UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF FLORIDA
ORLANDO DIVISION

In re	)	
	)	
XENERGA, INC.,	)	Case No. 6:09-bk-13954-KSJ
	)	
Debtor.	)	Chapter 7
	)	

FINDINGS OF FACT AND CONCLUSIONS OF LAW

The debtor, Xenerga, Inc., previously built plants that process biodiesel fuel. When building a plant for one of its customers, Coastal Biofuels, Inc. ("Coastal"), the debtor hired two subcontractors and suppliers, Ancon Construction, Inc., and Middlebury Electric, Inc. (together, the "Subcontractors"). The Subcontractors now object to a settlement reached between the Chapter 7 trustee, Marie Henkel, and Coastal regarding repayment of a prepetition loan, contending they have a superior claim to the monies. Because the settlement agreement is fair and equitable and because the Subcontractors have no superior claim, the Court overrules their objection and grants (again) the trustee's Motion for Approval of Compromise of Controversy.[1]

On January 11, 2010, the trustee filed a Motion for Turnover of Property of the Estate[2] asking Coastal to turnover $60,000 due to the debtor. On January 20, 2010, the Subcontractors objected to the motion for turnover,[3] arguing the debtor's estate has no interest in the loaned funds because the monies were intended to be used to pay each of their outstanding liens placed on Coastal's leasehold interest in the project property. In short, the Subcontractors argued either the loan funds were earmarked for payment of their outstanding construction liens or the Court should find the loan agreement created a constructive trust for their benefit. On March 30, 2010, the Court held a hearing on the trustee's turnover motion at which the trustee announced her intent to file a settlement agreement with Coastal.

[1] Doc. No. 25.
[2] Doc. No. 16.
[3] Doc. No. 19.

As promised, on April 16, 2010, the trustee filed a Motion for Approval and Notice of Compromise of Controversy with a negative notice legend giving parties 21 days to file a written objection.[4] The compromise requires Coastal to repay $60,000 to the trustee in three installments as follows: $15,000 on July 1, 2010 (which Coastal timely paid and the trustee is currently holding in trust pending the resolution of this dispute), $22,500 on June 1, 2011, and $22,500 on June 1, 2012. On May 12, 2010, the Court granted the trustee's motion for approval because no party had timely objected.[5]

Soon thereafter, on May 19, 2010, the Subcontractors filed a Motion to Vacate Order Granting Trustee's Motion for Approval and Notice of Compromise or in the Alternative Motion for Reconsideration.[6] On September 9, 2010, the Court heard argument on the Subcontractors' motion to vacate, at which their counsel explained his mistake in believing that his objection to the trustee's earlier motion for turnover was sufficient to establish their objection to the later settlement agreement. Because of this apparent confusion and to permit the parties to fully articulate any objection they have to the trustee's settlement, the Court vacated its prior order approving the settlement agreement[7] and set a final evidentiary hearing on the trustee's motion to approve the compromise for October 4, 2010.[8]

Based on the evidence and arguments presented at this hearing, the Court finds that the debtor was in the business of sourcing, configuring, and selling equipment, supplies, and services for biodiesel production facilities. On April 29, 2008, the debtor and Coastal entered into a Biodiesel Operator Agreement[9] whereby the debtor agreed to provide a package of equipment and services to construct and to operate a biodiesel production facility in Savannah, Georgia, at a total cost to Coastal of $550,000. In plain English, the debtor acted as the general contractor for

[4] Doc. No. 25.
[5] Doc. No. 33.
[6] Doc. No. 37.
[7] Doc. No. 48.
[8] In the interim, Ancon and Middlebury filed an Objection to Trustee's Motion for Approval and Notice of Compromise of Controversy (Doc. No. 46).
[9] Trustee's Ex. No. 1 (Doc. No. 52).

the project, and hired, among others, Ancon and Middlebury as subcontractors or suppliers to assist with certain aspects of constructing the production plant for Coastal. Xenerga began construction in spring 2008 and finished by May 2009. Per their agreement, Coastal paid Xenerga installment payments as follows: $100,000 in May 2008; $145,000 in May 2008; $245,000 in September 2008; and $60,000 in March 2009. Coastal thus paid an aggregate amount of $550,000 to Xenerga in full satisfaction of its payment obligations under the agreement.

The Subcontractors, on the other hand, performed work on the project for which they remain unpaid. On February 17, 2009, Middlebury filed a lien on Coastal's leasehold interest in the project property in the amount of $55,096.23.[10] Likewise, on February 18, 2009, Ancon filed a lien on the property in the amount of $40,292.[11] These liens, which exceed $95,000, remain unsatisfied and are the subject of ongoing state court litigation in Georgia.

In March and April 2009, Xenerga and Coastal addressed the Subcontractors' outstanding liens, albeit in a strange way. In March 2009, shortly after Coastal paid Xenerga the last remaining $60,000 under their agreement, Xenerga and Coastal executed a so-called "loan agreement" whereby Xenerga agreed to loan Coastal $60,000 with the apparent intention of having Coastal clear the Subcontractors' liens.[12] The agreement (which consists of four sentences) states "[t]he loan becomes due when the [Subcontractors'] liens have been cleared. Alternatively, the monies may be used to pay the [Subcontractors] directly, on behalf of Xenerga, who have placed liens on the plants."[13]

The parties' intent with regard to the "loan" is not entirely clear. The agreement itself and the testimony of the debtor's CEO, Jason Sayers, indicates the parties intended for Coastal to use the loan funds of $60,000 to pay off the Subcontractors' liens of over $95,000. Sayers

[10] Subcontractor's Ex. 4 (Doc. No. 51).
[11] Subcontractor's Ex. 3.
[12] Trustee's Ex. 2; Subcontractors' Ex. 5.
[13] Trustee's Ex. 2; Subcontractors' Ex. 5.

testified in open court and provided an affidavit stating that the sole purpose of the loan agreement was to satisfy or partially satisfy the Subcontractors' respective liens. But Coastal's President, John Mark Daniel Lofton, stated in his deposition testimony that he understood Xenerga was trying to raise additional investor funds that would be used to satisfy the outstanding liens on the project, such that the parties hoped the loan funds would not be needed to satisfy the Subcontractors' liens.[14] Moreover, the Subcontractors' objection describes the funds as a "refund of the final installment payment of $60,000.00" under the Biodiesel Operator Agreement. Also adding to the confusion is how the parties expected a $60,000 loan to pay $95,388.23 in liens.

Whatever their intentions, by April 6, 2009, Xenerga had wired $60,000 to Coastal.[15] But instead of using these funds to pay the Subcontractors, Coastal used all of the money to keep its business afloat in the aftermath of a catastrophic plant explosion in October 2009.[16] Clearly this was not the use of funds that Xenerga had in mind, and, under the terms of the loan agreement, Coastal no doubt still owes somebody $60,000, be it the Subcontractors or the trustee.[17]

On September 18, 2009, shortly before Coastal's plant exploded, Xenerga filed its voluntary petition for relief under Chapter 7 of the Bankruptcy Code.[18] The debtor's Schedule B of personal property lists a "Loan" described as:

> Loan to Coastal Biofuels, Inc. for payment of liens on real property for Coastal Biofuels to repay to Xenerga, Inc. or to pay lienors, Ancon Construction Co., Inc. and Middlebury Electric, Inc., directly – it is believed that Coastal Biofuels, Inc., Ancon Construction Co., Inc. and Middlebury Electric, Inc. have agreed for Coastal Biofuels, Inc. to pay them directly.

[14] Trustee's Ex. 13, p. 23, ¶¶ 22-24.
[15] Trustee's Ex. 3.
[16] Trustee's Ex. 13, p. 27, ¶¶ 7-8.
[17] Lofton testified that he knows he owes $60,000 to someone but that "to whom?" is a question "beyond his pay grade." Trustee's Ex. 13, p. 28, ¶¶1-2.
[18] All references to the Bankruptcy Code shall be to Title 11 of the United States Code.

On January 11, 2010, the trustee sought repayment of the loan from Coastal, regardless of whether the Subcontractors' liens first were satisfied. The trustee filed a motion for turnover of property of the estate under §§ 541 and 542(a) of the Bankruptcy Code, at the time believing Coastal held the loan funds in an escrow account. The trustee's assumption proved incorrect because by this time Coastal had spent all the money. Ideally, upon learning the money was no longer held in escrow, the trustee could have amended her motion to clarify that she was seeking repayment of an existing debt under § 542(b). In any event, this proved unnecessary because, within three months of the trustee's motion for turnover, Coastal voluntarily agreed to repay the loan. The Court construes the trustee's position, had she technically amended her motion, to be that the debtor and Coastal entered into a loan agreement that requires Coastal to repay $60,000, regardless of whether the Subcontractors' liens were released or not.

The Subcontractors argue, to the contrary, that satisfaction of their liens is a valid condition precedent to repayment of the loan to the debtor and that they accordingly have a superior right to the funds Coastal has agreed to repay. They contend any funds Coastal agrees to repay under the loan agreement are in essence earmarked for them. Alternatively, they request the Court find the $60,000 loan funds were held by Coastal in constructive trust. For these reasons, the Subcontractors object to the trustee's motion to approve the compromise between Coastal and the trustee.

Under Bankruptcy Rule 9019(a), a bankruptcy court may approve a compromise or settlement "on motion by the trustee and after a hearing on notice to creditors, the debtor and indenture trustee…." The court must determine whether the proposed compromise is "fair and equitable and in the best interests of the bankruptcy estate."[19] The Eleventh Circuit Court of Appeals has enunciated four factors bankruptcy courts should examine in making this determination: (1) the probability of success in litigation; (2) the likely difficulties in collection;

[19] *In re Gallagher*, 283 B.R. 342, 346 (Bankr. M.D. Fla. 2002).

(3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors and a proper deference to their reasonable view in the premises.[20] All four of these factors weigh in favor of the trustee.

As to the first factor, the trustee has demonstrated the probability of success in litigation, insofar as Coastal has agreed to repay the entire amount sought by the trustee, albeit over time. But even if Coastal had litigated the trustee's motion, the trustee likely would have prevailed because there is no question the debtor transferred $60,000 to Coastal with a promise by Coastal to repay the loan monies. The Subcontractors assert the trustee should have lost, arguing either the funds were earmarked for them or the Court should impose a constructive trust entitling them to the funds Coastal has agreed to repay. Neither of these arguments is persuasive.

The Subcontractors' earmarking argument, as best the Court can surmise, goes like this: Coastal was acting as a mere conduit to transfer monies to the Subcontractors and thus had no legal rights to the loan funds. Therefore, Coastal cannot use any funds to repay the debtor before first paying $60,000 to the Subcontractors. They cite no case law in support of this argument.

The classic earmarking doctrine is a defense to a trustee's avoidance action when a third party transfers funds to the debtor to be used to pay one or more of its creditors and the funds are so used.[21] In such circumstances, courts find the earmarked funds never become property of a debtor's estate because "a new creditor merely steps into the shoes of an old creditor."[22] Therefore, earmarked funds cannot be the subject of a trustee's preference or avoidance action.

Clearly the earmarking doctrine does not apply in this case. The debtor loaned money to Coastal to pay off the Subcontractors, and in theory, had the funds been used for that purpose, the debtor would have stepped into the Subcontractors' shoes as Coastal's creditor. Instead,

---

[20] *In re Justice Oaks II, Ltd.*, 898 F.2d 1544, 1549 (11th Cir. 1990); *In re Gallagher*, 283 B.R. 342, 346 (Bankr. M.D. Fla. 2002).

[21] *Tolz v. Barnett Bank of South Florida, N.A. (In re Safe-T-Brake of South Florida, Inc.)*, 162 B.R. 359, 363-64 (Bankr. S.D. Fla. 1993).

[22] *In re McDowell*, 258 B.R. 296, 300 (Bankr. M.D. Ga. 2001).

Coastal spent the loaned monies for its own business purposes and has yet to repay either the debtor or the Subcontractors.

The Subcontractors appear to have chosen elements of the earmarking doctrine to support their argument that Coastal has no obligation to repay the debtor. But neither the loan agreement nor Coastal's actions support this argument, and the Subcontractors have not cited to any case law in support of their position. The agreement clearly requires Coastal to pay Xenerga $60,000, to be repaid once the Subcontractors' liens are satisfied *one way or another*. That is, not necessarily with the loan funds. As Lofton testified, at the time the loan was made, Xenerga represented to Coastal that it anticipated being able to pay the Subcontractors with "new money."[23] The loan agreement contemplates this when it states "[t]he loan becomes due when the liens have been cleared." Coastal therefore was not just a conduit for payment to the Subcontractors, but it absolutely had legal rights to the $60,000 loan funds. Indeed, Coastal demonstrated its authority over the monies when it used the funds to pay its own operating expenses after the plant explosion. In sum, the Subcontractors' earmarking argument is simply not supported by the facts of this case or any legal authority.

Likewise, the Subcontractors' constructive trust argument fails because of one important fact: Coastal is no longer holding the loan funds. A court may impose a constructive trust to prevent a party from being unjustly enriched through abuse of confidence, duress, or fraud.[24] But a constructive trust may only be imposed where the trust *res* is "specific and identifiable property," or can be "clearly traced in assets of the defendant."[25] Here, the Court cannot find that Coastal held the loan funds in constructive trust for the Subcontractors because *there is no money being held in trust*. Lofton testified Coastal spent all $60,000 in the aftermath of its plant

[23] Trustee's Ex. 13, p. 28, ¶¶1-2.
[24] *Bank of America v. Bank of Salem*, No. 1D10-1424, 2010 WL 4723028 at *3 (Fla. App. 1 Dist. Nov. 22, 2010).
[25] *Id.* (quoting *Gersh v. Cofman*, 769 So.2d 407, 409 (Fla. 4th DCA 2000)). Although it is not entirely clear whether Florida or Georgia law applies to this controversy, the specific, identifiable *res* requirement is the same in both (indeed, all) states. *See, e.g.*, 76 Am. Jur. 2d Trusts § 175 (2010).

explosion (which is why Coastal agreed to repay the loan to the trustee in installments). Coastal simply is not holding the $60,000 loan funds.

For this reason the *Weben*[26] case relied on by the Subcontractors, in which a property owner *interpleaded funds* with the bankruptcy court overseeing a general contractor's bankruptcy case, is distinguishable and does not support their argument.[27] Although the *Weben* court imposed a constructive trust for the benefit of subcontractors, there was actual money interplead with the court that comprised the trust *res*. Here, Coastal no longer holds the $60,000 loan funds. The Court cannot belatedly impose a constructive trust for the Subcontractors' benefit.

Because the Court can neither impose a constructive trust nor find that the $60,000 loaned to Coastal was earmarked for the Subcontractors, the Court finds the trustee would likely prevail on her motion for turnover. The debtor clearly loaned the money to Coastal expecting to be repaid, and as noted above, the trustee *has* prevailed because Coastal has agreed to repay the loan in full. Although the Court sympathizes with the Subcontractors, who are both owed a considerable amount of money, they do not have a superior claim to the funds Coastal has agreed to repay to the trustee; they are general unsecured creditors of the debtor.

The second and third *Justice Oaks* factors—the difficulty in collection; the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it—also cut in favor of the trustee. Coastal is a Georgia-based company with no offices in Florida. Pursuing repayment from Coastal would be time consuming and expensive for the estate. Moreover, the fact that Coastal needs to repay the estate over three years demonstrates that Coastal is having financial difficulties and collectability of any judgment is a potential problem.

Finally, the fourth factor—the paramount interest of the creditors and a proper deference to their reasonable view in the premises—also supports the trustee's position. The trustee has

[26] *United Parcel Service, Inc., v. Weben Indus., Inc.*, 794 F.2d 1005 (5th Cir. 1986).
[27] Moreover, Coastal has not interpleaded funds; it has agreed to repay the loan to the Chapter 7 trustee.

reached an agreement that over the next two years will bring in $60,000 to the debtor's estate for payment to unsecured creditors on a pro-rata basis. The Subcontractors, of course, would like to cut in line and have their liens (mostly) paid off first. But they are not secured creditors of the debtor and they have no more right to the settlement funds than the debtor's other unsecured creditors. They should participate in the distribution as an equal to every other unsecured creditor.

In sum, the Court concludes the compromise between the trustee and Coastal is fair and equitable under the *Justice Oaks* factors. The Subcontractors have failed to raise a legitimate objection to the settlement agreement. Accordingly, the Court will overrule the Subcontractors' objection and again will grant the trustee's motion for approval of compromise of controversy.

A separate order consistent with these findings of fact and conclusions of law will be entered simultaneously.

DONE AND ORDERED in Orlando, Florida, on January 7, 2011.

KAREN S. JENNEMANN
United States Bankruptcy Judge

Copies provided to:

Debtor: Xenerga, Inc., 7075 Kingspointe Parkway, Suite 1, Orlando, FL 32819

Attorney for Debtor: Maureen A. Vitucci, Gray Robinson, PA, 301 E. Pine Street, Suite 1400, Orlando, FL 32802

Trustee: Marie E. Henkel, 3560 S. Magnolia Avenue, Orlando, FL 32806

Attorney for Trustee: Richard Blackstone Webber, II, Zimmerman Kiser & Sutcliffe PA, 315 E. Robinson Street, Suite 600, Orlando, FL 32801

Catherine Palumbo, Esquire, McCorkle & Johnson, LLP, 319 Tattnall Street, Savannah, GA 31401

United States Trustee, 135 W. Central Blvd., Suite 620, Orlando, FL 32801

Attorney for Creditors: Charles B. Jimerson, Esquire, 2124 Park Street, Jacksonville, FL 32204

All Creditors and Interested Parties