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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

BANKRUPTCY TRUSTEE'S STRONG-ARM POWERS BALKED BY A CONSTRUCTIVE TRUST

The case of *In re Howard's Appliance Corp.*¹ is apt to arouse every credit executive's interest in assuring close contact and flow of information among the legal, credit, sales, and shipping departments of the business to make sure that its security interests remain perfected. Equally cogent, however, is the lesson that an unperfected security interest may be protected from the reach of subsequent lien creditors or from the avoiding powers of a trustee in bankruptcy by the imposition of a constructive trust for the benefit of the secured creditor.

Factual Background

In 1984, Sanyo Electric, Inc., entered into a security agreement with Howard's Appliance Corp.,

a retailer of home appliances, giving Sanyo a security interest in all air conditioners possessed or thereafter acquired by Howard that were manufactured or sold by Sanyo. The collateral also included the proceeds from the sale of the Sanyo air conditioners. The agreement required Howard to keep the collateral at its retail store in Nassau County, New York, which was the only place of business operated by Howard at that time. The security agreement specifically provided that "there are no other places of business of debtor." Based on these representations, Sanyo properly perfected its security interest in New York on March 30, 1984, by filing UCC-1 financing statements with the Clerk of Nassau County and the Secretary of the State of New York.

Subsequent to the perfection of the security interest, Howard opened two retail stores in Suffolk County, New York. In March 1986, Howard sold its Nassau County store and began to operate solely in Suffolk County. Despite the sale of the Nassau store, that store continued to use the Howard name and logo, and Howard continued to advertise the store and to hold it out to the

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¹ 874 F.2d 88 (2d Cir. 1989).

public as one of its own. Howard never sent Sanyo written notice of the change of its business location. However, in March or April of 1986, Howard informed one of Sanyo's independent sales representatives who sold merchandise to Howard that the store had been sold, and the representative apparently communicated this information to Sanyo's credit department.

From 1981 to 1986, Howard stored all its inventory in its stores in Nassau County or Suffolk County. However, early in 1986, Howard rented space in a public warehouse in New Jersey to store its inventory. Although goods were delivered to the New Jersey warehouse, Howard did not sell the goods out of the warehouse, but would instead have the items reshipped to its New York locations on an "as needed" basis. "Significantly, Howard never told Sanyo, either orally or in writing, that goods were being stored in New Jersey; nor did Sanyo file any financing statements in that state."²

Knowledge of the New Jersey warehouse came to Sanyo's traffic department in February 1986 when Sanyo shipped, via common carrier, a large supply of air conditioners directly to that warehouse. Apparently the common carrier notified Sanyo's traffic manager that Howard had

instructed the carrier to deliver the goods to the New Jersey warehouse. According to normal procedure, Sanyo's traffic manager changed the bill of lading to reflect the New Jersey destination without reporting this change to any other department at Sanyo, including the credit department.

Filing of Chapter 11 Petition

On August 6, 1986, Howard filed a chapter 11 petition, and the automatic stay under Section 362 of the Bankruptcy Code prevented Sanyo from properly perfecting its security interest in the air conditioners located in New Jersey. Sanyo then moved for relief from the automatic stay so as to enable it to reclaim its collateral in Suffolk County and New Jersey. The bankruptcy court held that, according to Section 9-401(3) of the UCC, the original perfection in New York was sufficient to cover the goods located in Suffolk County.³ However, the security interest in the goods located in New Jersey was technically unperfected according to Sections 9-103(1)(b), 9-302, and 9-401(1)(c) of the UCC, due to the

³ Section 9-401(3) of the N.Y.U.C.C. (McKinney Supp. 1989) provides:

A filing which is made in the proper place in this state continues effective even though the debtor's residence or place of business or the location of the collateral or its use, whichever controlled the original filing is thereafter changed.

² *Id.* at 90.

failure to file a financing statement in New Jersey.⁴ Nonetheless, invoking the doctrine of equitable estoppel, the bankruptcy court determined that Sanyo possessed the rights of a validly perfected security interest in the air conditioners located in New Jersey.⁵ “[P]rinciples of equity had to be considered to determine whether Sanyo has a perfected interest despite its failure to file. . . .”⁶ Based on the testimony, the bankruptcy court concluded that Howard was “estopped from denying the New Jersey perfection of Sanyo’s security interest.”⁷

Testimony at Hearing

At the hearing in the bankruptcy court, the president of the debtor testified that the New Jersey warehouse was needed because of inadequate space at the New York locations, that he nev-

er sent Sanyo any formal written notice or informed them by telephone that Howard was storing Sanyo’s goods in New Jersey, but that he advised Sanyo’s independent sales representative as early as February 1986 that Howard probably would be storing goods in New Jersey. In addition, the president stated that he had told the independent sales representative that the goods were going to New Jersey when they were shipped two or three months after February 1986.

The independent representative testified that he had first become aware that Howard was storing goods in New Jersey two days after the chapter 11 petition was filed in August 1986. Moreover, the National Home Credit Manager for Sanyo testified that Howard had never notified Sanyo’s credit department, that he was never informed by Sanyo’s traffic department that the goods had been shipped to the New Jersey warehouse, and that he had first learned of the New Jersey warehouse two days after the chapter 11 had been filed, when he sent representatives to take an inventory.

In holding that the doctrine of equitable estoppel precluded Howard from asserting that the security interest in the goods located in New Jersey was unperfected, the bankruptcy court found the testimony of the independent sales representative

⁴ *Id.* at 91; see 12A N.J. Stat. Ann. §§ 9-302, 9-401(1)(c) (West Supp. 1986); see also N.Y.U.C.C. § 9-103(1)(b) (McKinney Supp. 1989).

Except as otherwise provided in this subsection, perfection and the effect of perfection or non-perfection of a security interest in collateral are governed by the law of the jurisdiction where the collateral is when the last event occurs on which is based the assertion that the security interest is perfected or unperfected.

⁵ See U.C.C. § 1-103 (“[T]he principles of law and equity, . . . *estoppel*, fraud . . . shall supplement its provisions”) (emphasis added).

⁶ 874 F.2d at 91.

⁷ *Id.* at 92.

and Sanyo's National Home Credit Manager credible. The court found that Howard had concealed the fact that it was storing the subject inventory in the New Jersey warehouse, that no highly placed official from Sanyo was ever directly told by Howard of that fact, and that Howard "expected that its concealment . . . would be relied upon by Sanyo in such a way as to dissuade [Sanyo] from filing a financial statement in New Jersey."⁸ The bankruptcy court also found that, by concealing this information from Sanyo, Howard "prevented Sanyo from protecting its security interest by filing in New Jersey."⁹ Accordingly, Howard was equitably estopped from denying proper perfection in New Jersey.

District Court Opinion

The district court, *inter alia*, affirmed the bankruptcy court's determination as to Sanyo's security interest in the merchandise stored in Suffolk County while Howard operated its Nassau store. As to the merchandise located in Suffolk County that was shipped after the closing of the Nassau store, the district court held that, pursuant to Section 9-401(1)(c) of the UCC, Sanyo was required to file a financing

statement with the Clerk of Suffolk County to perfect its interest. Finally, as to the property in Suffolk County acquired after the sale and as to all property in New Jersey, the district court found that the application of equitable estoppel would contravene the strong-arm powers of Howard in its capacity as debtor in possession. The district court held that, because a debtor in possession generally has the same rights, powers, and duties as a trustee, and because a trustee may avoid a lien under Section 544(a)¹⁰ even where he possesses actual notice of the lien's existence, "Howard[] has the power, just as would a trustee, to avoid Sanyo's unperfected lien. . . ."¹¹ The court found its analysis to be consistent with the "conscious decision by Congress to favor the trustee over unperfected creditors, regardless of the particular equities of the case."¹²

Furthermore, the district court opined that one of the purposes of providing the debtor in possession with the status of a lien creditor was "to prevent such defenses as

¹⁰ See 11 U.S.C. § 544(a) ("The trustee shall have, as of the commencement of the case . . . the rights and powers of, or may avoid any transfer of property of the debtor . . . that is voidable by—(1) a creditor that . . . obtains . . . a judicial lien on all property. . . ."). See also B. Weintraub & A. Resnick, *Bankruptcy Law Manual* ¶ 7.01.

¹¹ 874 F.2d at 92.

¹² *Id.*

⁸ *Id.*

⁹ *Id.*

estoppel from being raised."¹³ Sanyo could have protected its interest by taking a "precautionary measure" to ensure that the property was delivered to Howard's location in New York, where Sanyo had filed its financing statements. The district court concluded that the doctrine of estoppel could not prevent Howard from avoiding Sanyo's interest under Section 544(a) of the Bankruptcy Code.

After the district court's decision, the parties stipulated that no merchandise was shipped to Howard in Suffolk County after the sale of the Nassau County store. Therefore, the only issue remaining for the court of appeals was the extent of Sanyo's interest in the air conditioners located in New Jersey.

The court of appeals shifted the analysis from one based on equitable estoppel to one of constructive trust. By doing so, the court focused on Section 541 of the Bankruptcy Code, which defines the scope of property of the estate. Under Section 541, a debtor's legal and equitable interests in property, as of the commencement of the case, constitute property of the estate. However, pursuant to Section 541(d), the estate includes property in which the debtor holds mere legal title only to the extent of the legal interest, but not to the extent of any equi-

table interest in the property that the debtor does not hold. The estate does not include property interests of others in which the debtor has only a minor interest such as bare legal title.¹⁴ The court of appeals then cited several cases that have held that property owned by the debtor, but subject to a constructive trust for the benefit of another, does not become part of the bankruptcy estate.¹⁵ "A constructive trust, therefore, 'confers on the true owner of the property an equitable interest in the property superior to the trustee's. . . .'"¹⁶

The existence and nature of a debtor's interest and, correspondingly, the estate's interest in property are determined by state law: "One must look to state law . . . to determine whether to impose a constructive trust on property within the debtor's possession."¹⁷ Since the air conditioners had been delivered from Sanyo's New Jersey factory to Howard's New Jersey warehouse, where they

¹⁴ *Id.* (citing *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204 n.8 (1983)); 4 *Collier on Bankruptcy* ¶ 541.13 at 541-575 (15th ed. 1989) (estate succeeds only to the title and rights that the debtor possessed); *In re Quality Holstein Leasing*, 752 F.2d 1009, 1012 (5th Cir. 1985).

¹⁵ 874 F.2d at 93, n.5; see, e.g., *In re N.S. Garrett & Sons*, 772 F.2d 462 (8th Cir. 1985); *In re Quality Holstein Leasing*, 752 F.2d 1009 (5th Cir. 1985).

¹⁶ *Id.* at 93 (citing *In re Quality Holstein Leasing*, 752 F.2d at 1012); cf. *In re General Coffee Corp.*, 828 F.2d 669, 706 (11th Cir. 1987).

¹⁷ 874 F.2d at 93.

¹³ *Id.*

had always remained, the court held that New Jersey law applied. Under New Jersey law, "a constructive trust should 'be impressed in any case where to fail to do so will result in an unjust enrichment.'" ¹⁸ The court found that, under New Jersey law, "when property has been acquired or retained 'in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest, equity converts him into a trustee. . . .'" ¹⁹

The court of appeals quoted from an opinion of the Supreme Court of New Jersey holding that, in general:

"[A]ll that is required to impose a constructive trust is a finding that there was some wrongful act, usually, though not limited to, fraud, mistake, undue influence, or breach of a confidential relationship, which has resulted in a transfer of property. . . ." [Such a trust may arise] *even though the acquisition of the property was not wrongful*. It arises where the retention of the property would result in the unjust enrichment of the person retaining it. [Emphasis added.] ²⁰

¹⁸ *Id.* at 94 (citing *Stewart v. Harris Structural Steel Co.*, 198 N.J. Super. 255, 486 A.D. 1265, 1271 (Super. Ct. App. Div. 1984) and quoting *D'Ippolito v. Castoro*, 51 N.J. 584, 588, 242 A.2d 617, 619, 38 A.L.R.3d 672, 677 (1968)).

¹⁹ 874 F.2d at 94 (quoting *Stewart v. Harris Structural Steel Co.*, 486 A.2d 1265, 1271 (Super. Ct. App. Div. 1984)).

²⁰ *Id.* at 94 (quoting *D'Ippolito v. Castoro*, 51 N.J. 584 (1968), quoting *Scott on Trusts* § 462.2, at 3417 (3d. ed. 1967)).

The court of appeals found noteworthy that, until six months prior to the commencement of the chapter 11 case, Howard had stored all air conditioners in New York as required by the security agreement. The court stated that Howard's contentions that storage in the New Jersey warehouse was necessary and that it had no sinister motives in storing the merchandise "do not fall upon deaf ears." ²¹ Nevertheless, Howard acted with the expectation that Sanyo would not file a financing statement in New Jersey. Howard knew that under the terms of the security agreement it was obligated to keep Sanyo's merchandise in Nassau County and that its failure to do so would frustrate Sanyo's interest in the goods. The court also found it significant that Sanyo was never informed of the warehouse and had only learned of the warehouse through third parties after the petition was filed, at a time when it was too late to file a financing statement in New Jersey. "The direction to Sanyo's traffic department to ship the merchandise to New Jersey was not sufficient to place Sanyo on notice that its goods were being stored in New Jersey" since "it is common practice for buyers to change shipping destinations and . . . as a result of this practice, the traffic department routinely approved such

²¹ 874 F.2d at 94.

changes, as it did here, without notifying its 'principals.' Undoubtedly, Howard was aware of this practice."²² The court of appeals concluded:

Under these circumstances, we are authorized by the law of New Jersey to impress a constructive trust; as the beneficiary of the trust, Sanyo now enjoys a position superior to that of any lien creditor and to any of Howard's other creditors as well.²³

The court of appeals brushed off any concern relating to the trustee's avoiding power under Section 544(a) of the Bankruptcy Code. The constructive trust attached prior to the filing of the chapter 11 petition. Since property rights that attached before the petition date supersede the debtor in possession's lien creditor position under Section 544(a), the "strong-arm clause" does not destroy the constructive trust. "Indeed the court in *General Coffee*, . . . in considering the interplay between Sections 541 and 544, recognized that the rights of a beneficiary of a constructive trust 'prevail over a hypothetical ideal lienholder.'"²⁴

Conclusion

It is difficult to fault the court of appeals for applying state law in determining the vulnerability of a

security interest against the debtor in possession's "strong-arm" power under Section 544(a)(1). Clearly, Section 544(a)(1) gives the trustee the power to avoid a lien that could be avoided by a hypothetical judicial lien creditor as of the date of bankruptcy. However, Section 544(a) cannot stand alone in that it requires application of state law to see what, if any, liens may be avoided by a judicial lienor. If a judicial lien creditor as of the date of bankruptcy could not get better rights than the beneficiary of a constructive trust, then the trustee in bankruptcy or debtor in possession also could not obtain better rights.

We are not too disturbed by the fact that, as a general proposition, an equitable lien or constructive trust that is good as against a judicial lien creditor under state law may deliver a blow to the trustee's "strong arm," leaving it virtually in a sling. However, application of constructive trust concepts to Article 9 secured transactions, coupled with New Jersey's lax standards for the imposition of a constructive trust, causes serious concern for parties involved in commercial dealings. Since a constructive trust may be imposed in New Jersey without any finding of a breach of a special or fiduciary relationship between the parties, or even bad faith or fraud, it is likely that many security interests that become unperfected due to the secured cred-

²² *Id.* at 94-95.

²³ *Id.* at 95.

²⁴ *Id.* (citing *In re General Coffee Corp.*, 828 F.2d 699 (11th Cir. 1987)).

itor's failure to properly monitor or police the location of collateral will nonetheless be effective against judicial lienors and trustees in bankruptcy.

The real blow is to the clear predictability that Article 9 of the UCC is designed to provide to unsecured creditors, subsequent lienors, and bona fide purchasers, who should all be able to rely on the absence of a properly filed financing statement when advancing funds or otherwise dealing with the debtor. What would have happened if a creditor, seeing Howard's inventory stored in New Jersey, learning that no financing statements had been filed in that state, and unaware of Sanyo's interest, had advanced credit and properly perfected its own security interest in that inventory in New Jersey? Apparently Sanyo's interest would be superior despite its failure to mon-

itor its collateral, which Sanyo itself shipped to New Jersey. The ability to rely on the Article 9 filing system to determine whether assets are encumbered was virtually destroyed by the decision in *Howard's Appliance*.

The court of appeals decision also frustrates two of the stated policies underlying the Uniform Commercial Code. Section 1-102 (2) of the UCC provides that the "underlying purposes and policies of this Act are (a) to simplify, clarify and modernize the law governing commercial transactions; . . . (c) to make uniform the law among the various jurisdictions." If courts apply to Article 9 secured transactions illusive concepts of equitable liens and constructive trusts, tailor-made to particular variations of state law, the law in this area will be anything but simple, clear, modern, or uniform.