The Transactional Lawyer

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GONZAGA UNIVERSITY SCHOOL OF LAW

Beware of Constructive Trusts When Establishing the Borrowing Base

Stephen L. Sepinuck

Most commercial lenders that lend on a secured basis are well aware of the fact that some borrowers might be deemed by statute to hold some of their assets in trust for someone else. This is particularly likely for a retailer, who might be in receipt of:

- sales or cigarette taxes;[1]
- proceeds of sales of lottery tickets;[2]
- proceeds of sales of stored value cards;[3] or
- fine art held on consignment, or its proceeds.[4]

Similarly, the assets of a buyer of produce – not merely the produce purchased, but virtually all the buyer's assets – might be impressed with a statutory trust for the benefit of the unpaid produce seller.[5]

However, these examples are merely the tip of the iceberg, and cataloguing all the potentially applicable statutory trusts would undoubtedly be a titanic task.[6] Accordingly, lenders and their counsel must be on constant lookout for them. If some of a borrower's assets might be subject to a statutory trust, the lender should exclude those assets from the borrowing base, lest it extend credit in reliance on assets to which its security interest does not and cannot attach.[7]

The same issue can arise even in the absence of a statute that imposes a trust. Under traditional principles of law and equity, a constructive trust can be imposed when the debtor receives funds or other assets for the purpose of or with the expectation that those funds or assets will be forwarded to another. Common scenarios include:

- Funds provided by customers to a payroll processor, utility processor, or freight forwarder, for distribution to the customer's creditors;[8] and
- Accounts or receipts of a contractor that are supposed to be used in part to pay suppliers or subcontractors.[9]

In such a case, a transactional lawyer representing a prospective lender to someone with nominal ownership of these assets should carefully consider two related questions: (i) whether one or more persons will be entitled to have the assets imbued with a constructive trust in their favor; and (ii) if so, who would be entitled to priority – the beneficiaries of the constructive trust or the debtor's secured party?

Imposition of a Constructive Trust

The law regarding constructive trusts is somewhat vague, not entirely consistent, and hence difficult to predict. The most critical factors appear to be:

- whether the funds or other assets to be imbued with the constructive trust are, or are required to be, segregated from other funds or used for a specified purpose – a requirement that assets or funds be segregated or used for a specified purpose favors imposition of a constructive trust;[10]
- whether the putative trustee is obligated to pay interest on the funds – a requirement of interest is a hallmark of a debtor-creditor relationship, not a fiduciary relationship;[11] and
- whether the putative trustee is liable to the putative beneficiaries even if the putative trustee does not collect from a third party – such a requirement also implies a debtor-creditor relationship.[12]

However, none of these factors is conclusive. While courts frequently state that the first factor is the most important, they just as frequently disregard the absence of

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segregation, particularly if the funds would be held for numerous claimants and segregation for each would be impractical.[13]

It is worth noting, however, that none of the common scenarios mentioned above seems to fall within the grounds for a constructive trust under the Restatement (Third) of Restitution and Unjust Enrichment. The Restatement regards a constructive trust as a remedial device available whenever anyone was unjustly enriched by the acquisition of identifiable property at the claimant's expense.[14] However, the Restatement does not contain a general rule indicating that a person who receives funds or other assets for the purpose of forwarding those funds or assets to another has been unjustly enriched.[15] In other words, a constructive trust is available as a remedy in restitution for unjust enrichment, but these scenarios arguably do not give rise to unjust enrichment. Contracting parties are free to structure their relationship as they see fit and are presumed to understand the risks associated therewith. Perhaps that is why some courts place great weight on the language of the agreements in these cases. Absent evidence of an express trust, they are reticent to impose a constructive trust.[16]

Secured Lender's Defenses

Even if a constructive trust is imposed, that does not resolve the question of whether a security interest can attach to the trust res. In general, as long as a secured party acts without notice of the facts giving rise to the restitution claim, its security interest will attach and defeat the rights of the party seeking a constructive trust to support or enforce a restitution claim.[17]

When, however, the secured party has notice of the restitution claim, the secured party takes subject to the constructive trust.[18] This limitation could be problematic for the secured party in each of the common scenarios mentioned above because such a claim would arise in the normal operation of the debtor's business. Thus, even though a lender taking a security interest in the borrower's assets might not have notice of a particular restitution claim, a lender who was aware of how the borrower does business might be deemed to be on notice of any such claim flowing out of the borrower's regular operations, even if that claim arose after the creation of the security interest.[19] The security interest, if it attached at all, would therefore be subordinate to the constructive trust claim unless the constructive trust claimant knew of and consented to the grant of the security interest.[20]

Advice

The moral of this discussion depends on whom the transactional lawyer represents. Those representing a client that transfers funds or other assets with the expectation that the transferee will forward those funds or assets to a third party, should insist on documentation creating an express trust. Those that represent a secured lender to such a transferee should not only examine the transferee's agreements with its customers for evidence of an express trust, but carefully assess the risk that a constructive trust might be imposed.

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Notes

1. *See, e.g.,* Insurance Co. of the State of Penn. v. HSBC Bank of USA, 829 N.Y.S.2d 511 (N.Y. App. Div. 2007) (secured party with blanket lien who seized all of the assets of the debtor, a cigarette wholesaler, had to account to the state's subrogee for the commingled but traceable tax proceeds of cigarette sales because no security interest could attach to such funds), *rev'd on other grounds*, 882 N.E.2d 381 (N.Y. 2008).

2. Ga. Code § 50-27-21(a); Tenn. Code § 4-51-120. *See also* In re Cooper, 2010 WL 2265658 (Bankr. E.D. Tenn. 2010). *But cf.* In re M.W. Sewall & Co., 431 B.R. 526 (Bankr. D. Me. 2010) (proceeds of instant lottery tickets were not held in trust for the state and therefore were property of the seller's bankruptcy estate; the fact that the state had the right to and did regularly sweep the seller's deposit account to collect the amounts owed from sales of lottery tickets amounted only to bargained-for collection rights, it did not transform the deposit account, or any part of it, into a trust res).

3. In re Alco Stores, Inc., 536 B.R. 383 (Bankr. N.D. Tex. 2015) (state money transmitter statutes create a floating trust or lien on a retailer's assets in favor of the distributor of stored value cards, but only on assets commingled with the proceeds of such cards, not on all of the retailer's general assets).

4. While Article 9 applies to many consignment transactions, *see* U.C.C. §§ 9-102(a)(20), 9-109(a)(4), and, when it does, treats the artwork and its proceeds as property of the retailer, *see* U.C.C. § 9-319(a), some states have statutes that exempt a consignment of fine art from Article 9 and treat it instead as a bailment, with both the consigned property and its proceeds held in trust for the consignor. *See, e.g.*, Cal. Civ. Code §§ 1738.5 – 1738.9; Mont. Code §§ 22-2-501 – 22-2-505.

5. *See* Perishable Agricultural Commodities Act, 7 U.S.C. § 499a – 499s.

6. *See* In re Arctic Express, Inc., 636 F.3d 781 (6th Cir. 2011). In that case, owner-operators of trucking equipment, who had obtained a judgment against a lessee-carrier, brought a class action against the carrier's secured lender to enforce payment of the judgment. They argued – successfully – that their escrowed deposits for maintenance of the trucks, made pursuant to their lease agreements, were imbued with a statutory trust by 49 C.F.R. § 376.12(k). Because of that, the lender's sweep of the deposit accounts containing those funds – even though not segregated – violated the owner-operators' rights.

7. The issue is also relevant to the drafting of a commercial lease if the amount of rent will be based on gross sales. *See* Hartig Drug Co. v. Hartig, 602 N.W.2d 794 (Iowa 1999) (tenant's gross sales, for the purposes of calculating rent, did not include total amount the tenant's customers paid for lottery tickets and postage stamps, only the amount the tenant received from the state or U.S Postal Service as a result of those transactions).

8. *Compare* Lonely Maiden Productions, LLC v. Goldentree Asset Management, LP, 135 Cal. Rptr. 3d 69 (Cal. Ct. App. 2011) (no constructive trust for funds paid by clients to a payroll processor); *with* Slobodian v. United States, 533 B.R. 126 (Bankr. M.D. Pa. 2015) (funds that a payroll servicer received from its customers to pay their employees; withholding taxes were held in trust for the IRS). *See also* Variety Wholesalers, Inc. v. Salem Logistics Traffic Services, LLC, 723 S.E.2d 744 (N.C. 2012) (whether a security interest granted by freight bill processor attached to the funds provided to the processor by its clients was a question of fact not appropriate for summary judgment).

9. In some states, a statutory trust is imposed on such funds. *See* Mich. Comp. Laws § 570.151; Perini/Tompkins Joint Venture v. Comerica Bank, 2014 WL 1028945 (E.D. Mich. 2014) (because, pursuant to the Michigan Builder's Trust Fund Act, a contractor holds building contract fund in trust for unpaid subcontractors and suppliers, a lender's security cannot attach to those funds).

10. *See, e.g.,* Lonely Maiden Productions, 135 Cal. Rptr. 3d 69 (a security interest granted by payroll processor attached to funds provided to the processor by its clients because even though the processor's contracts with its clients required the processor to pay the clients' employees, the contracts disclaimed an agency relationship and did not require the processor to make the payments out of the funds provided).

11. *See, e.g.,* In re Columbia Gas Systems Inc., 997 F.2d 1039, 1060 (3d Cir. 1993).

12. *See, e.g.*, In re Coupon Clearing Service, Inc., 113 F.3d 1091, 1101-02 (9th Cir. 1997) (security interest of lender to a clearing house attached to the funds received by the clearing house when it redeemed manufacturer's coupons for retailers; the funds were not held in trust for the retailers because the clearing house was required to make payments to the retailers on a fixed schedule regardless of when it was paid by the manufacturers); United States v. Lequire, 672 F.3d 724 (9th Cir. 2012) (defendant's employer did not hold funds received for insurance premiums in trust for insurers because the Agreement allowed for commingling, required premium payments to be made regardless whether the employer had collected them, and allowed the employer to collect interest on late premium payments).

13. *See, e.g.*, In re Columbia Gas Systems Inc., 997 F.2d at 1061.

14. *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 55.

15. The Restatement provisions most likely to be applicable – §§ 37 and 54, which cover rescission and restitution for material breach – do not apply when the obligation breached is the payment of money. *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 37(2). A payroll processor's failure to pay its customer's employees or a contractor's failure to pay its subcontractors or suppliers would seem therefore not to be a basis for rescission and restitution.

16. In law, "constructive" is often a euphemism for "fictional."

17. *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT §§ 55, ill. 7, 66, 69. *See also* Buffets, Inc. v. Leischow, 732 F.3d 889 (8th Cir. 2013) (restaurant company that lost $3.5 million when a utility bill processor ceased operations had no claim against processor's banks under the Minnesota version of the Uniform Fiduciaries Act because the bank accounts were titled in the processor's individual name and therefore the banks were not required to inquire whether the processor was breaching an obligation as fiduciary).

18. *See, e.g.,* Variety Wholesalers, Inc. v. Salem Logistics Traffic Services, LLC, 723 S.E.2d 744 (denying summary judgment on secured party's bona fide purchaser defense with respect funds provided to the debtor freight bill processor by its clients because a question of fact remained as to whether the secured party had constructive notice of the clients' ownership of the funds); Safeco Ins. Co. v. Wheaton Bank and Trust Co.,

2009 WL 2407740 (N.D. Ill. 2009) (contractor's surety might have priority in contractor's deposit accounts over depositary bank's perfected security interest, and it stated a claim against bank for conversion of those funds and for a constructive trust by alleging that the bank knew the source of the funds).

19. *But see* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 69(1) (indicating that "notice" refers to "the facts giving rise to the restitution claim," suggesting that the claim must be specific to a particular claimant and must precede the lender's interest).

20. *See, e.g.,* In re Big Drive Cattle, LLC , 2015 WL 1509824 (Bankr. D. Neb. 2015) (prepetition payments by feedlot to owner of cattle following the feedlot's sale of the cattle were avoidable preferences; the payments were not made from funds held in constructive trust for the owner because the owner, as a member of the feedlot, knew of and consented to the feedlot's grant of a security interest in its deposit accounts and the subsequent deposit of the sale proceeds into those deposit accounts caused the funds to lose the protection they would otherwise have had as bailment proceeds).

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Recent Cases

SECURED TRANSACTIONS

In re Hadley,
2015 WL 7455630 (Bankr. N.D. Ohio 2015)
The debtor's lawyer, to whom the debtor had given possession of the certificates of title to two of the debtor's vehicles, had no security interest in the vehicles because there was no authenticated security agreement. The lawyer also had neither a common-law charging lien on the vehicles because such a lien encumbers only a judgment or other proceeds awarded to a client nor a retaining lien because such a lien would conflict with the state's Certificate of Motor Vehicle Title Law. Even if the lawyer had a security interest in or lien on the vehicles, that lien was unperfected because the attorney had not complied with the state's Certificate of Motor Vehicle Title Law by getting the interest noted on the certificates.

In re Sterling United, Inc.,
2015 WL 7573240 (W.D.N.Y. 2015)
Financing statements describing the collateral as "[a]ll assets of the Debtor including, but not limited to, any and all equipment, fixtures, inventory, accounts, chattel paper, documents, instruments, investment property, general intangibles, letter-of-credit rights and deposit accounts . . . and located at or relating to the operation of the premises at 100 River Rock Drive, Suite 304, Buffalo, New York" were effective despite the fact that the stated location of the collateral was incorrect because the language specifying the location modified the clause beginning "including, but not limited to," not the opening phrase "[a]ll assets of the Debtor," and even if the description was ambiguous, the purpose of filing is to provide inquiry notice and thus a searcher should investigate further.

In re Lehman Brothers Holdings, Inc.,
2015 WL 5828216 (S.D.N.Y. 2015)
A secured party that made loans due on demand and whose agreements with the debtor gave the secured party the right to demand additional collateral at any time cannot be liable for demanding additional collateral, even if that would render the secured party overcollateralized, because the obligation of good faith and fair dealing does not impose duties inconsistent with the express terms of the parties' contractual relationship.

Automotive Innovations, Inc. v. J.P. Morgan Chase Bank,
2014 WL 7745773 (N.J. Super. Ct. 2015)
Because, based on an earlier ruling, the buyer that acquired the debtor's assets at an Article 9 disposition had successor liability for the debtor's obligations, a judgment creditor of the debtor could levy on the buyer's bank accounts. It did not matter that the disposition discharged junior liens because the judgment creditor had no lien at the time and, in any event, the buyer remained liable for the judgment debt.

Citigroup Global Markets, Inc. v. KLCC Inv., LLC,
2015 WL 5853916 (S.D.N.Y. 2015)
A securities intermediary could not be liable for damages resulting from its refusal to complete a transfer requested by the secured party with whom it had a control agreement because the intermediary initiated an interpleader action when faced with competing claims to the assets credited to the account, and all the claimed damages therefore arise from acts that were within the intermediary's rights granted by law.

LENDING & CONTRACTING

In re Lehman Brothers Holdings, Inc.,
2015 WL 5828216 (S.D.N.Y. 2015)
A "hell or high water clause" in a guaranty that purports to waive all defenses based on the unenforceability of any loan document is effective to waive any defense based on lack of consideration or authority, even if the guaranty agreement was not the subject of extended negotiation.

Innovation Ventures, LLC v. Custom Nutrition Lab., LLC, 2015 WL 5679879 (E.D. Mich. 2015)

Although the asset purchase agreement pursuant to which a buyer acquired all of the assets of the seller expressly provided that the buyer was not assuming the seller's liabilities and that there were no third party beneficiaries, the buyer was nevertheless bound by terms in a prior settlement agreement between the seller and another entity, pursuant to which the seller agreed not to use specified products in its production of energy drinks, because the asset purchase agreement referenced the settlement agreement's restrictions in a clause dealing with the buyer's representations, thereby incorporating them.

Wells Fargo Bank v. Palm Beach Mall, LLC, 2015 WL 5712341 (Fla. Ct. App. 2015)

The clause in a non-recourse loan agreement governed by New York law providing for recourse liability if the borrower failed to maintain its status as a Special Purpose Entity, a term defined to require solvency, meant solvent under New York common law (paying debts as they become due), not solvent as defined under the UCC or Bankruptcy Code (having assets in excess of liabilities).

In re Min Sik Kang, 2015 WL 5786692 (E.D. Va. 2015)

The amended operating agreement for a limited liability company was effective even though not signed by the designed "independent member" because that individual had no interest in the company, was unaware of the operating agreement, and never accepted the position. A sale of a 60% interest in the company was void because the operating agreement, as permitted by Virginia law, required a secured party's consent to any transfer of more than 49% and the secured party had not consented.

Oasis Legal Finance Group, LLC v. Coffman, 2015 WL 7177951 (Colo. 2015)

The transactions by which litigation finance companies purported to buy interests in the proceeds of a personal injury claim were in reality non-recourse loans, not sales, because the obligations grow with the passage of time. Thus, the transactions were subject to the state's Consumer Credit Code.

Incline Energy LLC v. Weiner, 2015 WL 7351392 (N.D. Cal. 2015)

Although the parties' settlement agreement selected Reno, Nevada as the place to litigate "any disputes that may arise out of [the agreement]," under the "local action doctrine" jurisdiction was proper in California for an action to foreclose a lien on California real property. Nevada courts would not have jurisdiction over the dispute or over a non-signatory who claims a lien on or other interest in the property.

In re Tenderloin Health, 2015 WL 7015559 (N.D. Cal. 2015)

Even though a promissory note provided for the borrower to pay the lender's costs "to help collect," including attorney's fees, and the security agreement and loan agreement both provided for the borrower to pay the lender's attorney's fees "in connection with the enforcement of this Agreement," the lender was not entitled to reimbursement of attorney's fees incurred in successfully defending a preference claim brought by the borrower's bankruptcy trustee. The action was not about "collecting" the debt or about "enforcing" either of the agreements. While assertion of an affirmative defense can give rise to a claim for attorney's fees, the lender's defense was based on its setoff rights, which were independent of its contract rights.

Wofford v. M.J. Edwards & Sons Funeral Home Inc., 2015 WL 7428743 (Tenn. Ct. App. 2015)

A contract between a consumer and a funeral home did not require arbitration of disputes even though, directly above the signature line, the agreement provided: (i) "See part three for terms and conditions that are part of this agreement"; and (ii) "By signing this agreement, you are agreeing that any claim you may have against the seller shall be resolved by arbitration." The first clause did not incorporate the terms in part three because those pages were not provided to the consumer prior to execution of the agreement. The second clause was unconscionable because the agreement was a contract of adhesion, the arbitration provision is completely one-sided and provides offers little notice as to the procedure and effect of arbitration, even though those details would be filled in by law.

Brinkley v. Monterey Financial Services, Inc., 2015 WL 7302268 (Cal. Ct. App. 2015)

The portion of the arbitration clause in a consumer contract requiring the loser to pay all the fees and costs of the prevailing party was substantively unconscionable but could be severed from the remainder of the clause.

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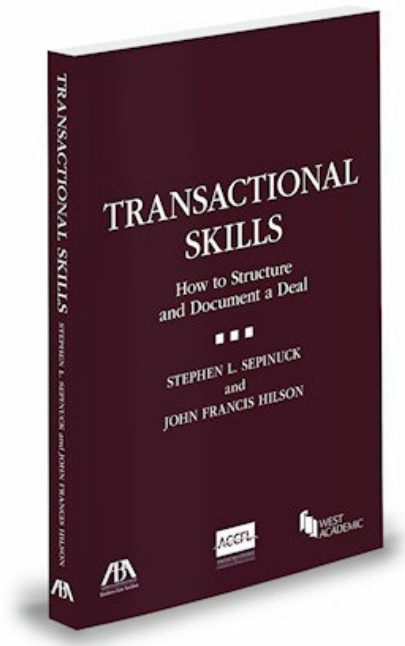
A NEW BOOK ON TRANSACTIONAL LAWYERING



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