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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

WHEN MONEY MISTAKENLY PAID TO THE DEBTOR IS TRANSFERRED TO ITS RIGHTFUL OWNER ON THE EVE OF BANKRUPTCY—VOIDABLE PREFERENCE OR CONSTRUCTIVE TRUST?

A basic policy that underlies the Bankruptcy Code is equality of treatment among creditors. Consistent with that policy, the Code gives a trustee or debtor-in-possession the power to avoid a preferential transfer made shortly before bankruptcy that gives one creditor unfair advantage over others.¹

Section 547(b) of the Bankruptcy Code lists the elements that must be proven for a transfer to be avoided as a preference. The first element is that there must have been a "transfer of an interest of the debtor in property."² Accordingly, courts have held that no preference takes place when payment is made from

escrow funds³; when a note is paid out of personal funds of comakers without any payment by the debtor⁴; when the debtor pays to the Internal Revenue Service withholding taxes held in a statutory trust fund⁵; or when funds are drawn on a letter of credit.⁶

An interesting case that tested the limits of the requirement that the property transferred belongs to the debtor is *Mitsui Manufacturers Bank v. Unicom Computer Corp.*,⁷ where the Court of Appeals for the Ninth Circuit held that a prepetition transfer by the debtor to a creditor of money belonging to the creditor but mistakenly received by the debtor did not constitute a preference under Section 547 despite the debtor's temporary possession of the money in the debtor's bank account.

The Facts

Unicom Computer Corporation, a computer equipment broker, arranged a computer equipment lease in 1983 between its client, Pitney

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¹ 11 U.S.C. § 547.

² 11 U.S.C. § 547(b).

³ See *In re Newcomb*, 744 F.2d 621 (8th Cir. 1984).

⁴ See *Brown v. First Nat'l Bank of Little Rock, Ark.*, 748 F.2d 490 (8th Cir. 1984).

⁵ See *Begier v. Internal Revenue Serv.*, 110 S. Ct. 2258 (1990).

⁶ See *In re Clothes, Inc.*, 35 B.R. 487 (Bankr. D.N.D. 1983).

⁷ 13 F.3d 321 (9th Cir. 1994).

Bowes, Inc., as lessee, and Mitsui Manufacturers Bank, as the lessor. Unicom worked out the terms of the agreement by which Mitsui purchased the equipment financed in part from the Philadelphia Savings Fund Society. The five-year lease between Mitsui and Pitney Bowes required Pitney to pay a monthly rental of \$44,197. The arrangement was for Pitney to make monthly payments directly to the Philadelphia Savings Fund Society, which then remitted to Mitsui the difference between Pitney's rent and the amount of Mitsui's monthly loan obligation to Philadelphia Savings.

Soon after Pitney told Unicom that it wanted to get out of the lease midway through the five-year term, Unicom located Cincinnati Milacron, a company willing to sublease the equipment for two years at an amount significantly less than Pitney's monthly rent obligation. Pursuant to an arranged deal, Pitney sublet the equipment to Unicom for twenty-four months at a monthly rental of \$20,000, and Unicom sublet the equipment to Cincinnati Milacron for the same two-year period at a monthly rental of \$22,000. Unicom then billed Cincinnati Milacron each month for \$22,000, of which Unicom kept \$2,000 as its broker's commission, and Unicom forwarded \$20,000 to the Philadelphia Savings Fund Society as partial payment of Mitsui's loan obligation. Unicom then billed Pitney for \$24,197, which was the difference between Pitney's monthly rental ob-

ligation under the lease and Unicom's monthly sublease payment. However, Unicom's bill noted that Pitney was to send this \$24,197 payment directly to the Philadelphia Savings Fund Society.

The loan from Philadelphia Savings to Mitsui was scheduled to be paid off two months before the expiration of the equipment lease to Pitney and, therefore, Pitney's final two lease payments were to be sent directly to Mitsui. However, Unicom failed to send Pitney a bill for the final two payments until several months after the five-year lease term ended. When Unicom sent the bill, it erroneously instructed Pitney to send its payment to Unicom rather than to Mitsui. When Unicom received Pitney's check, it deposited it in Unicom's general operating account instead of merely forwarding it to Mitsui. Unicom's mistake was corrected several months later when it sent to Mitsui the full amount of "Pitney's misdirected payment to Mitsui."⁸

Unicom Files for Bankruptcy Relief

Within ninety days after Unicom corrected its mistake by forwarding payment to Mitsui, Unicom filed a Chapter 11 petition. Unicom then filed an adversary proceeding against Mitsui seeking to recover Unicom's payment as a voidable preference under Section 547 of the Bankruptcy Code. Mitsui's defense was that the payment was not a

⁸ *Id.*, 13 F.3d at 323.

preference because it was not a transfer of Unicom's property. That is, Unicom was merely holding the money in a constructive trust for its rightful owner, Mitsui, and Unicom never had any right to use it.

The bankruptcy court rejected Mitsui's argument and held that it would be inequitable to impose a constructive trust over the money erroneously paid to Unicom and subsequently paid to Mitsui. The bankruptcy court reasoned that the money was deposited in Unicom's general operating account and was subject to Unicom's control. The bankruptcy appellate panel affirmed in a 2-1 decision. Although the BAP recognized that a constructive trust in favor of Mitsui would ordinarily arise under California law in these circumstances, Mitsui failed to prove that the equities mandated such a result under federal bankruptcy law. The dissenting BAP judge reasoned that once Mitsui had established its right to the money, the burden of proof shifted to the debtor-in-possession to prove that it would be inequitable to impose a constructive trust over the funds.

The Court of Appeals reversed the decisions of the bankruptcy court and the BAP. Recognizing that a transfer may be avoided under Section 547 only "if it involves property of the debtor and the transfer reduces the amount of the bankruptcy estate available for the payment of other creditors,"⁹ the court focused on the question of whether

Unicom's temporary possession of Pitney's final lease payment owed to Mitsui rendered it Unicom's property. "The key, of course, lies with the correct definition of 'property,'" ¹⁰ the court noted. The Bankruptcy Code does not define "interest of the debtor in property" as that phrase is used in Section 547. However, Section 541 of the Code governs "property of the estate" and was used by the Court of Appeals as a source of guidance for determining the meaning of "property" for Section 547 purposes. "In its simplest terms, property of the debtor may be said to be that which would have been property of the bankruptcy estate had the transfer not taken place," ¹¹ the appeals court stated.

Focusing on Section 541, the court noted that property of the estate does not include "any power that the debtor may exercise solely for the benefit" of another.¹² Moreover, property of the estate does not include "property in which the debtor holds . . . only legal title and not an equitable interest."¹³ The court thus concludes that "something held in trust by a debtor for another is neither property of the bankruptcy estate under Section 541(d), nor property of the debtor for purposes of Section 547(b)."¹⁴

¹⁰ *Id.* at 324.

¹¹ *Id.* at 324. The court of appeals cited *Begier v. Internal Revenue Serv.*, 496 U.S. 53 (1990), as authority for this statement.

¹² 11 U.S.C. § 541(b)(1).

¹³ 11 U.S.C. § 541(d).

¹⁴ 13 F.3d at 324.

⁹ *Id.* at 324.

The fact that the particular type of trust involved in this case was a constructive trust, rather than an express trust, was not relevant. The court referred to an illustration in the legislative history to establish that point: "For example, if the debtor has incurred medical bills that were covered by insurance, and the insurance company had sent the payment of the bills to the debtor before the debtor had paid the bill for which the payment was reimbursement, the payment would actually be held in a constructive trust for the person to whom the bill was owed."¹⁵

Once the court concluded that property held by the debtor in constructive trust for someone else is not property of the estate and, if transferred to its rightful owner before bankruptcy, would not constitute a voidable preference, it moved on to the question of whether the facts of this case warrant imposition of a constructive trust—an issue that involves state law. The court noted that under California law applicable in the *Unicom* case, a constructive trust may be imposed where the debtor wrongfully detains property of another as a result of simple negligence. The Court of Appeals distinguished its prior decision in *In re North American Coin & Currency, Ltd.*,¹⁶ where the court applied Arizona law that requires actual fraudu-

lent conduct on the part of the debtor before imposing a constructive trust.

In a footnote, the Court of Appeals characterized Unicom's conduct: "Although Mitsui has not explicitly accused Unicom of any deliberate misconduct, our reading of the record indicates that something more than excusable neglect may be involved here."¹⁷ The court noted that Unicom cancelled its original final billing to Pitney, which correctly instructed Pitney to make its payment to Mitsui, and then substituted one instructing Pitney to send its payment to Unicom instead. In addition, despite having received prior notice from Mitsui's leasing portfolio manager that the bill was in error, Unicom deposited Pitney's check in its own bank account. The court also pointed out that there was a five-week delay before Unicom corrected the mistake by sending its check to Mitsui.

Most significantly, the court said, "[i]t cannot be denied that the money represented by Pitney's misdirected check belonged to Mitsui, not Unicom."¹⁸ The court also found that, to the extent that California law required Mitsui to trace the wrongfully detained funds, it has done so.¹⁹ Therefore, the court concluded that "Unicom, having wrongfully and by virtue of its own mistake(s) acquired and retained funds properly belonging to Mitsui,

¹⁵ H.R. Rep. No. 595, 95th Cong., 1st Sess. 368 (1977).

¹⁶ 767 F.2d 1573 (9th Cir.), *amended*, 774 F.2d 1390 (1985).

¹⁷ *Id.*, 13 F.3d at 323, n.3.

¹⁸ *Id.* at 325.

¹⁹ *Id.* at 325 n.5.

had at most only a bare legal title to those funds."²⁰

The court, however, did not end the analysis with the application of state law. "[W]hile state law must be the starting point in determining whether a constructive trust may arise in a federal bankruptcy case, that law must be applied in a manner not inconsistent with federal bankruptcy law."²¹ But since Mitsui had established that grounds exist under state law for imposition of a constructive trust, the burden shifted to Unicom as debtor-in-possession "to prove that it would be inequitable as a matter of federal bankruptcy law to impose a constructive trust over those funds."²²

Unicom failed to meet this burden, the court pointed out, "Because we find nothing that would warrant overriding the dictates of California law in favor of some unspecified, overarching principle(s) of federal bankruptcy law, we hold

that a constructive trust in favor of Mitsui arose over the funds represented by Pitney's misdirected check."²³ Therefore, Unicom's preference action against Mitsui must fail.

Conclusion

The Court of Appeals was correct when it resorted to state law to determine the nature and extent, if any, of the debtor's interest in the funds that derived from the check that was mistakenly received and deposited by Unicom.²⁴ If California law would have treated these commingled funds as if they belonged to Mitsui, and as if they were temporarily held by Unicom only as trustee under a constructive trust, then transferring the funds to Mitsui prior to bankruptcy could not have constituted a voidable preference.

²³ *Id.* at 325.

²⁴ See, e.g., *In re FCX, Inc.*, 853 F.2d 1149, 1153 (4th Cir. 1988) ("The existence and nature of a debtor's, and hence the estate's, interest in property must be determined by resort to nonbankruptcy law . . . or, as is the case here, state law.").

²⁰ *Id.* at 325.

²¹ *Id.* at 325 n.6.

²² *Id.* at 325.