

Beware The Constructive Trust Claim

Law360, New York (October 13, 2010) -- Faced with the prospect of little recovery at some distant point in the future, larger unsecured creditors are using the remedy of a constructive trust to target specific property and to attempt to obtain a full recovery superior to all other claimants, including senior secured creditors.

Even if lacking in merit, the mere assertion of a constructive trust claim may prove to be an impediment in getting past an objection to plan confirmation based on the demand that the unresolved constructive trust claim be separately classified. The ultimate resolution of the claimant's entitlement to a constructive trust remedy, including the procedure to attack it, depends on the circuit in which the bankruptcy case is pending.

The Basic Law as to the Remedy of a Constructive Trust

"A constructive trust is an involuntary equitable trust created as a remedy to compel the transfer of property from the person wrongfully holding it to the rightful owner." *In re Real Estate Associates Ltd. Partnership Litig.*, 223 F. Supp. 2d 1109, 1139 (C.D. Cal. 2002).

"The imposition of a constructive trust requires: (1) the existence of res (property or some interest in property); (2) the right of the complaining party to that res; and (3) some wrongful acquisition or detention of the res by another party who is not entitled to it." See *Burlesci v. Petersen*, 68 Cal. App. 4th 1062, 1069 (1998).

The remedy of a constructive trust should only arise where the commission of tort is alleged or where the involuntary trustee is in possession of property allegedly owned by the claimant. However, it is commonplace for claimants to use facts which give rise to a contract claim to also allege tort liability — such as the allegation that an unpaid loan was procured through the misrepresentations of the borrower.

The claimant then seeks the recovery of specific property or a specific "res." To prove the existence of a specific "res", the claimant must be able to trace the alleged wrongfully obtained proceeds to specific property, which then raises issues of fact making an early disposition difficult.

In bankruptcy cases, "strict tracing" is generally required. For example, under Ninth Circuit law, a claimant seeking to recover specific assets from a debtor "bears the burden of tracing the alleged trust property 'specifically and directly' back to the illegal transfers giving rise to the trust. If [the creditor]

fails to trace the funds, [the court] must presume that the funds constitute ‘an interest of the debtor in property.’ See *Taylor Assocs. v. Diamant (In re Advent Mgmt. Corp.)*, 104 F.3d 293, 296 (9th Cir. 1997).

“Commingling trust funds with personal funds generally renders the trust unenforceable against the commingled funds or property acquired from the commingled funds.” *Bank of Alex Brown v. Goldberg (In re Goldberg)*, 158 B.R. 188, 195-96 (Bankr. E.D. Cal. 1993) (“California law as well as bankruptcy law requires that where a constructive trust is sought to be imposed against property of an insolvent debtor, strict tracing is required.”).

Because of the tracing requirement, a constructive trust claim can not be used as a substitute for a writ of attachment to, in effect, “secure” a general unsecured damage claim for breach of contract. See *Great-West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204, 205 (2002) (plaintiff “generally must seek not to impose personal liability on the defendant, but to restore the plaintiff’s particular funds or property in the defendant’s possession.”).

If allowed, the constructive trust claimant will of course obtain a remedy superior to all other claimants in the case since the entire trust res will be excluded from the property of the estate. Therefore, given the policies on which the Bankruptcy Code is based, and the impact it has as to all other claimants, the remedy of a constructive trust is allowed very sparingly.

Bankruptcy courts generally “act very cautiously in exercising such a relatively undefined equitable power in favor of one group of potential creditors at the expense of other creditors, for ratable distribution among all creditors is one of the strongest policies behind bankruptcy laws.” *Torres v. Eastlick (In re N. Am. Coin & Currency, Ltd.)*, 767 F.2d 1573, 1575 (9th Cir. 1985)(and cases cited therein holding policy behind bankruptcy code may override equitable remedies under state law).

Nevertheless, the assertion of a constructive trust remedy is occurring with more frequency if for no other reason to obtain a superior bargaining position.

In disposing of a constructive trust claim, the key issue is whether the so called “Strong Arm Powers” of the trustee under Section 544 may be used to avoid the constructive trust claim. The resolution of this issue turns on the determination of when the constructive trust came into existence. The metaphysics of determining the time when the trust came into being varies depending on the venue of the bankruptcy case.

The Third, Fifth and Eleventh Circuits’ Application of Section 541(d) vs. Section 544

In the Third, Fifth and Eleventh Circuits, Section 544 provides little help in defeating a constructive trust claim as to personal property.

For example, in *In re SHC Inc.*, 329 B.R. 438 (Bankr. D. Del. 2005), a year before the debtors’ bankruptcy filing, the debtors and an investor “Sierra” entered into a Stock Purchase Agreement in which Sierra was to pay all tax liability and indemnify the debtors for certain costs. Sierra established an escrow account with sufficient funds to meet its obligations and funds not used were to be returned to Sierra. The state of Massachusetts then assessed the debtors with a \$3.3 million tax claim. Although disputed, Massachusetts law required that the tax assessment be paid before it could be contested.

Prepetition, Sierra and the debtors agreed that funds in the escrow would be transferred to the debtors and then used to pay the tax claim, but that any refund received after contesting the tax claim would be returned to Sierra. After the debtors’ bankruptcy filing, the bankruptcy court entered a cash collateral

order granting the debtors' secured lenders replacement liens on all estate property, including after-acquired property.

Post-petition, the debtors reached a settlement with Massachusetts which resulted in approximately a \$2 million tax refund. After the secured lenders claimed a security interest in the proceeds of the refund, Sierra filed a complaint seeking turnover of the tax refund.

The lenders argued that section 544(a)(1) rendered any constructive trust as to the tax refund in favor of Sierra avoidable and, therefore, the tax refund constituted property of the estate subject to the lenders' post-petition replacement liens. Sierra argued that the estate may not avoid Sierra's constructive trust claim because the constructive trust was imposed by law prepetition and the tax payment and the refund never became property of the estate. *Id.* at 448.

In ruling on the effect of section 544 on a constructive trust claim, Judge Walrath wrote that "[c]ourts disagree whether section 544 may be used to avoid a constructive trust on personal property" and in surveying the law, noted that the law in the Ninth and Seventh Circuits differ from the Third, Fifth and Eleventh Circuits. *Id.* The Third Circuit looks to Section 541(d), which provides that property in which the debtor holds only legal, not equitable, title is not property of the estate.

Based thereon, Judge Walrath ruled "[h]owever, the law in this Circuit is clear ... Section 541(d)'s limitation on the scope of the bankruptcy estate prevails over the trustee's strong-arm powers under section 544 of the Code." *Id.* at 448. "While the status of a hypothetical lien creditor as of the petition date may create a lien in real property, it does not automatically create a lien in personal property." *Id.* at 448-49.

Therefore, in the Third, Fifth and Seventh Circuits Section 541(d) does not apply to a constructive trust claim against personal property, the trust comes into being when the wrong occurred and the trust res does not become property of the estate.

The Ninth and Seventh Circuits' Requirement of Prepetition Perfection

In contrast, in the Ninth and Seventh Circuits even if a constructive trust remedy may be available under state law, the specified target property "is not automatically excluded from the bankruptcy estate." See *In re Commercial Money Ctr.*, 392 B.R. at 831.

The Ninth Circuit does not distinguish between personal and real property and, instead, looks to see if the constructive trust remedy was "perfected" prepetition. Unless the right to a constructive trust is established or "perfected" by an order of a non-bankruptcy court prepetition, the specific res will not become property of the estate.

The Ninth Circuit cases reason that because "it is a remedy, a constructive trust cannot affect rights in the res until it is imposed." *Taylor Assocs. v. Diamant (In re Advent Mgmt. Corp.)*, 178 B.R. 480, 488 (9th Cir. BAP 1995)(trustee's § 544 powers trumped those of creditor who failed to perfect a lien or other security interest (including constructive trust) in the debtor's property outside of the preference period).

If not imposed prepetition by an order or judgment based on state law "then the right to [a constructive trust] remedy remains inchoate." See *In re Commercial Money Ctr.*, 392 B.R. at 831(citing *Elliot v. Frontier Props. (In re Lewis W. Shurtleff Inc.)*, 778 F.2d 1416, 1419 (9th Cir. 1985)). The "unperfected" constructive trust claim may then be avoided by the "Strong Arm Powers" of the trustee under Section 544.

Limitations on Attacking Improper Remedies — Whittlestone Inc. v. Handi-Craft Co

Although it is more difficult to obtain a constructive trust remedy in a bankruptcy case in the Ninth Circuit, it is also more difficult to dispose of the claim at an early stage. Given the nature of the relief sought, disposition of a constructive trust claim may be required to structure classes in a plan of reorganization or respond to an objection to confirmation.

Where an adversary proceeding to determine the claimant's rights is still pending, the constructive trust claimant will demand that his claim be placed in its own class and that the full amount of his pending claim be reserved. The claimant will also likely object to the determination of his entitlement to the constructive trust remedy in the confirmation process instead of within the adversary proceeding.

Typically, an adversary proceeding asserting a meritless constructive trust remedy would be met with a motion to strike under Rule 12(f). However, in a case of first impression, the Ninth Circuit has ruled that a Rule 12(f) motion may not be used to "strike a claim for damages." *Whittlestone Inc. v. Handi-Craft Co.*, 2010 WL 3222417, at *1 (9th Cir. Aug. 17, 2010).

The Ninth Circuit based its decision in part of the different standard of review applied to a ruling on a motion to dismiss under Rule 12(b)(6) as compared to a motion to strike under Rule 12(f). Motions under Rule 12(f) are reviewed for "abuse of discretion" whereas motions to dismiss are reviewed de novo. *Id.* at *4 n.2.

Whittlestone did note that alternatives to Rule 12(f) existed, such as a motion to dismiss under Rule 12(b)(6) or a motion under Rule 56. However, the Whittlestone court provided little guidance as to the proper manner in which to quickly deal with an improper remedy.

In practice, courts may be reluctant to permit a motion under Rule 12(b)(6) to be used to dismiss (even with leave to amend) the entirety of an otherwise well-pled claim because the remedy alone is improper. Rule 56 may be the only real alternative. See *FDIC v. Kipperman* (In re Commercial Money Ctr.), 392 B.R. at 832 (using rule 56 to determine if any issue of fact existed as to pre petition perfection of a security interest).

Nevertheless, where a large constructive trust claim is asserted, the estate may have to aggressively pursue its disposition early in the case to insure it will not interfere with plan confirmation.

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[1] The concept of a trust "res" and the necessity of tracing go hand in hand. "[A] trust will not be created by judicial decree when there is no property upon which the trust can be impressed [and], when 'the subject matter of the trust was money, the plaintiff's right to an adjudication of ownership depends upon his ability to identify the money as a particular fund or to trace it into specific property.'" *Corely v. Hennessy*, 58 Cal. App. 2d 883 (1943)(emphasis added); see also Restatement 3d Restitution § 55, comments at (g) ("A claimant who is entitled to restitution, but who cannot identify such property in the hands of the defendant, is not entitled to the remedy of a constructive trust.").

[2] See also *Jobin v. Youth Benefits Unlimited (In re M&L Business Mach. Co.)*, 59 F.3d 1078, 1082 (10th Cir. 1995) (“absent direct identification of the defrauded funds, it is to the detriment of all other similarly situated creditors to favor one defrauded party over another.”).

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