursuant to an agreement entered into between the general contractor, debtor, and materialman. The general contractor ("Konwiser") entered into a contract for construction with the debtor subcontractor for the installation of carpet. *Id.* at 959. Flooring Concepts, in turn, purchased carpet from a creditor-materialman ("Shaw"). *Id.* Shaw, thereafter, furnished materials and services to Flooring Concepts.

After approximately eight months into the contract, Shaw had yet to receive any payment from the debtor. *Id*. Having not received payment, Shaw served Konwiser with a twenty-day notice required under California law that it intended to enforce its materialman's lien rights. *Id*. After receiving notice, Konwiser entered into a three-way agreement during the 90 day preference period with the debtor and Shaw. *Id*. Pursuant to the three-way agreement, Konwiser was to pay Shaw the amount of money that it actually owed debtor. *Id*. at 960. Debtor assigned its right to payment to Shaw, and in consideration for receiving payment from Konwiser, Shaw agreed to forebear from filing the materialman's lien. *Id*.

The Ninth Circuit Bankruptcy Appellate Panel held that the agreement between Konwiser and Shaw created an independent obligation on the part of Konwiser to pay Shaw. *Id*. at 961. Because there was an independent agreement, the Ninth Circuit held that the payment was not part of the bankruptcy estate. *Id*.

D&R is correct in arguing that *Flooring Concepts* is analogous to the case at bar. The Court. however, disagrees with the conclusion reached by the bankruptcy panel. The *Flooring Concepts* holding contravenes § 547(b)'s proscription against preferential transfers. If D&R's argument based *on Flooring Concepts* were accepted, it is difficult to conceive of a situation in which the proscription against preferential transfers would apply. As explained by the bankruptcy court in *In re Northwest Elec. Co. of Ohio,* 84 B.R. 400,404 (Bankr. W.D. Pa. 1989):

> *The Flooring Concepts* court would allow the owner, the contractor, the subcontractor, and the material men to get together to provide that future payments to be earned by the subcontractor would be used to pay a particular debt and that the owner and the material men could avoid the filing of a mechanic's lien by such a device.... [B]y such a device, those parties have gotten together to arrange a method of disposition of assets so that the other creditors of the subcontractor will be prejudiced .... *Subcontractors who have a right to protect themselves by filing mechanic's lien claims should do so, and not engage in other transactions to evade the mechanic's lien filing requirements which may prejudice other creditors.*

(emphasis added). Simply, the *Flooring Concepts* rationale is contrary to Congress's clear policy choice in § 547(b), which is to ensure that a debtor's property is equitably distributed among all creditors, and not just a select few by way of an "independent agreement" entered into during the preference period. *See*

Bergier, 496 U.S. at 58 (discussing purposes behind avoidance provision).[3]

The Court does not dispute the fact that D&R had the right to protect itself from nonpayment. This right, however, is tempered by the restrictions in the bankruptcy code that prohibit a debtor from dissipating his own assets during the preference period in order to pay an antecedent debt. What D&R claims to be an independent obligation--the agreements reached as a result of the November 1994 meeting -- clearly threatens § 547's proscription against preferential transfers, and the Court is unwilling to read an exception into the statute that would completely swallow the rule contained therein.[4]

D&R alternatively argues that the language in paragraph 13(a) of the original contracts between Cambridge and Debtor created a preexisting, independent obligation on the part of Cambridge to pay D&R. *See* Appellee's Br. at 16-17. D&R relies upon the case of *Hoagland v. Edward Hines Lumber Co. (In re LWMcK Corp.)*, 196 B.R. 421 (Bankr. S.D. Ill. 1996). *Edward Hines* was an adversary proceeding that arose out of the same bankruptcy proceeding as the case at bar. The facts in *Edward Hines* are nearly identical to the facts of this case, and it involved the same contractual provision that is at issue in this case. The trustee in *Edward Hines* made demands upon Cambridge for payment of sums allegedly due and owing to Debtor with respect to work Debtor performed pursuant to its contract with Cambridge. *Id.* at 423. Cambridge refused the trustee's demand in part because Cambridge claimed that it partially satisfied its obligations to Debtor by making direct payments to Debtor's creditor-subcontractor.

---

[3]D&R argues that the fears expressed by the *Northwest Elec. Co.* Court are not present in this case because unlike the fact pattern presented in *Northwest Elec. Co.*, there was no predetermination in the case at bar of who would receive payment. *See* Appellee's Br. at 29 n.4. This argument is refuted by the findings of fact in this case. As noted earlier, the bankruptcy court stated that "Debtor agreed to transfer its right to payment, under the contract[s] with Cambridge, to D&R." (Doc. 32, ¶ 9, at 3). If this is not a predetermination of who would receive payment, the question arises of what would constitute a predetermined payment?

[4]D&R also relies on the bankruptcy court opinion of In re Steelvest, 112 B.R. 852 (Bankr. W.D. Ky. 1990) to support its argument that there was an independent obligation on the part of Cambridge to pay D&R. *See* Appellee's Br. at 14-15. The rationale relied upon, in part, by the *Steelvest* Court is identical to that relied upon by the *Flooring Concepts* Court, which this Court believes, as indicated above, contravenes Congress's clear policy choice in § 547(b).

Id. After Cambridge refused to pay Debtor, the trustee brought an adversary proceeding against the creditor-subcontractor, seeking to avoid the payment under 11 U.S.C. § 549 (post-petition transfer). *Id.* at 422.

Regarding paragraph 13(a), the *Edward Hines* Court reasoned:

> While the language of Paragraph 13(a) may not create an independent obligation between Cambridge and Defendant, its legal effect on the bankruptcy estate is the same--to exclude from the bankruptcy estate property which, but for the contractual terms, would otherwise be estate property under 11 U.S.C. § 541.

Id. at 424.

In reaching the conclusion in *Edward Hines* that paragraph 13 (a) has the same legal effect on the bankruptcy estate as if the paragraph had explicitly created an independent obligation on the part of Cambridge, the bankruptcy court relied extensively on the case of *In re Arnold,* 908 F.2d 52 (6th Cir. 1990). *Arnold,* however, involved an independent and explicit contractual obligation, and not merely the right, to withhold payment and pay creditor-subcontractors and materialmen. In *Arnold,* the State of Tennessee entered into a construction contract with the Shankle Construction Company ("Shankle"). *Id.* at 53. Shankle then subcontracted with the debtor in that case to perform electrical work. The debtor purchased materials from Braid Electric Company ("Braid") for its electrical work on the project. *Id.* At the time the debtor filed for bankruptcy, Shankle owed the debtor $61,756.14 for work it had performed under the contract. Shankle, however, did not pay the debtor. Instead, Shankle paid the amount to Braid because the debtor was indebted to Braid for the electrical supplies it had purchased. *Id.* at 54. The trustee in *Arnold* sought to recover the amount paid to Braid, claiming that the payment amounted to a post-petition transfer of the estate's property under § 549. *Id.* In response, the bankruptcy court held that the trustee could recover these payments and the district court affirmed this decision. *Id.*

Reversing the district court, the Sixth Circuit determined that the lower courts' findings were erroneous because the contract between Shankle and the State of Tennessee created an independent obligation on the part of Shankle to pay Braid. The contractual provision provided:

> Unless otherwise provided in the Contract Documents, [Shankle] *will provide and* pay for all labor, materials, equipment, tools, construction equipment and machinery, water,

> heat, utilities, transportation, and other facilities and services necessary for the proper execution and completion of the Work, whether temporary or permanent, and whether or not incorporated or to be incorporated in Work.

Id. (emphasis added).

Arnold is clearly distinguishable from the case at bar. Unlike the contractual provision at issue in *Arnold*, paragraph 13(a) is couched in discretionary terms and not in terms that create an independent obligation on the part of Cambridge to pay Debtor's subcontractors or materialmen. Under the terms of the contracts between Cambridge and Debtor, the obligation to pay subcontractors and materialmen fell squarely upon Debtor unless Cambridge exercised its discretion to pay the subcontractors and materialmen itself. In fact, the December 15, 1994, letter from Cambridge to Debtor explicitly states that "[i]t is agreeable that [Cambridge] assume [Debtor's] obligation to pay [D&R]." (Defendant's Exhibit 4). If there was an independent contractual obligation on the part of Cambridge, Cambridge certainly would not have had to "assume" an obligation of Debtor.

The Court finds the opinion of the Bankruptcy Court for the Western District of Pennsylvania, *In re Buono,* 119 B.R. 498 (W.D. Pa. 1990), on point with regard to a contractual provision that creates only a right, and not an obligation, to withhold payment in favor of creditor subcontractors and materialmen. In *Buono,* the debtor, Anthony Buono Floors & Walls, performed work as a subcontractor for Max, a general contractor. Dal-Tile provided materials to the debtor, and the debtor had accumulated a past-due balance to Dal-Tile for those materials. Within 90 days of the debtor filing his voluntary bankruptcy petition, Max, the debtor, and Dal-Tile executed a joint check agreement whereby it was agreed that any payments made to the debtor by Max would be made payable jointly to the debtor and Dal-Tile. *Id.* at 499.

After the filing of the bankruptcy petition, the trustee demanded that Dal-Tile return the funds it had been paid pursuant to the joint check agreement. *Id*. In its defense, Dal-Tile argued that the original contract between Max and the debtor prevented the funds at issue from becoming an interest of the debtor in property under § 547. The contract provided, in relevant part that, *"[i]f the Contractor deems it necessary,* payments may be withheld to assure payment of the Subcontractor', s unpaid obligations." *Id. at* 500 (emphasis added). Like the language of paragraph 13(a), the contract in *Buono* was couched in discretionary terms--it did not create an independent obligation on the part of Max. The bankruptcy court in *Buono* held that despite this contractual language, the debtor still had a property interest in those funds paid to Dal-Tile because (1) of the existence of the joint check agreement and (2) pursuant to its contract with Max, the debtor was entitled to payment for the work completed. *Id.*

D&R argues that because the case at bar does not involve a joint check agreement, it is distinguishable from *Buono*. *See* Appellee's Br. at 25. *Buono,* however, did not turn solely on the presence of the joint check agreement. The first reason provided by the *Buono* Court for its conclusion that the debtor had an interest in the payments made by Max to Dal-Tile was that pursuant to the original contract between Max and the debtor, the debtor was entitled to payment. *Id.* at 500.

Similarly, pursuant to the original contract between Cambridge and Debtor, Debtor had an interest in the funds paid to D&R by Cambridge. The documents submitted by D&R in support of its summary judgment indicate that Debtor was entitled to payment. Mr. Russell Schlatter, Financial Vice President of Cambridge Homes, stated in his affidavit that in December 1994, he wrote a letter to Debtor. (Doc. 18, ¶ 16). The letter to which he refers provides:

> *Cambridge . . . has amount due [Debtor] . . .* in the amount of approximately $275,000. This amount will be used to satisfy all supplies such as Hines Lumber and Amron Stairs as well as held as retainage for the $6,500,000 of [Debtor] contract work

> under warranty. *It is expected that claims by suppliers will total no more than $75,000 leaving $200,000 as retainage to cover warranty obligations....*
>
> . . .
> *It is agreeable that [Cambridge] assume obligation to pay D&R the estimated $200,000 warranty retainage for relief of like amount due [Debtor]....*
>
> /s/ Russell Schlatter.

(Doc. 15, Defendant's Exhibit 4) (emphasis added). In other words. D&R's documentary evidence that was allegedly in support of its motion for summary judgment actually harms its argument that Debtor had no interest in the funds paid by Cambridge to D&R. By Cambridge's own admission, it owed Debtor money, which demonstrates that Debtor had an interest in the funds paid by Cambridge to D&R. *See In re Crysen,* 902 F.2d 1098, 1101 (2d Cir. 1990) (property of the estate includes a debtor's accounts receivable).

D&R argues, however, that the distinction between an "independent obligation" on the part of Cambridge to pay D&R and a "right" to pay D&R is irrelevant. The difficulty with this argument is that the case relied upon by D&R in support of this argument, *In re Sun Belt Electrical Constructors, Inc.*, 56 B.R. 686 (Bankr. E.D. Cal. 1986), involved an explicit obligation, and not merely a right, to withhold payments from a debtor-subcontractor in favor of creditor-materialmen. Hence, *Sun Belt Electrical* does not even address the argument made by D&R.

In *Sun Belt Electrical,* the general contractor entered into a contract with a construction subcontractor. *Id.* at 687. During the course of the construction, the subcontractor purchased electrical materials from a materialman. *Id.* Pursuant to the contract between the general contractor and the subcontractor, the general contractor agreed to make payments for the construction work by checks jointly payable to both the subcontractor and materialman. *Id.* In return for this agreement. the materialman agreed not to pursue its lien rights. *Id.* The general contractor became indebted to the subcontractor for work performed prior to the subcontractor filing for bankruptcy. *Id.* at 688. In connection with the construction work, the subcontractor was indebted to the materialman for the electrical equipment. *Id.* Based on these facts, the *Sun Belt Electrical* Court held that the funds made jointly payable by the general contractor to the subcontractor and materialman were not part of the debtor-subcontractor's estate. *Id.* at 690.

Sun Belt Electrical falls in the same category of cases in which *In re Arnold, supra*--those cases in which the terms of the contract explicitly create an independent obligation on the part of the general contractor. The contract between the general contractor and the subcontractor in *Sun Belt Electrical* created an independent obligation on the part of the contractor to make its checks jointly payable to the subcontractor and the materialman. *Id.* at 687-88, 690. In this case, however, the original contract between Cambridge and Debtor did not create any such obligation on the part of Cambridge. Cambridge's contractual obligation was to pay Debtor, and Debtor alone.

The last argument that D&R makes in an attempt to persuade the Court that there was an independent obligation is that if this Court were to hold that paragraph 13(a) did not create obligation on the part of Cambridge to pay D&R. Cambridge would be subject to double liability. *See* Appellee's Br. at 28-30. Assuming that D&R even has standing to assert this argument, the Court is not persuaded. While the Court sympathizes with Cambridge's position, this argument is insufficient to create an independent obligation on its part. The point in time for Cambridge to sufficiently protect itself from the threat of double liability was when it entered into the contract with Debtor, and not within the 90-day preference period set forth in the Bankruptcy Code. Instead of creating a right to withhold payments from Debtor, Cambridge could have just as easily created an explicit obligation on its part to pay subcontractors and materialmen who remained unpaid by Debtor. The Court is in no position to question the business judgment of Cambridge and speculate why it chose not to create an explicit, independent obligation on its part to pay debtor subcontractors and materialmen. Whatever Cambridge's motive might have been, the fact remains that paragraph 13(a) creates only a right to withhold payment and not an obligation to pay creditor subcontractors and materialmen.

B. Earmarking Doctrine Issue.

In addition to arguing that Cambridge had an independent obligation to pay D&R, D&R also argues that the arrangement between itself and Cambridge falls under the judicially-created earmarking exception to the avoidance provisions. *See* Appellee's Br. at 20-23. Both parties agree that this case does not present circumstances that normally call for the invocation of the traditional ear-marking doctrine. Here, in contrast to the traditional earmarking case in which a third party lends money to a debtor for the specific purpose of paying a selected creditor, *see In re Bohlen Enterprises, Ltd.*, 859 F.2d 561, 567 (8th Cir. 1988), there was no loan from Cambridge to Debtor to pay D&R. Cambridge directly paid D&R.

Nevertheless, D&R argues that despite the absence of the traditional earmarking case, the earmarking doctrine should still apply. D&R cites *In re Network 90*, 126 B.R. 990 (N.D. Ill. 1991), for the proposition that the circumstances that normally attend a classic earmarking case need not be present for the earmarking doctrine to apply. In *Network 90*, the district court applied the earmarking doctrine even though the third party in that case did not lend money to the debtor, but instead, directly paid the debtor's creditors. *Id.* at 966. The *Network* Court stated that "what is crucial to the finding of earmarking in these circumstances is not the presence of a new creditor which loans the debtor funds for the purpose of reducing existing debt, but the debtor's lack of control over the funds received and forwarded to the existing creditor." *Id.*

In light of the Seventh Circuit's subsequent opinion in *In re Smith*, 966 F.2d 1527 (7th Cir.), *cert dismissed*, 506 U.S. 1030 (1992), however, *Network 90's* expansion of the earmarking doctrine appears to be incorrect. In *Smith*, the court of appeals stated unequivocally that the earmarking doctrine "is applicable *only where a third party lends money to the debtor* for the specific purpose of paying a selected creditor...." 966 F.2d at 1533 (emphasis added). This Court recognizes that the court of appeals was not faced with the issue in *Smith* of whether an expanded view of the earmarking doctrine is appropriate. Nevertheless, the unambiguous dictum in *Smith* indicates that the Seventh Circuit would reject the expanded view of the earmarking doctrine if faced with the issue.

Even if the Seventh Circuit were to adopt the more expanded view of the earmarking doctrine, D&R would still have to show that Debtor never exercised control over the funds at issue. *In re Hartley*, 825 F.2d 1067, 1070 (6th Cir. 1987) ("the [expanded earmarking doctrine] asks whether the debtor controlled the property to the extent that he owned it and thus the transfer diminished his estate"). D&R makes a strong argument that Debtor had no control over the funds at issue based on the language of paragraph 13(a). According to the plain language of paragraph 13(a), if the conditions precedent contained in that paragraph were present. Cambridge could have chosen to exercise its discretion to withhold payment from Debtor and pay Debtor's creditors directly. Hence, paragraph 13(a), on its face, supports D&R's argument that Debtor neither had control over the decision to pay D&R directly nor the payment of the funds on to D&R on March 20, 1995.

The bankruptcy court's findings of fact, however, indicate that in spite of the language of paragraph 13(a), Debtor did have control over the funds at issue. Again, this Court's attention is drawn to paragraph 9 of the lower court's findings of fact wherein the court stated that "Cambridge agreed to pay D&R for the outstanding invoices that remained unpaid by Debtor, and Debtor agreed to transfer its right to payment, under the contract with Cambridge to D&R." (Doc. 32, ¶ 9, at 3). The bankruptcy court continued by finding that "Debtor transferred to D&R its right to payment under its contract with Cambridge." (Doc. 32, ¶ 9, at 3)

One might argue, even though D&R does not, that the findings of fact in paragraphs 9 and 10 of the bankruptcy court's order are clearly erroneous. This argument, however, is not persuasive. The undisputed documents submitted by D&R in support of its motion for summary judgment fully support the bankruptcy court's finding that Debtor transferred its right to payment. In the November 24, 1994, letter from Debtor to Cambridge, Debtor "authorize[d] Cambridge ... to issue any checks for monies owed [Debtor] to Joe Denk, Denk & Roche Builders." (Doc. 15, Defendant's Exhibit 9). Cambridge responded by letter on December 15, 1994, in which Cambridge acknowledged that it owed Debtor approximately $275,000. The letter further stated that Cambridge would pay approximately $200,000 of the $275,000 directly to D&R, and that said amount would "be firmed up once there [was] an agreement in principal between [Cambridge, Debtor, and D&R].

The Court recognizes the inconsistencies between the plain language of paragraph 13(a) and the correspondence between Cambridge and Debtor. While the plain language of paragraph 13(a) would indicate that Cambridge had a unilateral right to withhold payment from Debtor if the conditions precedent in said paragraph were present the documentary evidence submitted by D&R in support of its summary judgment indicates that the two parties to the contract, Cambridge and Debtor, performed under said contract as if there was something other than a unilateral right on the part of Cambridge. Based on these documents, the Court is not left with a definite and firm conviction that the bankruptcy court's findings of fact in paragraphs 9 and 10 of its order are incorrect. *See Anderson v. City of Bessemer City*, 470 U. S. 564, 573 (1985)*; see also EEOC v. Sears, Roebuck & Co.*, 839 F.2d 302, 309 (7th Cir. 1988) (where two permissible conclusions can be drawn, the factfinder's choice cannot be clearly erroneous). Accordingly, if Debtor had a right to payment and transferred said right, D&R cannot logically argue that Debtor had no control over the funds at issue.[5]

Additionally, D&R's reliance on *Network 90* is misplaced. Despite the district court in that case holding that the earmarking doctrine applied, the court distinguished *In re Buono, supra,* without criticizing it. The Court stated:

> [I]n contrast to the expanded agreement in this case, the agreement under review in *Buono* was entered into during the 90-day preference period rather than before it... . Thus, the debtor in *Buono* still had control over the payments it would receive at the beginning of the preference period, and its surrender of control consequently resulted in a diminution of the estate. In this case, however, Network 90N had relinquished its interest in the payments well before the preference period began; accordingly, the transfer of those payments did not dissipate the estate.

126 B.R. at 995. Hence, the *Network 90* Court determined that a dispositive difference between the case before it and the *Buono* case was that in *Buono* the transfer of interest occurred within the 90-day preference period and that the debtor in that case had no control over the funds at issue. The debtor *in Network 90* had no control over the funds at issue in that case and the transfer occurred well before the 90-day preference period. *See In re Jones,* 161 B.R. 809, 814 (C.D. Ill. 1993) (harmonizing *Network*

[5] In its brief, D&R argues that the bankruptcy court's finding that Debtor transferred its right to payment to D&R does not actually mean what it says. See Appellant's Br. at 23 n.3. D&R states that Debtor's November 24, 1994, letter to Cambridge (Defendant's Exhibit 9) must be read in light of paragraph 13(a), which granted Cambridge the authority to withhold and redirect payment without Debtor's authority. Id. Assuming this is true, D&R fails to explain Cambridge's December 15, 1994, response in which it acknowledged that it was paying monies directly to D&R and other creditors which were owed to Debtor.

90 with Buono).

Accordingly, the Court rejects D&R's argument and holds that the ear-marking doctrine does not apply. First, the Court believes that based on the dictum in the *Smith* opinion, the Seventh Circuit would adopt the more traditional approach to the earmarking doctrine. Second, even if the Seventh Circuit were to adopt the more expanded view of the earmarking doctrine, the bankruptcy court's findings of fact refute D&R's argument that Debtor lacked any control over the funds at issue.

C. Constructive Trust Issue.

D&R also argues that there was a constructive trust between itself and Cambridge that obligated Cambridge to pay D&R. *See* Appellee's Brief at 27-30. Quoting the Sixth Circuit opinion *of Selby v. Ford Motor Co.,* 590 F.2d 642 (6th Cir. 1979), D&R argues:

> [C]ourts and legislatures have increasingly found that the parties have an independent legal duty arising from reasonable commercial expectations to see the proper application of construction funds. *In the absence of statute, courts have declared that construction funds in the hands of a contractor are held subject to a constructive equitable lien.* Even in the absence of a state builders trust statute, *federal bankruptcy* courts in a variety of situations have refused to apply the property, preference and statutory liens sections of the Bankruptcy Act to favor unsecured creditors over the equitable claims of subcontractors and materialmen to proceeds of a construction project in the hand of a bankrupt contractor.

Appellee's Br. at 28 (quoting *Selby,* 590 F.2d at 1566-67) (emphasis added).

Whether there is a constructive trust in this case is not dependent upon the law of the Sixth Circuit but the law of the State of Illinois. *See In re Yonikus,* 996 F.2d at 869 ("courts must look to state law to determine whether and to what extent the debtor has any legal or equitable interest in the property as of the commencement of the case"). The Court has not found, and D&R has not cited, any provision from the Illinois Compiled Statutes that creates a constructive trust. Additionally, this Court has not found any Illinois cases that would support the invocation of a constructive trust based on the findings of fact before the Court. Illinois common law does allow for the invocation of the constructive trust doctrine, but only in limited circumstances. *See Suttles v. Vogel,* 126 Ill. 2d 186, 533 N.E.2d 901 (1988). These limited circumstances are where actual or constructive fraud is present, where there is a fiduciary duty and a subsequent breach of that duty, or where duress, coercion, or mistake is present. *Id.* at 193, 533 N.E.2d at 904-05.

Because the bankruptcy court's holding was based solely on the effect of paragraph 13(a) of the contracts between Cambridge and Debtor, the bankruptcy court had no reason to make findings of fact regarding the existence or nonexistence of a constructive trust in this case. Accordingly, based on the limited record before the Court, the issue of whether there was a constructive trust in this case under Illinois common law is not ripe for review.

II. § 549 Analysis.

The question of whether the March 20, 1995, payments made by Cambridge to D&R constitute a post-petition transfer under § 549 necessarily turns on the issue of whether the funds were "property of the estate." For the reasons discussed in Part I of this opinion, the Court concludes that the March 20, 1995, payments were property of the estate. *See Bergier*, 496 U.S. at 58-59 & n.3 ("interest of the debtor in property," as used in § 547, is coextensive with the phrase "property of the estate," as used in § 549).

III. Contemporaneous Exchange For New Value Analysis.

The last argument made by D&R is that the payments received by D&R from Cambridge were not preferential transfers because there was a contemporaneous exchange for new value under 11 U.S.C. § 547(c)(1). *See* Appellee's Br. at 31-33. Section 547(c)(1) provides:

> (c) The trustee may not avoid under this section a transfer--
>
> (1) to the extent that such transfer was
>
> (A) intended by the debtor and creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
> (B) in fact a substantially contemporaneous exchange
> . . . .

The term "new value" is defined as:

> [M]oney 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 ... *but does not include an obligation substituted for an existing obligation.*

§ 547(a)(2) (emphasis added).

D&R argues that its forbearance of its lien rights resulted in Cambridge agreeing to relinquish its claim for indemnification, which amounted to a new value for Debtor. *See* Appellee's Br. at 32. D&R further argues that its assumption of the warranty obligations minimized Debtor's exposure for damages and claims, which also amounted to new value. *Id.*

It is very clear, at least in the Seventh Circuit, that a release from contractual obligations does not constitute "new value" under § 547. *See In re Energy Coop., Inc.,* 832 F.2d 997, 1003 (7th Cir. 1987). Accordingly, it is tenuous, at best, in light of *Energy Coop.* to argue that Debtor's release from its contractual obligations, and D&R's contemporaneous assumption thereof, constitute "new value." Furthermore, the bankruptcy cases cited by D&R in support of its "new value" argument have been explicitly rejected by the Eleventh Circuit Court of Appeals, *see In re Chase & Sanborn Corp.*, 904 F.2d 588 (11 th Cir. 1990), and the bankruptcy courts of the Northern District of Ohio and the Middle District of Tennessee, respectively. *See In re Hatfield Elec. Co.*, 91 B.R. 782, 785-86 (Bankr. N.D. Ohio 1988) and *In re H&S Transp. Co,* 80 B.R. 441, 447 (Bankr. M.D. Tenn. 1987), *rev'd on other grounds,* 90 B.R. 309 (M.D. Tenn. 1988). Nevertheless, because the issue was not addressed by the bankruptcy court and, therefore, no findings of fact were made regarding whether or not there was "new value" as defined by the Code, the Court does not reach the issue of whether D&R met its burden under § 547(c). *See* 11 U.S.C. § 547(g) (party against whom avoidance is sought has burden of proving nonavoidability under subsection (c)).

CONCLUSION

For the foregoing reasons, the order by the United States Bankruptcy Court for the Southern District of Illinois granting summary judgment in favor of Defendant-Appellee, Denk & Roche (Doc. 32) is **REVERSED** and the summary judgment motion of Plaintiff-Appellant, Donald Hoagland, is **DENIED.** This case is **REMANDED** back to the bankruptcy court for proceedings consistent with this order.

IT IS SO ORDERED.

DATED: January 9, 1998

/s/ James L. Foreman
DISTRICT JUDGE