



Business Reorganization Committee ABI Committee News

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The Imposition of Constructive Trusts in Bankruptcy Proceedings

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Constructive trusts are creations of state law. However, some bankruptcy courts have exercised their equitable powers to impose constructive trusts on estate assets. Other bankruptcy courts have concluded that the notion of constructive trusts is at odds with the goals of the Bankruptcy Code. As set forth below, a party seeking imposition of a constructive trust must commence an adversary proceeding. The plaintiff has the burden of proof, and the standard is clear and convincing evidence. Courts evaluate several factors in determining whether a constructive trust can and should be imposed. Depending on applicable state law, these factors generally include some showing of wrongdoing and an ability to trace the funds upon which a constructive trust is sought to be imposed.

Bankruptcy Court's Authority to Impose a Constructive Trust

Although a bankruptcy court has broad equitable powers under §105(a) of the Bankruptcy Code, such powers are not unlimited.[1] "While the equitable powers emanating from §105(a) are quite important in the general bankruptcy scheme, and while such powers may encourage courts to be innovative, and even original, these equitable powers are not a license for a court to disregard the clear language and meaning of the bankruptcy statutes and rules." [2] Accordingly, it would be improper for a bankruptcy court to impose a constructive trust under the auspices of §105 without a direct connection to a specific Code section.[3] Indeed, some bankruptcy courts have refused to impose constructive trusts because "constructive trusts are

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anathema to the equities of bankruptcy.”[4]

Procedure For Seeking Imposition of a Constructive Trust

Adversary proceeding must be commenced prior to the imposition of a constructive trust because the relief sought is a “proceeding to recover money or property,” a proceeding to determine an “interest in property” or a proceeding to obtain “other equitable relief” pursuant to Bankruptcy Rule 7001(1), (2) or (7) respectively.[5] In the same vein, to the extent a constructive trust may be based on a finding of fraud, such allegations must be stated with particularity in accordance with Fed. R. Civ. P. 9(b), made applicable to adversary proceedings by Bankruptcy Rule 7009. Imposition of a constructive trust without these procedural safeguards would constitute reversible error.[6]

A party seeking to recover trust funds bears the burden of demonstrating its entitlement to such funds by clear and convincing proof.[7] Generally, in order for a constructive trust to be imposed, there must be “clear and convincing evidence not only of wrongdoing, but also of the circumstances that render it inequitable for the holder of the legal title to retain the beneficial interest.[8] In *Peninsula Methodist Homes*, the Court of Appeals for Maryland held that there was no clear and convincing evidence as to the character and form of a gift annuity agreement, and remanded the case for the purposes of determining whether facts existed that would warrant the imposition of a trust.[9] Also, courts have held that the party seeking imposition of a constructive trust must be able to trace the funds; co-mingled funds are not generally treated as trust funds.[10]

Factors Justifying Imposition of a Constructive Trust

In determining whether a trust should be imposed upon property within the bankruptcy estate, courts generally have looked to state law.[11] However, at least one court has suggested that federal law governs.[12]

State law varies with respect to the substantive elements that must be proven before imposing a constructive trust. For example, although Maryland law requires a showing that some wrongful act was committed, Virginia law permits imposition of a constructive trust if equity so requires, even if there has been no wrongful conduct.[13] A constructive trust may be imposed under Minnesota law “whenever the legal title to property is obtained through fraud, oppression, duress, undue influence, force, crime, or similar means, or by taking improper advantage of confidential or fiduciary relationship.”[14] Under Pennsylvania law, “courts [may] impose them where there is a finding that a party, against whom the trust is imposed, acquires property in a manner that creates an equitable duty in favor of the party seeking the constructive trust. Traditionally, constructive trusts have been imposed where a party acquires legal title to property by violating some express or implied duty owed to another.”[15] In *Brockway*,

the court noted that there are no required standards for the imposition of a constructive trust.[16]

The Restatement (First) of Restitution defines a constructive trust as follows: "Where a person holding title to property is subject to an equitable duty to convey it to another on the ground that he would be unjustly enriched if he were permitted to retain it, a constructive trust arises." [17]

In *Wimmer v. Wimmer*, the Court of Appeals of Maryland defined a constructive trust as follows:

A constructive trust is the remedy employed by a court of equity to convert the holder of legal title to property into a trust for one who in good conscience should reap the benefits of the possession of said property. The remedy is applied by operation of law where property has been acquired by fraud, misrepresentations, or other improper method, or where the circumstances render it inequitable for the party holding the title to retain it ... The purpose of the remedy is to prevent the unjust enrichment of the holder of the property.[18]

In any event, in determining whether to impose a constructive trust, a court should examine the circumstances surrounding the inception of the transaction, and not the effects of the subsequent event.[19] Further, a constructive trust should not be impressed cavalierly.[20]

Nonetheless, in the bankruptcy context, it has been held that a constructive trust should only be imposed where there has been some wrongdoing or breach of fiduciary duty. [21] Bankruptcy courts have imposed constructive trusts. For example, in *Claybrook v. Consolidated Foods Inc. (In re Bake-Line Group LLC)*, [22] a chapter 7 trustee filed a preference action against the transferee of funds the debtor paid it after the debtor realized the debtor erroneously received and deposited funds, which were intended for the transferee. In denying the relief requested by the trustee, the court held, that the debtor held the funds for the transferee/defendant in a constructive trust.[23] Accordingly, the debtor never had an interest in the funds, and those funds did not become part of the bankruptcy estate.[24]

Also, in *Old Republic Nat'l Title Ins. Co. v. Tyler (In re Dameron)*, [25] the court imposed a constructive trust over funds in debtors' bank accounts as of the petition date. In that case, the debtors conducted real estate settlements and wrote title insurance policies. [26] In the month before the petition date, debtors conducted several closings but failed

to fully comply with lenders' closing instructions and retained more than \$450,000 in loan proceeds, which should have been held in escrow.[27] Lenders filed an adversary proceeding seeking, the imposition of a constructive trust over the funds.[28] The court held that "the concept of constructive trust is not inherently incompatible with the fair treatment of creditors in bankruptcy."^[29] After analyzing Virginia law on constructive trusts,^[30] the court held that the "debtors could not have acquired an interest in the lenders' loan proceeds deposited in . . . [debtor's] account . . . [and the] funds held by a debtor as a depository of an escrow may be excluded from the bankruptcy estate . . . [unless] the claimant cannot trace the funds."^[31]

Tracing Funds

"[A] party claiming entitlement to a trust must be able to trace its assets into the fund or property that is the subject of the trust."^[32] In cases where the trust funds have been commingled with other funds, courts apply the lowest intermediate balance rule.^[33]

[P]ursuant to the lowest intermediate balance rule, if the amount on deposit in the commingled fund has at all times equaled or exceeded the amount of the trust, the trust's funds will be returned to their full amount. *Conversely, if the commingled fund has been depleted entirely, the trust is considered lost.* Finally, if the commingled fund has been reduced below the level of the trust fund but not depleted, the claimant is entitled to the lowest intermediate balance in the account. *In no case is the trust permitted to be replenished by deposits made subsequent to the lowest intermediate balance.*^[34]

In *In re Edison Brothers, Inc.*,^[35] the debtors' plan of reorganization, the debtors reserved (from an over-funded pension fund) the sum of \$5.7 million to pay potential tax liabilities; however, to the extent no taxes were due, the debtors were required to transfer the money to EBS Pension for distribution to general unsecured creditors.^[36] The plan of reorganization, however, did not require that the \$5.7 million be held in escrow or segregated in any manner.^[37] The debtors were later informed that no additional tax liability existed, and EBS Pension demanded the funds.^[38] Prior to the transfer of the funds, Edison Brothers filed a second bankruptcy proceeding.^[39] EBS Pension sued for imposition of a constructive trust for the \$5.7 million.^[40]

Edison Brothers had a cash management system pursuant to which cash was swept on a daily basis to pay off the secured lenders.^[41] Under their revolving credit agreement, Edison Brothers had sufficient availability to borrow the \$5.7 million at all relevant times

prior to the second filing.[42] The bankruptcy court held that under the lowest intermediate balance test (defined in the opinion as the "LIBT"):

[t]he effect of [the Debtors' cash management] system was that for some period each day the Debtors had no cash on hand. Thus, under the LIBT, the constructive trust funds were dissipated. The deposit of new funds into the Debtors' bank accounts (through cash receipts and through loans from the secured loan facility) does not re-create the constructive trust funds; instead, they are lost under the LIBT.[43]

Therefore, the bankruptcy court declined to impose a constructive trust on the \$5.7 million under the lowest intermediate balance test.[44]

Next, the bankruptcy court turned to the nexus test to determine whether the traceability requirement could be met under this rule. The bankruptcy court found that even under the nexus test, which only requires a nexus between the assets sought and the asserted trust fund, the funds could not be traced.[45] The bankruptcy court agreed with the debtors' argument that funds transferred to a third-party lender depleted the trust fund.[46] In addition, the bankruptcy court found that the ability to borrow funds that could have paid the claimant was an insufficient nexus to create a constructive trust. The bankruptcy court distinguished between funds held in a bank account and being able to draw on a line of credit, stating that "until the money is borrowed it is property of the secured lenders." [47] In conclusion, the bankruptcy court concluded that neither the LIBT nor the nexus test were met and therefore declined to impose a constructive trust on the \$5.7 million.[48]

It has also been held that the alleged trust assets must be traceable to a particular account as opposed to the debtor's assets or accounts generally.[49] In *Connecticut General*, there was no dispute that the lowest intermediate balance in the account into which the alleged trust funds were deposited was zero, but the plaintiff argued that all of the debtor's bank accounts should be considered as one fictional combined bank accounts because the debtor's financial statements listed "cash" as a single item.[50] We reject this argument, holding that "[t]he point of tracing is to follow the *particular* entrusted assets, not simply to identify *some* assets." [51]

Recent Constructive Trust Litigation in Bankruptcy Court

In *Mastercraft Interiors Ltd.*, Case No. 06-12769PM (Bankr. D. Md.), the court entered an order, *sua sponte*, to show cause why a constructive trust should not be imposed for the benefit of consumers who paid pre-petition deposits to the debtors toward the purchase of furniture.[52] The debtors, the debtors' secured lender and the official

committee of unsecured creditors all responded to the court's show cause order in opposition to the imposition of a constructive trust and raised some of the issues addressed in this article, including tracing issues and due process issues.[53] Ultimately, the court confirmed a liquidating plan without expressly resolving the show cause order. [54]

In *In re Pina*, [55] a creditor sought the imposition of a constructive trust based on a pre-petition state court order directing the debtor to convey her interest in property to the creditor.[56] The court denied the creditor's request.[57] In so holding, the court found that the creditor "failed to establish that it obtained a constructive trust . . . that arose before the commencement of the Debtor's case, and, even if it did . . . its rights must yield to those of the Trustee who as asserted his status as a bona fide purchaser of real property"[58] under 11 U.S.C. §544(a)(3).[59]

Conclusion

For some creditors, at first blush a constructive trust seems like a very advantageous remedy, even in bankruptcy, for purposes of wresting control of property away from a trustee or other creditors. However, some bankruptcy courts may refuse to impose a constructive trust under any circumstances. Most bankruptcy courts will require proof, by clear and convincing evidence, that a constructive trust should be imposed and will require tracing before imposing a constructive trust. Moreover, a constructive trust should not be imposed without the safeguards of an adversary proceeding. In the end, however, a constructive trust may be a viable option for creditors or other parties in interest in controlling property for the benefit of some creditors over others.

[1] See *In re Tate*, 253 B.R. 653, 667 (Bankr.W.D.N.C. 2000) (use of the term "provisions" in §105(a) rather than "purposes" in describing courts' power to carry out Bankruptcy Code suggests that exercise of §105 must be linked to specific section of Bankruptcy Code, and not merely to general objective of bankruptcy process); *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988) ("[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code"); *Official Committee of Equity Security Holders v. Mabey (A.H. Robbins)*, 832 F.2d 299 (4th Cir. 1987) (holding that bankruptcy court's exercise of equitable powers must be strictly confined within prescribed limits of Bankruptcy Act).

[2] *Official Committee of Equity Security Holders v. Mabey*, 832 F.2d at 302.

[3] *Id.*

[4] *In re Omegas Group Inc.*, 16 F.3d 1443, 1452 (6th Cir. 1994). See also *In re Stotler and Co.*, 144 B.R. 385, 388 (Bankr. N.D. Ill. 1992) (constructive trust is fundamentally at odds with general goals of Bankruptcy Code).

[5] See, e.g., *In re Haber Oil Co. Inc.*, 12 F.3d 426 (5th Cir. 1994) (reversing bankruptcy court's order imposing constructive trust in part because debtor did not receive all procedural protections guaranteed by adversary proceeding rules); *In re K Chemical Corp.*, 188 B.R. 89, 98 (Bankr. D. Conn. 1995) (action to impose constructive trust "must . . . be prosecuted as adversary proceeding, with its attendant procedural formalities and safeguards as afforded by Part VII of Federal Rules of Bankruptcy Procedure.").

[6] See *Haber Oil*, 12 F.3d at 439.

[7] See *Schuyler v. Littlefield*, 232 U.S. 707 (1914); See also *Brown v. Coleman*, 318 Md. 56, 566 A.2d 1091 (1989) (Maryland law requires beneficiary of trust to establish by clear evidence that his or her funds can be traced to account or property over which constructive trust is sought); *Crestar Bank v. Williams*, 250 Va. 198, 203 (Va. 1995) (where investors failed to prove by clear and convincing evidence tracing of funds to particular assets, no constructive trust was appropriate under Virginia law); *In re Twin B Auto Parts*, 271 B.R. 71, 84 (Bankr. E.D. Va. 2001) (standard for establishing constructive trust requires clear and convincing proof); *In re Whitacre Sunbelt, Inc.*, 211 B.R. 411, 418, (Bankr, N.D. Ca. 1997) (party asserting constructive trust has burden of proof).

[8] *Peninsula Methodist Homes & Hospitals, Inc. v. Cropper*, 261 A.2d 787, 793 (Md. 1970).

[9] *Id.*

[10] *In re Whitacre Sunbelt, Inc.*, 211 B.R. at 418.

[11] See *In re Dameron*, 155 F.3d 718, 722 (4th Cir. 1998) (examining Virginia law to determine whether trust over property of estate should be established); *In re Greenbelt Road Second Limited Partnership*, 1994 WL 592766 (4th Cir. 1994) (unpublished opinion) (examining Maryland law to determine whether the appellants were entitled to a constructive trust); *Haley, Chisholm & Morris, Inc. v. Parrish*, 127 B.R. 366, 369 (W.D. Va. 1991) (reviewing Virginia law); *Connecticut General Life Ins. Co. v. Universal Ins. Co.*, 838 F.2d 612, 618-19 (1st Cir. 1988) (whether there is a trust relationship is a question of state law); *In re Whitacre Sunbelt, Inc.* 211 B.R. at 418 (examining Georgia constructive trust statute).

[12] *EBS Pension L.L.C. v. Edison Brothers Stores Inc. (In re Edison Brothers Inc.)*, 268

B.R. 409 (Bankr. D. Del. 2001) (federal law governs determination of whether constructive trust exists) (citing *Official Committee of Unsecured Creditors of Columbia Gas Transmission Corp. v. Columbia Gas Sys.*, 997 F.2d 1039, 1058 (3d Cir. 1993)).

[13] *Wimmer*, 287 Md. at 668; *In re Twin B Auto Parts, Inc.*, 271 B.R. at 84; *Crestar Bank v. Williams*, 250 Va. at 204.

[14] *Ferris, Baker Watts, Inc. v. Stephenson (In re MJK Clearing, Inc.)*, 286 B.R. 109, 126 (Bankr. D. Minn. 2002), quoting *Bly v. Gensmer*, 386 N.W.2d 767, 769 (Minn. App. 1986).

[15] *Brockway Pressed Metals Inc. v. Eynon Associates, Inc. (In re Brockway Pressed Metals Inc.)*, 363 B.R. 431, 454 (Bankr. W.D. Pa. 2007).

[16] *Id.*

[17] Restatement (Second of Restitution § 160 (1937); See also 5 Collier on bankruptcy, ¶541.11[3], 541-65 (15th ed. Rev 2003).

[18] 414 A.2d 1254, 1258 (1980).

[19] *Mayor of Annapolis v. West Annapolis Fire & Improvement Co.*, 288 A.2d 151, 155 (Md. 1972) (denying city's argument that constructive trust was established); See *In re Greenbelt Road Second Limited Partnership*, 39 F.3d 1176 (4th Cir. 1994) (unpublished opinion) (upholding bankruptcy court's holding under Maryland law in declining to impose constructive trust with respect to earnest money that should have been, but was not, placed in escrow by debtor).

[20] *In re Omegas Group Inc.*, 16 F.3d at 1451 (citing *In re Behring Int'l Inc.*, 61 B.R. 896, 902 (Bankr. N.D. Tex. 1986). See also *In re Greenbelt Road Second Limited Partnership*, 1994 WL 592766 at * 3 (affirming denial of imposition of constructive trust over assets of bankruptcy estate where funds were commingled with debtor's funds); *In re Dameron*, 206 B.R. 394, 400 (Bankr. E.D. Va. 1997) (internal quotation omitted), *aff'd*, 155 F.3d 718 (4th Cir. 1998).

[21] See *Haley, Chisholm & Morris Inc.*, 127 B.R. at 370.

[22] 359 B.R. 566 (Bankr. D. Del. 2007)

[23] *Id.* at 571-72.

[24] *Id.* at 575.

[25] 206 B.R. 394 (Bankr. E.D. Va. 1997), *aff'd In re Dameron*, 155 F.3d at 718.

[26] *Id.* at 395.

[27] *Id.* at 397.

[28] *Id.*

[29] *Id.* at 400.

[30] In Virginia, constructive trusts are trusts that, independently of the intention of the parties, the law creates under certain circumstances in order to prevent fraud or injustice that would otherwise ensue. These trusts are not based upon the presumed intention of the party. On the contrary, they exist contrary to intention. They are trusts that are forced upon the conscience of the party by operation of law. *Id.* at 401.

[31] *Id.* at 402.

[32] *In re Dameron*, 155 F.3d at 723. See also *In re Twin B Auto Parts, Inc.*, 271 B.R. at 85 (recognizing that many constructive trusts fall prey to tracing requirement, in which the proponent must be able to "distinctly trace" trust property); *Haley, Chisholm*, 127 B.R. at 370 (trust beneficiary must be able to identify claimed funds "with high degree of specificity"); *In re Whitacre Sunbelt, Inc.*, 211 B.R. 411, 418 (Bankr. N.D. Ga. 1997) (constructive trust can only be imposed where "the plaintiff's funds are themselves located or traced into other funds or property").

[33] See *Schuyler v. Littlefield*, 232 U.S. at 710; *In re Dameron*, 155 F.3d at 723-24; *Connecticut General*, 838 F.2d at 619.

[34] *In re Dameron*, 155 F.3d at 724 (citations omitted) (emphasis added). Certain courts have also applied a "nexus" rule, which requires a nexus between the assets sought and the asserted trust. See, e.g., *Begier v. IRS*, 496 U.S. 53, 65 (1990) (finding that nexus test met where debtor voluntarily paid from commingled funds its trust fund tax obligation to the IRS); *In re Edison Brothers Inc.*, 268 B.R. at 414-15 (finding that no sufficient nexus established where debtors did not designate account funds as funds subject to asserted trust).

[35] 268 B.R. at 409.

[36] *Id.* at 411.

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] *In re Edison Brothers Inc.*, 268 B.R. at 411.

[41] *Id.*

[42] *Id.*

[43] *Id.* at 414

[44] *Id.* at 414.

[45] *In re Edison Brothers Inc.*, 268 B.R. at 414-15

[46] *Id.*

[47] *Id.* at 415.

[48] *Id.*

[49] *Connecticut General Life Ins. Co. v. Universal Ins. Co.*, 838 F.2d 612, 619-20 (1st Cir. 1988).

[50] *Id.* at 619.

[51] *Id.* at 620.

[52] Docket No. 155 (June 2, 2006).

[53] Docket Nos. 226, 228, 241.

[54] Docket No. 504 (April 3, 2007).

[55] 363 B.R. 314 (Bankr. D.Mass. 2007).

[56] *Id.* at 318.

[57] *Id.* at 322-31.

[58] *Id.* at 325.

[59] Pursuant to 11 U.S.C. §544(a)(3), the trustee may avoid any transfer of property of the debtor that is voidable by "a bona fide purchaser of real property . . . from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists." The state court order was not recorded as a *lis pendens* prior to the bankruptcy filing. *Id.* at 330. The court stated that if the order had been recorded, the trustee "would be unable to prevail as a hypothetical bona fide purchaser without notice." *Pina*, 363 B.R. at 330.