Equitable Liens and Constructive Trusts in Bankruptcy: Judicial Values and the Limits of Bankruptcy Distribution Policy

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EQUITABLE LIENS AND CONSTRUCTIVE TRUSTS IN BANKRUPTCY: JUDICIAL VALUES AND THE LIMITS OF BANKRUPTCY DISTRIBUTION POLICY

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Equitable claims against property of the bankruptcy estate, such as claims of equitable lien or constructive trust, have never been the focus of comprehensive attention. After decades of fitful amendments to the Bankruptcy Act of 1898 (the Act),[1] Bankruptcy Courts reached at least a consistent, if not coherent, understanding of how to treat them. Accordingly, equitable claims had ceased to be a source of difficulty and were thought relatively unimportant.[2] Congress then enacted the 1978 Bankruptcy Code[3] (the 1978 Code), and in doing so, mistook the relative unimportance of these claims for their disappearance, intentionally omitting to provide for their treatment. And lo, the sleeping giant awoke.

Predictably, the unexpected occurred. By failing to treat these equitable claims, Congress permitted resurrection of the entire array. As was recognized in 1949,[4] "Ordinarily every claimant to the assets in the hands of the trustee of the bankrupt estate desires priority and for that reason seeks to establish that his property was acquired under circumstances giving rise to a relationship other than that of an unsecured creditor." Accordingly, hundreds of creative and conscientious lawyers have seized the opportunity to argue that their client is entitled to an equitable interest in the property of the estate. Hundreds of courts have wondered how to treat these claims under a statute that explicitly ignores them. Left to resolve these claims under provisions designed for other purposes, some courts have applied one inapposite provision, some have chosen another, some have resorted to older cases under the Act, and some have relied on nothing at all. The effect is an astonishingly incoherent collage of judicial opinion and result in which large numbers of unsecured claimants have managed to obtain better treatment than the general creditors. These cases challenge the limits of a number of fundamental bankruptcy policies,

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1. 30 Stat. 544 (1898).

2. The perception of unimportance is well evidenced by the lack of attention given to the topic by the authors of the treatises and casebooks in the 1970s. For example, of the thousands of pages in Collier's Fourteenth Edition, only seven were devoted to the trustee's power to avoid equitable liens. 4B W. COLLIER, COLLIER ON BANKRUPTCY ¶ 70.62 (1976). Professor Countryman's 768-page casebook devoted a one-page note to the topic. V. COUNTRYMAN, CASES AND MATERIALS ON DEBTOR AND CREDITOR 475-76 (2d ed. 1974). Of the 714 pages in D. EPSTEIN & J. LANDERS, DEBTORS AND CREDITORS CASES AND MATERIALS (1978), the chapter on equitable liens is eight pages long, containing one case and one-half page of text. Professor Riesenfeld's 797-page casebook does not mention equitable liens or constructive trusts. S. RIESENFELD, CASES AND MATERIALS ON CREDITORS' REMEDIES AND DEBTORS' PROTECTION (3d ed. 1979).

3. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

4. *In re* Tate-Jones & Co., 85 F. Supp. 971 (W.D. Pa. 1949).

including the policy of distributing only the property of the debtor, the abhorrence of secret liens, and the policy of equal distribution among unsecured claims.

In this article, I look at these cases, describing in Part I their historical treatment under the Act, and providing in Part II an overview of their treatment under the 1978 Code. In Part III, I discuss the cases in detail, and by looking at the characteristics of winners and losers, I attempt to extract the working principles — the factors likely to cause a Bankruptcy Court to treat the equitable claimant more favorably than general creditors. In Part V, I discuss the policy implications of these cases, recommend amendments to the 1978 Code, and suggest how courts should treat these claims in the meantime.

I. Constructive Trusts, Equitable Liens, and Their Treatment Under Prior Bankruptcy Law

Constructive trusts and equitable liens are equitable remedies available to vindicate restitutionary claims. It is generally said that "[a] person who has been unjustly enriched at the expense of another is required to make restitution to the other."[5] The range of circumstances causing an enrichment to be held "unjust" is nearly boundless and the subject of numerous treatises.[6] The more familiar grounds include fraud, mistake, duress, undue influence, conversion, and ordinary breach of contract. Enrichment takes many forms beyond the obvious transfer of money or property and includes satisfaction of debt, improvement of property, discharge of lien, and so on. Having established some form of enrichment and a ground for characterizing it as unjust, the plaintiff is entitled to restitution. This means the court will provide a remedy that will have the effect of restoring to the plaintiff the benefit conferred. Restitution "is not aimed at compensating the plaintiff, but at forcing the defendant to disgorge benefits that it would be unjust to let him keep."[7] Thus, the choice of remedy depends on the form of the enrichment and the techniques available for disgorgement; it will not depend on the substantive ground (fraud, mistake, etc.) for the restitutionary claim.[8]

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5. RESTATEMENT OF RESTITUTION § 1 (1937).

6. *See. e.g.*, G. PALMER, THE LAW OF RESTITUTION (1978). *See generally* Wade, *The Literature of the Law of Restitution*, 19 HASTINGS. L.J. 1087 (1968).

7. D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES 224 (1973).

8. Of course, remedy should reflect substance and implement its policy. But usually substantive law is enunciated without much regard for the remedy, which is usually fashioned after substance is determined. D. DOBBS, *supra* note 7, at 228.

Constructive trust and equitable lien, the two equitable remedies discussed here, are among the many remedies available to a plaintiff.[9] They are similar in that they are available only when the plaintiff can establish some connection between the benefit conferred and an identifiable asset held by the defendant at the time restitution is sought. Establishing this connection is usually called tracing. Both remedies give the plaintiff an interest in the traced asset. The difference between them is that imposition of a constructive trust, which is wholly different from a true trust,[10] gives the plaintiff title to the asset,[11] whereas imposition of an equitable lien merely gives the plaintiff a lien on the asset.[12] Determining which remedy is the more appropriate depends on the nature of the benefit to be disgorged. For example, where a person makes mistaken improvements upon the land of another such that the owner is unjustly enriched, disgorgement of this benefit will best be accomplished by requiring the owner to pay the person the value of the benefit. To secure the payment, the land will be subjected to an equitable lien.[13] In contrast, when a person mistakenly transfers land to another, the transferee should be required to disgorge title. Accordingly, the transferee will be said to hold title subject to a constructive trust for the transferor.[14] Of course, it is not always so clear which of the two remedies is more appropriate, and the nature of the enrichment may entitle the plaintiff to the option of one or the other.[15] So it is not unusual to find plaintiffs who seek both remedies in the alternative.[16]

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9. The full panoply of available remedies is described in RESTATEMENT OF RESTITUTION §§ 150-62 (1937).

10. A true trust is based on the intention of the parties to create a trust. If the intention is inferred from the facts, the trust is called a resulting trust. By contrast, a constructive trust may be imposed for remedial purposes wholly apart from the intentions of the parties. The constructive trust is often compared to the more familiar quasi contract, which is also a restitutionary remedial device having nothing to do with true contract. *See generally* D. DOBBS, *supra* note 7, at 240-42; RESTATEMENT OF RESTITUTION § 161 comments a & b (1937).

11. The constructive trust plaintiff wins an *in personam* order that requires the defendant to transfer specific property in some form to the plaintiff. D. DOBBS, *supra* note 7, at 241.

12. *Id.* at 248-50.

13. RESTATEMENT OF RESTITUTION § 161 comment a (1937).

14. *Id.* § 163.

15. The Restatement gives the following example:

> If one person misappropriates money of another and with it purchases property, the other can at his option either enforce an equitable lien upon the property so acquired, holding the wrongdoer personally liable for the balance, if any, or enforce a constructive trust of the property. If the property falls in value, the constructive trust is his better remedy.

Id. § 161 comment a.

16. *In re* Daves, 770 F.2d 1363 (5th Cir. 1985); *In re* Pearl, 40 Bankr. 860 (Bankr. D.N.J.

What has been said so far describes only the relationship between the restitutionary claimant and the defendant, or debtor. However, a restitutionary claimant who is entitled to one of these equitable remedies may also have to compete with claims of other parties to the disputed asset. Hornbook law states that when the debtor transfers property subject to an equitable lien or constructive trust to a third party, two things happen: 1) the claim attaches to the proceeds or product of the transfer;[17] and 2) the claim follows the property into the hands of the third party, and takes priority over his claim unless the third party is a bona fide purchaser for value.[18] In this context, a purchaser for value includes buyers and persons extending credit contemporaneously secured by the property,[19] but does not include creditors acquiring a judicial lien on it.[20]

Because there are many kinds of restitutionary claims and this article focuses only on those for which the equitable remedy of equitable lien or constructive trust is sought, I will refer to them as equitable claims. Before discussing their treatment in bankruptcy, the general nature and effect of these equitable claims under state law may be summarized as follows: if a debtor has been unjustly enriched and the claimant can trace the claim into specific property of the debtor, then the claimant may be entitled to either an equitable lien or constructive trust against the property. The choice between the two will depend on the nature of the benefit received by the debtor, and not on the substantive basis of the claim. If a third party claims a competing interest in the property, the equitable claim will normally have priority, including priority over competing judicial liens, but the equitable claim will be subordinate to that of a bona fide purchaser for value.

Treatment of these equitable claims in bankruptcy over the eighty-year tenure of the Act varied greatly. Most variations were the inadvertent result of statutory amendments made for some other purpose, but which swept equitable claims along with them. One profoundly

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1984) (decided under the old Bankruptcy Act); *In re* Minton Group, Inc., 28 Bankr. 774 (Bankr. S.D.N.Y. 1983).

17. D. DOBBS, *supra* note 7, at 242-44; RESTATEMENT OF RESTITUTION §§ 202-03 (1937).

18. D. DOBBS, *supra* note 7, at 281-83; RESTATEMENT OF RESTITUTION §§ 172-75 (1937).

19. Generally, present value must be given for the transfer. The Restatement specifically excludes satisfaction or security for pre-existing debt. RESTATEMENT OF RESTITUTION § 173(1) comment b & § 173(2) (1937).

20. "[A] creditor who attaches the property or obtains and records a judgment or levies execution upon the property is not a bona fide purchaser, although he had no notice of the constructive trust . . . ." *Id.* § 173 comment j.

important inadvertent effect, the unfortunate consequences of which continue to proliferate today, was the confusion of constructive trusts with true trusts, which caused claims of constructive trust to be treated differently from claims of equitable lien.

The story begins with Congress's early struggles over secret claims. One fundamental distributional principle has always been that property to be distributed to a bankrupt's general creditors can include only the debtor's interest in property. If ownership of an asset is somehow shared with another, only the debtor's share or its value can be distributed. From the start, however, some sorts of third party interests, though valid against the debtor, were thought, because of their secret nature, to be undeserving of such deference and were declared void in bankruptcy. For example, original section 67(a) provided that "claims which for want of record . . . would not have been valid liens as against claims of creditors of the bankrupt shall not be liens against the estate."[21] The rationale for avoiding the unrecorded lien was, and still is, that some general or unsecured creditors might have extended credit to the bankrupt in reliance on the debtor's apparently unfettered ownership of the asset. Because the secret claimholder could presumably protect against this misunderstanding by publicizing its claim, the claimant should not be entitled to retain the lien. In 1898, both constructive trusts and equitable liens were valid in bankruptcy despite their secrecy, because they were not required to be recorded, and thus would not have been invalid against creditors "for want of record."

In 1898, Congress had foreseen only a few difficulties presented by secret claims and others began immediately to appear. As Professor Morris has well described,[22] in 1910 Congress enacted two amendments aimed at solving the secret lien problem. The first amendment was the enactment of the "strong arm" clause, giving the trustee the powers of a levying creditor and expanding the trustee's power to avoid certain unrecorded liens. The second amendment made transfers tardily recorded within the four-month period prior to bankruptcy voidable as preferences.[23] Though secret, equitable claims were not yet considered part of the problem.

The awareness that equitable liens (but not constructive trusts) were part of the secret lien problem first surfaced after the 1910

21. Act of July 1, 1898, ch. 541, § 67(a), 30 Stat. 564 (cited in Morris, *infra* note 22).

22. Morris, *Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens*, 54 MINN. L. REV. 737, 745-47 (1970).

23. *Id.* at 746.

amendments. For example, a person with an equitable lien based on the debtor's unperformed promise to grant a lien in the future could then successfully assert an unpublicized claim in bankruptcy. Because such a claim was not required to be recorded and took priority under state law over lien creditors, neither of the trustee's two new powers would defeat it.[24]

These difficulties, among others, were addressed in 1938 with the passage of the Chandler Act.[25] Discarding for the first time explicit mention of recording, the Act was modified to provide that transfers were deemed to occur, for the purpose of determining voidable preferences, when they were so far perfected that, under local law, no bona fide purchaser and no creditor of the transferor could thereafter acquire rights superior to the transferee. In the absence of such perfection, all transfers were deemed to have occurred just prior to bankruptcy. Because under state law equitable liens were inferior to the claim of a bona fide purchaser, equitable liens were deemed to arise just prior to bankruptcy and were voidable as preferences.[26] The effect on equitable liens, as intended, was to avoid them all.

It was here that voidability of equitable liens and constructive trusts parted ways. Throughout the pre-1938 period, constructive trust claims had survived in bankruptcy along with equitable liens, but on a strikingly different theory. Though just as secret as equitable liens, restitutionary claims seeking the remedy of constructive trust were apparently considered the equivalent of true trusts. Accordingly, property impressed with a constructive trust had unfailingly been treated as property in which the debtor holds only "bare legal title," and did not become part of the estate.[27] Ironically, the so-called "equitable assignment," which is distinct from an equitable lien only in that the claimant obtains title rather than a lien, had long been recognized as causing the same difficulties as the equitable lien. Of course, equitable assignment is just another name for constructive trust, except that courts did not mistakenly treat equitable assignments as true trusts. Rather, they were treated like equitable liens.[28] For obvious reasons, to a claimant in bankruptcy a constructive trust was an equitable assignment that, by the other name, smelled far more sweet.[29] Thus, claims of equitable assignment became quite rare.

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24. *Id.* at 748.

25. Act of June 22, 1938, ch. 575, 52 Stat. 840 (cited in Morris, *supra* note 22).

26. Morris, *supra* note 22, at 749.

27. *See, e.g., In re* Jacob Berry & Co., 147 F. 208 (2d Cir. 1906); *In re* Woods & Malone, 121 F. 599 (S.D. Ga. 1903).

28. 3 W. COLLIER, COLLIER ON BANKRUPTCY ¶ 60.37[5] (1973).

29. My apologies to William Shakespeare.

The 1950 amendments were not intended to alter the treatment of equitable liens, since they had all been made voidable in 1938 and had subsequently caused no difficulty. However, the 1938 bona fide purchaser test for voidable preferences had caused difficulty with regard to inventory and accounts financing.[30] Section 60(a)(2) was thus amended to change the time a transfer of personalty was deemed to occur from the time of perfection against a bona fide purchaser to the time of perfection against a lien creditor. The time of transfer regarding realty was left to turn on perfection against a bona fide purchaser. This amendment, for the first time, effected different treatment for claims against realty than for claims against personalty, creating problems that continue today.[31] It also, if left alone, would have had the effect of revitalizing equitable liens against personalty, because they ordinarily defeat lien creditors under state law. Recognizing this, Congress added section 60(a)(6), which declared *certain* equitable liens void: transfers for security when available means of perfecting legal liens against third persons had not been employed.[32] Although there is no indication that Congress intended it,[33] by specifically avoiding only these equitable liens on personalty, others were revitalized, such as the construction surety's equitable subordination claim.[34]

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30. Morris, *supra* note 22, at 750-52.

31. *See infra* note 52 and accompanying text.

32. For the first time since 1910, the trustee's power of avoidance was effective against liens only where available means of perfecting had not been employed. This is a much smaller group of liens than those that are simply unperfected as against some specified competitor, shielding from avoidance those unperfected liens for which no means of perfecting is available. I have found no indication in the legislative history that these secret liens for which no available means of perfection exists were intended to be saved. Indeed, this would run directly counter to policy against secret liens. It may have been a simple drafting error. However, the 1978 Code retained the distinction for reasons that were given clearly inadequate thought. *See infra* note 51 and accompanying text.

33. The only explanation in the legislative history for the language chosen in § 60(a)(6) is that the drafters intended the section to solve the same problems that had motivated the 1938 changes, namely the belatedly filed transfer and the "pocket lien." The 1938 changes had gone much further in solving these problems, yet there is no indication that Congress believed they had gone too far, except for the 1950 concerns regarding inventory and accounts. The narrowness of § 60(a)(6) is probably due to the political expediency of legislating the smallest changes possible to remedy only the specific perceived ailment.

34. One example of an equitable claim defeating the trustee because no means for perfection were available is the construction surety's equitable subordination claim. *See In re* J.V. Gleason Co., 452 F.2d 1219 (8th Cir. 1971); Federal Ins. Co. v. Constructora Maza, Inc., 500 F. Supp. 246 (D.P.R. 1979); *In re* William P. Bray Co., 127 F. Supp. 627 (D. Conn. 1954); Dannais v. De Matteo, 102 F. Supp. 874 (D.N.H. 1952). These, however, have become so familiar in the construction industry that they are not normally thought of as secret liens. *See also* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 888-89 (1980).

Prior to the drafting of the 1978 Code, a development of great importance occurred. The drafters of the Uniform Commercial Code attempted to eradicate the equitable lien from personal property security law. Comment 5 to section 9-203 forcefully stated that a security interest that fails to satisfy the formal requirements of Article Nine "cannot be made [enforceable] on any theory of equitable mortgage or the like . . . . More harm than good would result from allowing creditors to establish a secured status by parol evidence after they have neglected the simple formality of obtaining a writing."[35] Professor Grant Gilmore, one of the principal drafters of Article Nine, was also the leader in the early drafting of the new Code. Apparently convinced that the UCC drafters had been successful, the Gilmore Committee Report advised Congress that bankruptcy law need no longer bother with equitable liens. The report stated,

> [T]he ambiguous provisions of Section 60(a)(6) on so-called equitable liens, which were necessary when Section 60 was redrafted in the late 1940s, no longer serve any function, for the reason that Article 9 has turned the "equitable liens" against which Section 60(a)(6) was directed into "unperfected security interests" which the trustee can in any case set aside.[36]

Of course, the Gilmore Committee was only partly correct. Article Nine may have turned equitable liens arising out of failed attempts to create security interests into unperfected security interests, but it had no such effect on equitable liens arising out of the multitude of other circumstances creating restitutionary claims.[37] Nevertheless,

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35. U.C.C. § 9-204 comment 5 (1977).

36. H.R. REP NO. 595, 95th Cong., 1st Sess. 209 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787.

37. This overstatement by the Gilmore Committee is curious in light of the fact that Professor Gilmore had been aware earlier of the limited effect § 9-204 would have on other sorts of equitable claims. In his treatise, 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 345 (1965), he noted that the Code's attempt to eliminate all equitable mortgages had "overshot the mark." In a well known passage, Gilmore stated:

> Article 9, for all its comprehensiveness, is a statute drafted to regulate certain well-known or institutionalized types of financing transactions . . . . [A] transaction which sets out to be one of those types should conform to the Article 9 rules or fall by the wayside. But beyond the area of institutionalized transaction, there stretches a no-man's land, in which strange creatures do strange things. For these strange things there are no rules; it makes no sense to measure them against the rules which professionals have developed for professional transactions.

Id. at 336-37.

Congress took the Gilmore Committee's advice. The 1978 Code contains no provision directed to the treatment of equitable liens. To the extent that the legislative history discloses any thought given to the treatment of constructive trusts, it discloses only the continued failure to distinguish between constructive and true trusts.[38]

II. CONSTRUCTIVE TRUSTS AND EQUITABLE LIENS UNDER THE 1978 BANKRUPTCY CODE

The enactment of the Bankruptcy Reform Act of 1978[39] and the Bankruptcy Amendments and Federal Judgeship Act of 1984[40] created the current Bankruptcy Code.[41] The sections relating most directly to the treatment of equitable liens and constructive trusts are sections 541 and 544. Section 541 defines property of the estate extremely broadly.[42] Under the language of subsection 541(a), the bankruptcy estate includes not only all legal or equitable interests of the debtor at the date of commencement, but also all interests the trustee recovers or preserves for the benefit of the estate under sections 550 and 551 through the exercise of avoiding powers. One of those avoiding powers, of course, is the strong arm power of section 544(a).

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38. As an example of a situation "where property ostensibly belonging to the debtor will actually not be property of the debtor, but will be held in trust for another," the legislative history posits a mistaken payment held in constructive trust. H.R. REP. NO. 595, 95th Cong., 1st Sess. 367-68 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 6324; S. REP. No. 989, 95th Cong., 2d Sess. 82, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5868.

39. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

40. Bankruptcy Amendments & Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333.

41. 11 U.S.C. §§ 101-1330 (1978). Unless otherwise indicated, citations throughout this article are to the Bankruptcy Code.

42. The relevant portions are:

> Section 541. Property of the estate.
>
> (a) The commencement of a case . . . creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
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> (1) Except as provided . . . all legal or equitable interest of the debtor in property as of commencement of the case.
>
> (2) All interests of the debtor . . . in community property . . . .
>
> (3) Any interest in property preserved for the benefit of . . . the estate under section . . . 551 of this title . . . .
>
> (d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate under subsection (a)(1) or (a)(2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

The breadth of subsection 541(a) is tempered by the redundant reminder in subsection (d) that the estate under subsections (a)(1) and (a)(2) is expressly limited to the "interests of the debtor in property" at the time of filing. If the debtor held only "bare legal title," as when the debtor is the trustee of a true trust, that is all the estate holds.[43] But the specific reference in subsection (d) to subsections (a)(1) and (a)(2) makes clear that subsection (d) in no way limits subsections (a)(3) and (a)(4) — property recovered by the trustee through the exercise of avoidance powers. As originally enacted in 1978, subsection (d) referred simply to subsection (a) property, but the 1984 amendments narrowed the reference to subsections (a)(1) and (a)(2) only, so as to clarify what to many was self-evident.[44] The treatise writers have characterized this as a "clarifying change"[45] and a "minor technical amendment."[46]

In the case of an equitable claim to a specified asset of the estate, the first analytical step is to determine whether the claim is effective under state law. Again, this means the debtor has received a benefit from the claimant that if retained, would unjustly enrich the debtor, and the claim is sufficiently traced into the disputed asset. If the claimant succeeds and the court determines the debtor holds the asset subject to the claimant's equitable lien or constructive trust, the asset becomes part of the bankruptcy estate under subsections (a)(1), (a)(2), and (d) only to the extent of the debtor's limited interests. However, because the estate is comprised of *all* subsection (a) property types, the possibility that the property might come into the estate under subsection (a)(3) or (a)(4) would still need consideration. The trustee's avoidance powers are well-known to have the effect of acquiring for the estate property the debtor did not hold and could not have acquired. Accordingly, the next analytical step is to determine whether

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43. Subsection (d) could be rationally read to exclude only beneficial legal interests, such as life estates, remainders, mortgages and the like. The legislative history refers primarily to the secondary mortgage market. 146 CONG. REC. H11,096 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,413 (daily ed. Oct. 6, 1978). The legislative history suggests that § 541(a)(1) does not include property held subject to constructive trusts. *See supra* note 38. As a result, most courts have correctly concluded that equitable liens were excluded here too.

44. A number of pre-1984 cases recognized that § 541(d) was not intended to preclude inquiry into the voidability of a restitutionary claim. *See, e.g., In re* Anderson, 30 Bankr. 995, 1008-10 (D. Tenn. 1983); *In re* Hurst, 27 Bankr. 740 (Bankr. E.D. Tenn. 1983); *In re* Elin, 20 Bankr. 1012, 1015-17 (D.N.J. 1982).

45. W. NORTON, 4 BANKRUPTCY LAW AND PRACTICE 134 (Supp. 1985).

46. W. COLLIER, BANKRUPTCY CODE 315 (pamphlet ed. 1986).

the trustee has the power to avoid the equitable claim. It is here that section 544 comes into play.[47]

Section 544(a)(1) contains the trustee's familiar "strong arm" power, which permits the trustee to avoid any claim to the debtor's property that would be defeated under state law by a judicial lien creditor without knowledge of the claim. Subsection (a)(3) adds a new avoidance power as to transfers of realty, that of a bona fide purchaser (BFP) without knowledge against whom applicable law permits such transfers to be perfected. The chief limitation on this new BFP power is that, while the trustee in exercising it will be deemed to be without *knowledge* of the transfer, the trustee is still vulnerable to the defense that the trustee had *notice* of it. The courts have been virtually unanimous in concluding that circumstances imparting constructive notice to an ordinary purchaser will be effective against the trustee as well.[48]

To summarize, when a restitutionary claim to an asset is made, the statute mandates a number of analytical steps. Before awarding the asset to the claimant, the court must conclude: 1) there is an adequate basis under state law for providing a restitutionary remedy; 2) the claim is sufficiently traced under state law into the disputed asset; 3) regardless whether the asset is realty or personalty, a lien creditor would not, under state law, defeat the claim; and 4) if the disputed asset is realty, either a) state law does not permit the claim to be perfected against a bona fide purchaser, or b) despite lack of perfection, the claim is one that, for some reason such as constructive notice, would defeat a bona fide purchaser who lacked knowledge of the claim.

Recall now the state priority rules, under which restitutionary claims are normally effective against subsequent lien creditors, but

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47. Its pertinent parts are:

Section 544.

(a) The trustee shall have, as of the commencement of the case and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by —

(1) a creditor that extends to the debtor at the time of commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien, whether or not such a creditor exists;

. . .

(3) a bona fide purchaser of real property, other than fixtures, 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 purchaser exists.

48. *See infra* note 96 and accompanying text.

not against bona fide purchasers without notice. Applying these two rules in bankruptcy to restitutionary claims that are validly based and adequately traced, one would expect claims to personalty to defeat the trustee's lien creditor power, and claims to realty to fall to the trustee's BFP power as long as the circumstances do not impart constructive notice and the claim is one that "applicable law permits . . . to be perfected."

On setting out to run this gauntlet, one is struck by a number of oddities. First is the lengthy list of required state law determinations, particularly when the disputed asset happens to be realty: adequacy of the basis for the claim, adequacy of tracing, priority as against lien creditors, priority as against bona fide purchasers, existence of constructive notice, and finally, permissibility of perfection. This last element, the limitation in subsection (a)(3) that applicable law must *permit* the claim to be perfected, is confusing. Does the new BFP power work, as did old section 60(a)(6),[49] only where perfection is required for validity against third persons? Or does it work against any claimant that, with a little cunning, might have protected itself against third persons? Another source of confusion is the Code's different validity criteria for claims to personalty than the criteria for claims to realty. The anomaly will be most pointed if the fund the claimant seeks to trace has been distributed by the debtor into both realty and personalty.

When one looks to the legislative history and to the treatise writers for help with these and other oddities, one finds very little — and what one does find is always oversimple and often contradictory. For example, the only discussion in the legislative history about the meaning of the permitted-to-be-perfected clause in the statement that a transferee should not be required to perfect when applicable law makes perfection impossible.[50] One might infer from this that a transferee

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49. The language of § 60(a)(6) of the Bankruptcy Act was:

> The recognition of equitable liens where available means of perfecting legal liens have not been employed is declared to be contrary to the policy of this section. If a transfer is for security and if (A) applicable law *requires* a signed and delivered writing, or a delivery of possession, or a filing or recording or other like overt actions as a condition to its full validity against third persons . . . and (B) such overt action has not been taken, and (C) such transfer results in the acquisition of only an equitable lien, then such transfer is not perfected within the meaning . . . of this subsection.

11 U.S.C. § 60(a)(6) (1950) (emphasis added).

50. 124 CONG. REC. H11,097 (daily ed. Sept. 26, 1978); 124 CONG. REC. S17,413 (daily ed. Oct. 6, 1978).

will be expected to do what is possible, or at least reasonable, to protect its interest. But because the only example given is both confusing and based on language that was eventually deleted,[51] the meaning of the clause remains obscure.

The legislative history is only slightly more helpful on the question of why equitable claims to realty are treated differently from equitable claims to personalty. The history suggests that this was a mistake. The new BFP power in subsection (a)(3) was added to eliminate the inconsistent effect in bankruptcy of the state-to-state variations in the treatment of unrecorded claims to realty.[52] By failing to consider the effect on equitable claims, the drafters ironically created precisely the type of inconsistency they sought to eliminate. A court facing a claim traced into both realty and personalty will find little comfort in this knowledge.

The treatise writers and commentators have added very little. For example, the leading treatise, *Collier*, has reserved a section on equitable liens for future use;[53] to date it has not been drafted. Elsewhere, Collier makes oversimple statements such as, "Any secret lien or equitable interest that is not otherwise protected by appropriate state law . . . will be invalid as to the trustee."[54] Collier's statement in another section that constructive trusts do not become part of the estate[55] reflects and perpetuates the common misconception that constructive trusts and equitable interests are wholly unrelated. Similarly,

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51. At one point in the drafting process, both §§ 544(a)(1) and (a)(3) contained permitted-to-be-perfected clauses. The example of its application to personalty involved a buyer at an improperly noticed bulk sale. Since the purchaser cannot perfect against the debtor's general creditors, he should not be held responsible for failing to do the impossible. *See supra* note 50.

Not only is there no formal procedure for "perfecting" but there is nothing a purchaser can do about his vulnerability to claims of these creditors. This suggests that the permitted-to-be-perfected phrase means there exists some reasonable means of protecting one's claim against the debtor's creditors. Because the means to protect claims to realty are usually available, this may suggest that the clause in § 544(a)(3) is not much of a limitation on the trustee's BFP power.

On the other hand, the bulk sale example is a baffling one because it is the purchaser at the bulk sale who must give the required notices. U.C.C. § 6-106 (1977). Having failed properly to do so, the purchase is ineffective against creditors. Granted, the purchaser is in a vulnerable position due to his failure. Why such a purchaser should not be held responsible for failing to eliminate this vulnerability is a mystery to me.

I am left with the strong impression that the permitted-to-be-perfected clause was not very well thought out. The courts seem to be of the same opinion because they have ignored it almost completely. *See infra* notes 63-64 and accompanying text.

52. W. NORTON, 2 BANKRUPTCY LAW AND PRACTICE § 30.05 (1981).

53. W. COLLIER, 4 COLLIER ON BANKRUPTCY ¶ 547.50 (15th ed. 1979).

54. *Id.* ¶ 544.06.

55. *Id.* ¶ 541.13.

the Norton treatise states that equitable doctrines may provide a remedy for fraud or inadvertence. Furthermore, the remedy may involve a trust that is enforceable against the estate on the grounds that the property did not pass to the estate, or "in other cases, state law will describe the remedy as a lien . . . ."[56] Norton then states that such liens should be voidable as they were under section 60(a)(6) without mentioning why such a different result should turn on how state law might "describe the remedy."

Not all commentators believe constructive trusts are to remain outside the estate. According to Teofan and Creel, "Equitable interests of beneficiaries under . . . constructive trusts will . . . fall before the attack of the trustee as bona fide purchaser. In addition, the trustee will cut off equities created by mutual mistake, fraud or similar situations for which equitable relief is afforded by state law."[57] Unfortunately, they add that the effect of section 541(d) on the trustee's avoiding powers is unclear.[58]

One is forcefully led to conclude that neither the drafters nor the treatise writers have given much attention to the way in which these equitable claims are to be treated under the Bankruptcy Code. The courts, confronted with the job of deciding the validity of these claims against the bankruptcy estate, have been left in an extremely awkward position. A court is bound to apply the law, and the law in this instance is a wonderland of incomplete, conflicting, and sometimes ludicrous directives from which the courts are expected to choose. In many instances, a careful judge can do no better than select the least embarrassing of a number of flawed analytical paths. Accordingly, it is not surprising to find the case law in the current disarray I now begin to describe.

I examined all of the more than one-hundred cases treating claims of equitable lien or constructive trust under the 1978 Code. In the few instances in which the Code gives specific attention to claims of this type, such as those of reclaiming sellers of goods[59] or victims of securities fraud,[60] the courts had little difficulty. Among the remaining

56. W. NORTON, *supra* note 52, at § 32.28.

57. Teofan & Creel, *The Trustee's Avoidance Powers Under the Bankruptcy Act and the New Code: A Comparative Analysis*, 85 COM. L.J. 542, 545 (1980).

58. *Id.* at 545 n.51.

59. *See* 11 U.S.C. § 546(c) (1982); *see also In re* United Precious Metals, 39 Bankr. 14 (Bankr. S.D. Fla. 1984); *In re* Coast Trading Co., 31 Bankr. 667 (Bankr. D. Or. 1982); *In re* Deephouse Equip. Co., 22 Bankr. 255 (Bankr. D. Conn. 1982).

60. *See* 11 U.S.C. § 510(b); *see also In re* Flight Transp. Corp., 730 F.2d 1128, 1137 (8th Cir. 1984).

cases, however, I was astonished at the range of analytical approaches I found. There were no fewer than six theories on which the trustee defeated the restitutionary claim,[61] and seven theories on which the claimant defeated the trustee.[62] Except for the cases denying the claim

61. The first theory is that the claim lacks an adequate basis for restitution under state law. Of course, this ruling is correct when the debtor has not been unjustly enriched. However, even when the debtor has been unjustly enriched by ordinary standards, there are three ways to fail here. First, the court may incorrectly hold that the debtor was not unjustly enriched. *See. e.g., In re* Stiennon, 73 Bankr. 905, 907 (Bankr. W.D. Wis. 1987) (court incorrectly held debtor was not unjustly enriched because estate retained debtor's funds for equitable distribution); *In re* Fidelity Standard Mortgage Corp., 43 Bankr. 654, 657 (Bankr. S.D. Fla. 1984) (court incorrectly held debtor was not unjustly enriched because beneficiary of claimant's efforts was trustee on creditors' behalf). Second, a few courts have held that despite the debtor's unjust enrichment, the remedy of constructive trust is available only prospectively, originating when the claim is sought to be enforced. Thus, in the context of these cases, no interest in the debtor's estate existed before bankruptcy *See, e.g., In re* First Capital Mortgage Loan Corp., 60 Bankr. 915, 919 (Bankr. D. Utah 1986); *In re* Guaranteed Ins. Underwriters, Inc., 44 Bankr. 1004 (Bankr. S.D. Fla. 1984); *In re* Tinnell Traffic Servs., Inc., 41 Bankr. 1018, 1021 (Bankr. M.D. Tenn. 1984). Finally, in some states these equitable remedies are rigidly circumscribed and available only when the unjust enrichment is the result of fraud or constructive fraud; claims based on other forms of unjust enrichment apparently entitle the claimant only to a money judgment. *See In re* Stiennon, 73 Bankr. 905, 907-08 (Bankr. W.D. Wis. 1987); *In re* Minton Group, Inc., 28 Bankr. 774, 783 (Bankr. S.D.N.Y. 1983); *In re* Dexter Buick-GMC Truck Co., 2 Bankr. 251, 252 (Bankr. D.R.I. 1980); *see also In re* Albritton, 17 Bankr. 555, 557-58 (Bankr. M.D. Fla. 1982) (holding claimant's mistake is inadequate as basis for constructive trust, but adequate as basis for equitable lien).

A second theory on which the trustee may prevail is that the claim is not adequately traced under state law. *See, e.g., In re* Independent Clearing House Co., 41 Bankr. 985, 1000-04 (Bankr. D. Utah 1984). A third theory is that the claim lacks an adequate basis for restitution under federal law, despite the fact that there is an adequate basis for the claim under state law. *See In re* North Am. Coin & Currency, 767 F.2d 1573, 1575 (9th Cir. 1985). A fourth theory is that the claim falls to the trustee's lien creditor power. *See infra* note 84. A fifth theory is that the claim falls to the trustee's BFP power. *See e.g., In re* Great Plains W. Ranch Co., 38 Bankr. 899, 905-06 (Bankr. C.D. Cal. 1984). A sixth category of theories might be called the miscellaneous specialized solutions. A number of restitutionary claims have fallen within the ambit of a specialized section of the Code and found resolution there. *See, e.g.,* Flight Transp. Corp., 730 F.2d 1128 (8th Cir. 1984) (case was resolved under § 510(b)); *In re* United Precious Metals, Inc., 39 Bankr. 14 (Bankr. S.D. Fla. 1984); *In re* Deephouse Equip. Co., 22 Bankr. 255 (Bankr. D. Conn. 1982).

62. Virtually all of the cases in which the claimant defeated the trustee began with the determination that the claim under state law is an adequately based restitutionary claim and properly traced into an asset of the estate. One popular theory under which restitutionary claims have defeated the trustee is that property subject to an equitable claim is not part of the bankruptcy estate, either on the authority of § 541(d), see *In re* Shepard, 29 Bankr. 928, 932 (Bankr. M.D. Fla. 1983), or on no authority at all, see *In re* Jones, 50 Bankr. 911 (Bankr. N.D. Tex. 1985). A second theory is that the equitable claim defeats the trustee's lien creditor power. *See, e.g., In re* Storage Technology Corp., 45 Bankr. 363 (Bankr. D. Colo. 1985). A third theory is that the equitable claim defeats the trustee's BFP power where constructive notice exists. *See In re* Elin, 20 Bankr. 1012 (Bankr. D.N.J. 1982), *aff'd*, 707 F.2d 1400 (3d Cir. 1983). A fourth

under state law, most were analytically flawed, albeit some more deeply than others. Perhaps the biggest surprise in the way these claims have been analyzed is that not one court has paid attention to the permitted-to-be-perfected clause. A few have mentioned it tangentially,[63] but none have relied on or attempted to interpret it. Although relevant in a number of cases,[64] the availability of so many other ways to achieve any desired result seems to have permitted the courts to sidestep this one.

Inherent in this broad array of theories is a variety of ideas about the nature of these equitable claims. Some courts have treated equitable liens and constructive trusts as interchangeable.[65] Some courts have recognized that equitable liens and constructive trusts are substantively identical, yet remedially different.[66] A large proportion of courts have treated them as totally unrelated devices, stating that constructive trusts defeat the trustee but equitable liens do not. These courts have then proceeded to decide which one the claimant is entitled to, either by looking at the basis for the claim in the mistaken belief that telling differences lie there,[67] or by simply choosing the characterization that will produce the desired result.[68]

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theory is that facts truly creating only a restitutionary claim are improperly held to create either a resulting trust, see Lancaster v. Key, 24 Bankr. L. Rep. 897, 899 (E.D. Tenn. 1982), or a true trust, see *In re* Elrod, 42 Bankr. 468 (Bankr. D. Tenn. 1984). A fifth theory is that avoiding powers normally applied on behalf of a Chapter 7 trustee are refused enforcement for the benefit of a Chapter 13 debtor. *See In re* Chapman, 51 Bankr. 663 (Bankr. D.D.C. 1985); *see also In re* Moore, 54 Bankr. 781, 783-84 (Bankr. E.D.N.C. 1985) (case involving a Chapter 11 debtor in possession). A sixth theory is that although the restitutionary claim is voidable by the trustee, the court may impose its own constructive trust on the asset for the claimant's benefit. *See* McAllester v. Aldridge, 30 Bankr. 995, 1013-15 (Bankr. M.D. Tenn. 1983). A seventh theory finds an apparent conflict between §§ 541(d) and 544 so that the trustee's avoiding powers are not enforced because the policies of § 541(d) overpower those of § 544. *See In re* Quality Holstein Leasing, 725 F.2d 1009 (5th Cir. 1985).

63. *See, e.g.,* McCannon v. Marston, 679 F.2d 13, 17 (3d Cir. 1982).

64. In the case of *In re* Great Plains W. Ranch Co., 38 Bankr. 899 (Bankr. C.D. Cal. 1984), the court held that equitable claims based on fraud would be defeated by the trustee's BFP power. The court did not mention how these claims were permitted to be perfected under state law.

65. *See, e.g., In re* Minton Group, Inc., 28 Bankr. 774, 785-86 (Bankr. S.D.N.Y. 1983). Some courts do not bother to characterize the claim as one or the other, referring to the claim instead simply as an "equitable right." *See In re* Mitchell, 9 Bankr. 577, 578 (Bankr. D. Or. 1981).

66. *See, e.g., In re* Jones, 50 Bankr. 911, 921-23 (Bankr. N.D. Tex. 1985) (court imposed constructive trust on much of the property of the estate, but imposed equitable lien to a limited extent on debtor's homestead).

67. *See In re* Albritton, 17 Bankr. 555, 557-58 (Bankr. M.D. Fla. 1982) (court treated alternatively claimed remedies as having different substantive bases).

68. *See, e.g., In re* Graham, 28 Bankr. 928, 931-32 (Bankr. N.D. Iowa 1983) (court held

Feeling somewhat like a biologist trying to type mutant fruit flies, I searched at length for correlations between the various modes of analysis and the types of restitutionary claims. I found none.[69] The only pattern I was able to detect is the emergence of what might be called three analytical strains. The first courts considering equitable claims under the new Bankruptcy Code, seeming to believe that the rules of the old Bankruptcy Act were still in force, applied the simple rubric that equitable claims not based on an unrecorded transfer beat the trustee. Often they made no reference to any statute, as though these rules are too obviously correct to need explanation.[70] Eventually, these courts began to find support in section 541(d) and its skimpy legislative history.[71] This view continues to appear today,[72] despite the elimination in 1984 of any doubt as to the mandate to inquire into voidability.

The second analytical approach, which began to appear soon after the first, recognized the need to consider the voidability of the equitable claim.[73] Despite having sometimes to struggle to find sense in the statutory mandate,[74] these courts, at least, did not ignore it. This approach did not replace the first, but simply took its place alongside it. Rather than criticizing the early courts for their inconsistent view, these courts seemed unaware of the split.

The third, and much more enlightened strain has appeared only recently. These cases recognize the analytical mandate of the statute but recoil from its lack of sophistication. Equitable claims often present difficult conflicts between bankruptcy policy and nonbankruptcy policy

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claimant entitled to a lien, but because lien avoidance was a "complex issue," it would impose constructive trust instead). Similarly, in the case of *In re* Wyatt, 6 Bankr. 947, 954 (Bankr. E.D.N.Y. 1980), the court imposed a constructive trust to the limited extent of the claim, which was nothing but a lien. The court then held that the estate was under the equitable duty to convey the property to the claimant. *Id.* at 954.

69. There were, of course, correlations in factual patterns, as distinct from analytical patterns. For example, claims based on imperfect attempts to transfer property, as discussed in Part IIIA, tended to be devoid of tracing problems because the subject property was usually still around. It is only natural that when cases are lumped together because of some shared characteristic, they will turn out to share other characteristics as well.

70. *See, e.g., In re* Wyatt, 6 Bankr. 947 (Bankr. E.D.N.Y. 1980) (citing only pre-Code case law); *In re* Garland Corp., 6 Bankr. 452 (Bankr. D. Mass. 1980).

71. *See, e.g., In re* Cubbler, 17 Bankr. 674 (Bankr. E.D. Pa. 1982).

72. *See, e.g., In re* Lodek, 61 Bankr. 66 (Bankr. W.D. Tex. 1986).

73. The first of these cases included *In re* Trotta, 12 Bankr. 843 (Bankr. D. Conn. 1981); *In re* Mitchell, 9 Bankr. 577 (Bankr. D. Ore. 1981); *In re* Taylor, 8 Bankr. 806 (Bankr. D.D.C. 1981).

74. *See, e.g., In re* Great Plains W. Ranch Co., 38 Bankr. 899 (Bankr. C.D. Cal. 1984).

or between competing bankruptcy policies. Sensible resolution of these conflicts often requires a careful balancing. What has emerged from these cases so far is a recognition that sections 541 and 544 are somehow inconsistent and that one of them must overpower the other. These courts have held, for example, that fundamental bankruptcy policy authorizes the disregard of avoiding powers despite the statutory mandate,[75] or, conversely, that it authorizes a court to find no equitable claim in bankruptcy even though one clearly would be recognized under state law.[76] Although these early solutions are still somewhat crude, they light the way to a more sophisticated debate as to how the Code ought to treat equitable claims.

Given these three analytical approaches and the multitude of variations on each, the result is that decent precedent can be found for virtually any solution to the problem posed by an equitable claim. In effect, under the Bankruptcy Code as currently interpreted, courts must confront these disputes virtually without guidance and with no greater constraint than to have to select from among the numerous analytical modes. The result is a nearly classic example of the common law at work. The cases provide important insights into the types of claims the judiciary thinks deserving and undeserving. Unfortunately, the opinions speak in terms of statute and precedent as if these were true guides, rather than a mere matrix into which courts fit conclusions. Because the true operative factors are obscured, the process of developing workable standards is severely slowed and often sidetracked. Perhaps worse, the current state of the law provides opportunity for extensive argumentation, brief writing, and unnecessary delay.[77]

It is my thesis that by studying the characteristics of winners and losers, insights may be gained that will serve as a basis for developing the first coherent statutory guidelines for proper and efficient resolution of these claims. In Part III of this article, I discuss the cases, lumped for convenience into eight categories, and attempt to extract the factors at work in determining success or failure as against the trustee. Based on that learning, in Part V, I discuss the policy implications of these cases and recommend a new approach to equitable claims in bankruptcy.

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75. *See, e.g., In re* Quality Holstein Leasing, 752 F.2d 1009 (5th Cir. 1985).

76. *See, e.g., In re* North Am. Coin & Currency, 767 F.2d 1573 (9th Cir.), *amended by* 774 F.2d 1390 (9th Cir. 1985), *cert. denied,* 475 U.S. 1083 (1986).

77. For an example of one court's outrage at the amount of paper generated by a motion to dismiss a constructive trust claim, see *In re* Storage Technology Corp., 55 Bankr. 479 (Bankr. D. Colo. 1985).

III. THE CASES

Of the numerous cases treating equitable claims under the 1978 Code, one hundred five proved to be directly useful. The rest were decided on such unique[78] or ambiguous[79] grounds as to be of collateral use only. The largest group of cases, and the one that the courts have treated most consistently and coherently, is the group I have labeled

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78. One important group of uniquely decided cases includes those based on Congress's special concern for the secondary mortgage market. The generous language in the legislative history of § 541(d) has led some courts to conclude that investors in that market are intended to defeat the trustee even if their claims would lose to a bona fide purchaser, or even if they have no valid equitable claim under state law at all. *See In re* Mortgage Funding, Inc., 48 Bankr. 152 (Bankr. D. Nev. 1985); *In re* Fidelity Standard Mortgage Corp., 36 Bankr. 496 (Bankr. S.D. Fla. 1983); *In re* Columbia Pac. Mortgage, Inc., 20 Bankr. 259 (Bankr. W.D. Wash. 1931); *In re* Adana Mortgage Bankers, Inc., 12 Bankr. 989 (Bankr. N.D. Ga. 1980). Three of the many cases decided under the narrow and specific authority of § 546(c) include *In re* United Precious Metals, Inc., 39 Bankr. 14 (Bankr. S.D. Fla. 1984); *In re* Coast Trading Co., 31 Bankr. 667 (Bankr. D. Or. 1982); *In re* Deephouse Equip. Co., 22 Bankr. 255 (Bankr. D. Conn. 1982). A case involving a securities fraud claim that was decided under § 510(b) is *In re* Flight Transp. Corp., 730 F.2d 1128 (8th Cir. 1984). There are numerous cases that deny constructive trust claims on such restrictive state grounds as to be of no use. *See, e.g., In re* Latham Exploration Co., 83 Bankr. 423 (Bankr. W.D. La. 1988); *In re* Kuchavek, 79 Bankr. 393 (Bankr. W.D. Wis. 1987); *In re* Stiennon, 73 Bankr. 905, 907-08 (Bankr. W.D. Wis. 1987); *In re* Guaranteed Ins. Underwriters, Inc., 44 Bankr. 1004 (Bankr. S.D. Fla. 1984); *In re* Dexter Buick-GMC Truck Co., 2 Bankr. 251 (Bankr. D.R.I. 1980). Six Michigan cases are dominated by the unique manner in which the seller of a bar in Michigan goes about retaining an interest in the liquor license. *See In re* Gullifor, 47 Bankr. 450 (Bankr. E.D. Mich. 1985) (the cases are cited therein at 453); *see also In re* Pike, 62 Bankr. 765 (Bankr. W.D. Mich. 1986).

Another case dominated by unique state law is *In re* Cox, 68 Bankr. 788 (Bankr. D. Or. 1987). After a lengthy discussion of Oregon recording law, the court held that mortgages of a vendee's interest in a land sale contract are not protected against subsequent bona fide purchasers even if properly recorded. In permitting the trustee to defeat two properly recorded institutional lenders, the court expressed the belief that it would be "appropriate for the legislature to address the dilemma which this opinion creates for equitable mortgage holders whose vendee files bankruptcy." *Id.* at 803.

79. One ambiguous case was dominated by the fact that the interest claimed had originated with a grant of federal funds. *In re* Madison County Economic Opportunity Comm'n, 53 Bankr. 541 (Bankr. S.D. Ill. 1985). One case was dominated by the Code's § 365(i) (now § 365(j)) provision of a vendee's lien to a person who has made a down payment on a rejected executory contract to purchase real estate. *In re* Roman Crest Fruit, Inc., 35 Bankr. 939 (Bankr. S.D.N.Y. 1983). Examples of cases decided on express or statutory trust theories include *In re* F.L. Ross Enters., Inc., 19 Bankr. 237 (Bankr. S.D. Ohio 1982) (express trust theory); *In re* Fresh Approach, Inc., 51 Bankr. 412 (Bankr. N.D. Tex. 1985) (statutory trust theory). Also of little use are cases in which the equitable claim is lost through a procedural error. *See In re* Earl Roggenbuck Farms, 51 Bankr. 913 (Bankr. E.D. Mich. 1985). Also useless are those cases in which the allusion to the equitable claim is too terse to provide any information. *See In re* Timberline, slip op. (Bankr. S.D.N.Y. Apr. 9, 1986); *see also infra* notes 86 & 211.

the "imperfect transfer" cases. These are the cases in which a legal transfer from the debtor to the claimant was attempted, not always voluntarily, but the transfer was not fully effective due to some inadvertence or inaction on the part of one of them — usually the claimant. The most common examples of imperfect transfers are the familiar unperfected mortgage or security interest, and the improperly recorded sale of realty. The one hundred five case sample contained thirty-seven cases in which the equitable claim was based on an imperfect transfer.

On departing from the imperfect transfer cases, categorization becomes much more difficult. The open-ended nature of the unjust enrichment concept assures that the remaining restitutionary claims arise out of a wide variety of circumstances and interactions. For the purpose of analysis and discussion, I have grouped the remaining sixty-eight cases in the following categories, indicating in parentheses the number of cases in each group: fraud (14), intentional misrecording (7), conversion of funds placed for investment (13), conversion of property entrusted to agents (6), mistaken payments (5), divorce (9), and miscellaneous (14). Of the one hundred five, the claimant won fifty, the trustee or debtor in possession won fifty-one, and the results in four were mixed.

As noted in the previous section, my attempts to explain the array of results in terms of judicial application of the statute failed. It was not until I disregarded the stated bases for the judicial opinions and looked simply for correlations between the characteristics of the claims and the outcomes that patterns emerged and inferences became possible.

Two separate factors appear to influence the success of an equitable claim to property of the bankruptcy estate. One factor is sympathy for the claimant, and the other is enmity toward the debtor. The existence of either high claimant sympathy or high debtor enmity will bring success to the claimant. In cases where a modest degree of both are found, there may be a bolstering effect. Although it is occasionally surprising what types of claims receive the highest sympathy, the powerful effect of the high-sympathy phenomenon is generally consistent with frequently articulated bankruptcy or debtor-creditor policy. In contrast, the effect of the high-enmity factor often contradicts articulated doctrine by bringing success to claimants who are no more deserving than general creditors. Courts rarely specify the role of high enmity in their analysis, making it more difficult to identify.

The high-sympathy claimants generally tend to be those who, under the circumstances in which the claim arose, cannot reasonably be expected to have better protected themselves. Sympathy may develop for those occupying a certain station in the transaction, such as persons occupying the classic, highly vulnerable positions of consumer-buyers, the unsophisticated and elderly, divorcees, and employees. It may arise out of transactional factors, such as clerical errors. It may result from a claimant's extraordinarily diligent efforts or by the luck of association.

By contrast, the high-enmity factor operates without regard to the nature of the claim or the claimant. Rather, the heart of this phenomenon is that the debtor, having been unjustly enriched at the expense of the claimant, would somehow retain the benefit despite filing bankruptcy if the equitable claim were defeated. In essence, the circumstances are such that the court sees the claimant as competing with the debtor rather than with the general creditors. Examples of such circumstances include: 1) when the debtor claims the disputed asset as exempt; 2) when the debtor is in Chapter 13 and confirmation or completion of the plan will be facilitated by retaining the asset; 3) when some debts are determined to be nondischargeable and the disputed asset, if retained, will be applied to reduce or discharge the debts; and 4) when there is a debtor in possession in Chapter 11. In these circumstances, the victorious claimant is the beneficiary of good fortune. The equitable claim succeeds because, thanks to some characteristic of the bankruptcy estate, the court would prefer to see the asset go to the claimant than to the estate.

In the discussion that follows, I describe the cases in each of the designated categories, attempting to extract from each group some understanding of these two influences.

A. *Imperfect Transfer Cases*

The courts have had the easiest time with the thirty-seven imperfect transfer cases. These are cases in which the parties have attempted to transfer an interest in property from the debtor to the claimant, or the claimant has attempted to retain an interest in transferred property, but due to some defect in the process, the transfer to the claimant did not achieve full legal effect. It is here that courts are most certain as to the drafters' intent. The statements in the legislative history saying that there was no need for a counterpart to section 60(a)(6) were based on the assumption that equitable liens had been eliminated.[80] This was, of course, only partly true, but it was most accurate in the realm of imperfect transfers. The result is that the courts treat these claims with greater consistency and assurance than other sorts of equitable claims.

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80. *See supra* notes 35-38 and accompanying text.

As between imperfect transfers of realty and personalty, courts have had a particularly easy time with the thirteen cases involving personalty. Courts have denied these claims practically without fail, the words of Professor Gilmore ringing loudly in nearly every ear.[81] Because claims based on imperfect transfers of personalty are normally made by low-sympathy claimants — ordinary creditors who have no excuse for the predicament in which they find themselves[82] — there are no complicating sympathy factors. All thirteen of these claims to personalty were based on security interests that failed; none were based on purchases.[83] Eleven of the security interests failed for lack of perfection,[84] and two failed for lack of a transfer intended as security.[85] The trustee was able to avoid all thirteen of these under section 544(a)(1), despite claims of equitable lien.[86] These courts were quite clear that, despite the general rule that equitable claims defeat lien creditors, claims of equitable lien arising out of failed attempts to obtain a security interest in personal property are to be treated as mere unperfected security interests.[87]

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81. *See, e.g., In re* Einoder, 55 Bankr. 319, 328 (Bankr. N.D. Ill. 1985); *In re* Washington Communications Group, 10 Bankr. 676, 679 (Bankr. D.D.C. 1981).

82. *But see* the "Humphries Exception," *infra* note 87.

83. Buyers of personal property usually avoid these problems. Only in special cases, such as the purchase of motor vehicles, are buyers of personalty required to take special steps to perfect their transfers from subsequent parties.

84. The eleven claims voided on the basis of lack of perfection are *In re* Wiggs, 87 Bankr. 57 (Bankr. S.D. Ill. 1988); *In re* Groves, 75 Bankr. 227 (Bankr. M.D. Tenn. 1987); *In re* Doyen, 56 Bankr. 632 (Bankr. D.D.C. 1981); *In re* Einoder, 55 Bankr. 319 (Bankr. N.D. Ill. 1985); *In re* Henzler Mfg. Corp., 36 Bankr. 303 (Bankr. N.D. Ohio 1984); *In re* Davies Ins. Servs., Inc., 33 Bankr. 252 (Bankr. W.D. Pa. 1983); *In re* Washington Communications Group, Inc., 10 Bankr. 676 (Bankr. D.D.C. 1981); *In re* Trim-Lean Meat Prods., 10 Bankr. 333 (Bankr. D. Del. 1981); *In re* Roy A. Dart Ins. Agency, 5 Bankr. 207 (Bankr. D. Mass. 1980); *In re* Solar Energy Sales & Servs., 4 Bankr. 364 (Bankr. D. Utah 1980); *In re* Alvillar, 4 Bankr. 364 (Bankr. D. Utah 1980).

85. The twelfth voidable claim, based on lack of intent to create a security interest, appeared in *In re* O.P.M. Leasing Servs., 23 Bankr. 104 (Bankr. S.D.N.Y. 1982). The thirteenth, based on lack of any legal lien at all, appeared in *In re* Bob Cooper, 65 Bankr. 609 (Bankr. M.D. Fla. 1986).

86. A fourteenth aberrational case first held correctly that the claimants' perfected security interest defeated the claim of the Chapter 11 debtor in possession. As an alternative theory, the court said incorrectly that even if the claimants did not have a perfected security interest, they would be entitled to the asset under equitable principles. *In re* Air Fla. Sys., Inc., 49 Bankr. 321, 325 (Bankr. S.D. Fla. 1985). Since the mention of equitable principles appeared as a gratuitous secondary theory, I attribute little significance to the ruling.

87. One court, in deciding two of the cases, mentioned the "Humphries Exception" under which a claim of equitable lien would defeat the trustee. *See In re* Solar Energy Sales & Servs., Inc., 4 Bankr. 364 (Bankr. D. Utah 1980). In the case of *In re* Humphries, 1 Bankr. 82 (Bankr. D. Utah 1979), the same court had held a creditor that had done all it could reasonably do

The twenty-four cases treating equitable claims to realty were more interesting. Although the treatment of these claims is conceptually the same as the treatment of claims to personalty, courts have received less guidance here for a number of reasons. The treatment of imperfect transfers of realty has not received the notoriety it has regarding personalty, state recording acts are far less uniform than state versions of Article 9 of the UCC, and subsection 544(a)(3) is not as facially straightforward as subsection 544(a)(1). The realty cases are also more interesting because of the greater factual variety and the need for judicial speculation in deciding constructive notice claims.[88] Accordingly, the sympathy and enmity factors play larger roles in the cases involving imperfect transfers of realty.

Of the twenty-four realty cases, thirteen were cases in which the court did not discuss constructive notice at any length. The trustee won twelve of these thirteen, ten on the ground that the claim was voidable under section 544(a)(3) and two by denying the claim of constructive trust. These twelve losing claims were asserted by the likes of mortgagees,[89] commercial lessees,[90] and investor-buyers,[91] all of

under the circumstances to perfect, was "entitled to an equitable lien as against the trustee in bankruptcy." *Id.* at 83-84. The *Humphries* case, which was filed just before the effective date of the Bankruptcy Code, cited only Commerce Bank v. Chambers, 519 F.2d 356 (10th Cir. 1975), as authority for the concept it called "equitable perfection." *Id.*

88. Though § 544(a)(3) requires that the transfer be "permitted to be perfected" to be voidable, these cases do not give rise to discussion of the meaning of this phrase because virtually all imperfect transfers of realty are so permitted.

89. *In re* Allenwear & Assoc., 89 Bankr. 53 (Bankr. E.D. Pa. 1988) (unrecorded mortgage); *In re* Currie, 57 Bankr. 224 (Bankr. M.D. La. 1986) (unrecorded assignment of mineral rights); *In re* Hastings, 4 Bankr. 292 (Bankr. D. Minn. 1980) (unrecorded mortgage). Though unrecorded lenders are normally low-sympathy claimants, the last of these four losing claimants seemed to have generated some sympathy, though not enough. In the case of *In re* Mosely, 55 Bankr. 341 (Bankr. W.D. Ky. 1985), the debtors, two weeks before filing bankruptcy, had sold two of three parcels of land and the bank had inadvertently released its mortgages on all three. In an entertaining opinion in which the court expressed repeated sympathy for creditors whose rights was lost "through simple inattention, to the sweeping avoidance powers of the trustee," the court held "in this clearest of cases that the trustee's powers under section 544 negate the equitable lien claim of the bank . . . ." *Id.* at 342-43. The court seemed to lament having to find for the trustee, characterizing him as the second lowest of creatures in the law of personal property, ranking just above the thief. *Id.* at 342 n.1. Curiously, the court did not consider, as many have, the possibility of finding constructive notice to defeat the trustee. If the court were truly as distressed to find in favor of the trustee as it purported to be, one would expect this avenue to have been explored, as in the cases discussed next.

90. *In re* Belize Airways, Ltd., 12 Bankr. 387 (Bankr. S.D. Fla. 1981).

91. *In re* Emerald Oil Co., 807 F.2d 1234 (5th Cir. 1987); *In re* Washburn & Roberts, Inc., 795 F.2d 870 (9th Cir. 1986); *In re* Lewis W. Shurtleff, Inc., 778 F.2d 1416 (9th Cir. 1986); *In re* Tleel, 79 Bankr. 883 (Bankr. 9th Cir. 1987); *In re* Eads, 69 Bankr. 730 (Bankr. 9th Cir.

whom failed to record. The thirteenth claimant succeeded explicitly on the basis of high-enmity for the debtor. In *In re Chapman*,[92] the Chapter 13 debtor sought to avoid an unrecorded trust deed on his home and to claim the home as exempt. The debtor's only unsecured creditor had not filed a claim. The Bankruptcy Court, citing virtually no Code authority,[93] said, "in view of the fact that the Debtor's plan provides only a *de minimus* benefit (if that much) to only one unsecured creditor, this court holds that the strong-arm clause should not be applied . . . ."[94]

In eight of the remaining eleven cases involving imperfect transfer claims to realty, the courts discussed at some length the theory that constructive notice defeats the trustee's BFP power. All eight of these claimants succeeded in defeating the trustee on that basis. The last three cases were Tennessee cases, which, owning to the vagaries of Tennessee recording law, must be discussed separately.

Constructive notice exists when the circumstances would cause a reasonable purchaser to be at least suspicious of the existence of the claimant's competing interest in the property. All purchasers are then on notice of the claim, so that no bona fide purchase is possible. When constructive notice is claimed, the court must speculate as to both the level of awareness that might passively visit a reasonable purchaser, and how much active inquiry that awareness might reasonably induce.[95]

Initially, there was some uncertainty whether the trustee's BFP power was vulnerable to the defense of constructive notice. The Third Circuit set the matter straight in *McCannon v. Marston*,[96] and sub-

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1986); *In re* Cohoes Indus. Terminal, Inc., 70 Bankr. 214 (Bankr. S.D.N.Y. 1987); *In re* Marino, 49 Bankr. 600 (Bankr. N.D. Cal. 1985), *rev'd on other grounds*, 813 F.2d 1562 (9th Cir. 1987). The dissent in *Washburn & Roberts* sympathized with the buyers who had been convinced to leave the deed unrecorded for business reasons. 795 F.2d at 874-75. Apparently the majority, as is usually the case with parties who intentionally misrecord, was not as sympathetic. Cases involving owners who, for pecuniary reasons, intentionally left record title in another are treated in the section on intentionally misrecorded transfers. *See, e.g., infra* notes 236-40 & 249-50 and accompanying text.

92. 51 Bankr. 663 (Bankr. D.D.C. 1985).

93. For the proposition that the strong arm power is intended solely to benefit creditors, the court cited two cases decided under the prior Act. *Id.* at 666, *citing In re* Vintero Corp., 735 F.2d 740 (2d Cir.), *cert. denied*, 469 U.S. 1087 (1984); *In re* Parkwood, 461 F.2d 158 (D.C. Cir. 1971). The court distinguishes the only case it cites that was decided under the Code. 51 Bankr. at 666, *citing In re* Great Plains W. Ranch Co., 38 Bankr. 899 (Bankr. C.D. Cal. 1984).

94. *In re* Chapman, 51 Bankr. 663, 666 (Bankr. D.D.C. 1985).

95. *See* Bump v. Dahl, 26 Wis. 2d 607, 612, 133 N.W.2d 295, 300 (1965); IV AMERICAN LAW OF PROPERTY §§ 17.11-.28 (A. Casner ed. 1952).

96. 679 F.2d 13, 16-17 (3d Cir. 1982).

sequent courts have consistently recognized the constructive notice defense. The two clearest cases in which constructive notice existed were *McCannon* and *In re Lewis*,[97] cases in which residential buyers had failed to record their contracts for deed, but had taken continuous possession. It is uniformly held that "possession by the purchaser is equivalent to recording."[98] *In re Fitzpatrick*[99] presented a similar but slightly more complex case. There, the Ellsworths purchased a duplex from the debtor on an unrecorded contract for deed and moved in. Six months later, they moved out and rented to tenants who paid rent to them. Two and one-half years later, the debtor filed bankruptcy and the Ellsworths sought a determination that the trustee could not exercise section 544 rights against them. The court held that the recording act did not protect lien creditors and that the possession of the tenant provides constructive notice of the landlord's interest.[100]

In another set of cases, three courts found constructive notice in recorded defective documents. In *In re Ryan*,[101] the court found that the recording of an improperly witnessed mortgage constitutes constructive notice. In *In re Elin*,[102] as part of a divorce settlement, the claimant's former husband had given her a deed to his "curtesy" interest in the family home. Because they had held the house by the entireties, there was no curtesy and the recital, which was the result of attorney error, made no sense. Years later, when the former wife filed a complaint in the husband's pending bankruptcy to clear title, the court held that a deed purporting to transfer a nonexistent interest constitutes a "clew" that would lead a purchaser to discover the plaintiff's interest.[103] In *In re Chateau Royale*,[104] an institutional creditor had loaned the debtor $35,000, taking a third mortgage that, though properly recorded, did not contain any legal description of the property. The mortgage referred to the description in "attached Schedule A," which was not attached. Referring to the great liberality with which the recording act had been interpreted, the court held that the duty to make further inquiry would serve to validate the mortgage.[105]

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97. 19 Bankr. 548 (Bankr. D. Idaho 1982).
98. *Id.* at 550.
99. 29 Bankr. 701 (Bankr. W.D. Wis. 1983).
100. *Id.* at 704-05.
101. 70 Bankr. 509 (Bankr. D. Mass. 1987).
102. 20 Bankr. 1012 (Bankr. D.N.J. 1982), *aff'd,* 707 F.2d 1400 (3d Cir. 1983).
103. *Id.* at 1020.
104. 6 Bankr. 8 (Bankr. N.D. Fla. 1980).
105. *Id.* at 12.

In another set of constructive notice cases, two courts found constructive notice in the commencement of foreclosure proceedings. In the case of *In re Jones*,[106] a mortgagee had obtained a foreclosure judgment on the debtor's house and purchased the house at its own foreclosure sale. The debtor then sued in state court staying issuance of the sheriff's deed. Before the deed could be issued, the debtor filed Chapter 13 and sought to avoid the claimant's interest under section 544. The court held that the docketing of a foreclosure judgment created a duty to inquire into the result of that action, defeating the section 544 BFP power.[107] *In re Richardson*[108] presented a similar but somewhat less compelling constructive notice argument. There, the holder of a second trust deed filed a notice of default, which was required under state law to precede by 90 days any act in furtherance of foreclosure. Four months later, the holder filed a notice of public sale, and sold the home to Preston Family Investment Company for the amount of the debt. On the following day, before Preston recorded its purchase, the debtor filed Chapter 7 and the trustee sought to avoid the unrecorded transfer of the debtor's equity in the home. The court held that the recorded notice of default and published notice of sale placed the world on constructive notice of an impending sale. Because an inquiry would have disclosed Preston, the trustee could not defeat Preston's claims under Section 544.[109]

The role of the sympathy/enmity factors is not obvious in these cases. The highest-sympathy claimants had the strongest constructive notice arguments, such as that of a residential buyer in possession. I found no imperfect transfer cases in which the courts were forced to bend over backwards to find constructive notice in favor of a sympathetic claimant.[110] Thus, what we see here is courts finding in favor of claimants with decent constructive notice claims as long as the claimant is moderately sympathetic. For example, the individual investor-buyers in *Fitzpatrick* are not as sympathetic as the purchasers of a residential home,[111] but they are more sympathetic than an investment

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106. 20 Bankr. 988 (Bankr. E.D. Pa. 1982).

107. *Id.* at 989-93. The enmity some courts feel for a Chapter 13 debtor who retains the realty as exempt may have worked in the claimant's favor here.

108. 23 Bankr. 434 (Bankr. D. Utah 1982).

109. *Id.* at 440. The court went on to hold that the sale might be voidable as a fraudulent conveyance, depending on factual showings made at trial. *Id.* at 441-49.

110. *See also infra* notes 141-43 and accompanying text. *But see In re* Investment Sales Diversified, 38 Bankr. 446 (Bankr. D. Minn. 1984) (involving a fraud-based claim).

111. *E.g.*, McCannon v. Marston, 679 F.2d 13 (3d Cir. 1982); *In re* Lewis, 19 Bankr. 548 (Bankr. D. Idaho 1982). Both are easy winners.

group such as a limited partnership.[112] Also, the notice in *Fitzpatrick* through the possession of a tenant is not as certain as notice through actual possession, but it serves as the basis of at least a colorable constructive notice claim. Accordingly, the *Fitzpatrick* case may be an example of a moderately sympathetic claimant whose chances of success were bolstered just enough by a pretty good constructive notice argument.

The Tennessee courts have generated a bizarre trio of cases that can only be fathomed together. They arose in a state that holds to the unusual proposition that a lien creditor is in a more powerful position than an innocent purchaser for value. The Tennessee recording act has historically been interpreted as protecting unrecorded real estate transfers against purchasers with notice, but not against lien creditors, regardless of notice. Thus, in a circumstance providing constructive notice of a transferee's unrecorded interest, the transferee would defeat buyers from the transferor, but not levying creditors of the transferor.[113] Applying section 544 to an unrecorded transfer in which there is constructive notice, then, yields the surprising result that the transfer is effective against the BFP power of subsection (a)(3), but voidable under the lien creditor power of subsection (a)(1). The judicial difficulties in Tennessee arose when three high-sympathy claimants with excellent constructive notice arguments walked into this Juggernaut.

In the first case, *In re Easterly*,[114] Charlie and Robbie Key purchased a house from the debtor, paid the full price, received the warranty deed, and moved in. Unfortunately, they failed to record the deed until the debtor was in Chapter 7 one year later. The trustee sought to recover the house under section 544. Bankruptcy Judge Clive Bare, recognizing that most courts do not go so far in construing similar recording statutes, and stating that his decision was not a pleasant one, awarded the house to the trustee under section 544(a)(1).[115] On

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112. *In re* Shurtleff, Inc., 778 F.2d 1416 (9th Cir. 1986); *In re* Washburn & Roberts, Inc., 17 Bankr. 305 (Bankr. E.D. Wash. 1982).

113. This result is well out of step with the general view that bona fide purchasers, who reasonably expect to obtain good title, deserve greater deference than lien creditors, who tend to grab an asset and hope to obtain some value. Recent changes in the language of the Tennessee statute seem to permit a departure from the antiquated rule. Yet Judge Bare curiously characterizes the new and decidedly different language as being similar to the old. *See In re* Hurst, 27 Bankr. 740, 743-44 (Bankr. E.D. Tenn. 1983).

114. 18 Bankr. 749 (Bankr. E.D. Tenn.), *rev'd*, 24 Bankr. 897 (E.D. Tenn. 1982).

115. *Id.* at 754-55. Judge Bare added that this determination made any ruling under § 544(a)(3) unnecessary.

appeal to the Federal District Court, Judge Taylor in *Lancaster v. Key*[116] did not feel so constrained; on either of two horribly flawed theories, he reversed. The first theory, based on an 1882 Tennessee case involving the creditors of the transferee rather than the transferor,[117] was that the trustee's rights can be no greater than the debtor's rights in the property.[118] The second theory, based on an 1816 case,[119] was that a grantee who pays the purchase price for real property, yet fails to record is the beneficiary of a resulting trust, and the trustee's "ideal lien" therefore cannot attach to the grantee's equitable interest.[120] The case illustrates the lengths to which one judge was willing to go to find in favor of a sympathetic claimant. However, he drew severe criticism in doing so, as will be seen.

The second case again came before Judge Bare. *In re Hurst*[121] presented a contest between the same trustee, William Lancaster III, and the debtor's former wife. Approximately ten years previously, the former wife had received in the divorce decree the right to occupy a house owned by the debtor rent free so long as she did not remarry and used the house for the care of their minor daughter. She had never recorded the decree. Judge Bare held that the decree could have been filed and that failure to do so rendered her occupancy rights voidable under subsection (a)(1), even assuming that her continuous occupancy with her daughter would charge the trustee with notice.[122] He pointedly stated that the case was distinguishable from *Lancaster*, not on the basis of the numerous factual differences in the cases, but on the ground that the cases on which the district court relied in reversing him were inapposite.[123] In the least, Judge Bare chose an unusual way to "distinguish" a case. Before one leaps too quickly to criticize Judge Bare for sacrificing a deserving claimant to a vendetta against a reversing judge, one should note that the daughter was twenty years old at the time of the decision. Soon, if it had not happened already, the use of the house "for the care of the daughter" would have come to an end. The days of the claimant's occupancy rights being so numbered, this decision eliminated a substantial amount

116. 24 Bankr. 897 (Bankr. E.D. Tenn. 1982).
117. *Id.* at 898-99.
118. Leech v. Hillsman, 76 Tenn. 747 (1882). The flaw in this theory hardly needs explanation.
119. Russel v. Stinsen, 4 Tenn. 1 (3 Hayw. 1816).
120. *Lancaster*, 24 Bankr. at 899.
121. 27 Bankr. 740 (Bankr. E.D. Tenn. 1983).
122. *Id.* at 745.
123. *Id.*

of complexity[124] without depriving the claimant of a great deal, if anything.

The third case, *In re Anderson*,[125] is the most astonishing of the three. It involved seven claimants, all of whom had purchased tracts of land from the debtor under deeds that were defectively worded.[126] The court held this defect to be fatal, causing the deeds to be null and void as to creditors and bona fide purchasers without notice.[127] The court then held that despite the fact that "[a] bona fide purchaser would certainly have been put on notice of the debtor's prior conveyances"[128] so as to defeat the trustee under subsection (a)(3), the deeds were nevertheless voidable under subsection (a)(1).[129] In the process, District Court Judge Paine lambasted the *Lancaster* opinion extensively,[130] and correctly rejected the argument that a claim under section 541(d) bars application of section 544.[131] Having adroitly avoided so many analytical pitfalls in concluding that the claims were voidable by the trustee, the court then took an amazing turn. Persuaded that such a result would inflict a grievous injury on the claimants, the court ordered the trustee to convey the parcels to them. "Sitting as a court of equity," the court constructed its own trust in favor of the claimants, subject to the condition that they jointly reimburse the trustee for his costs and attorney's fees.[132] The opinion did not solve the mystery as to the source of the court's authority to impose its own constructive trust,[133] nor as to the logic of avoiding an equitable interest and then recreating it. Of course, the sympathy for claimants who are victimized by the combination of an extraordinarily harsh priority rule and a technical drafting error is manifest. Most courts faced with such a claimant have found a way to hold in the claimant's favor. In the

124. The holding saved the trustee the trouble of asserting the debtor's right to return of the house when the ex-wife's occupancy right terminated under the divorce decree's terms. Litigation over the precise moment of termination might have been complex.

125. 30 Bankr. 995 (M.D. Tenn. 1983).

126. The acknowledgment portion of the form deeds stated that the grantor "personally appeared" before the notary rather than being "personally acquainted" with the notary, as the court held the statute required. *Id.* at 1000-02.

127. *Id.* at 1002.

128. *Id.* at 1007.

129. *Id.* at 1008.

130. The Court spent more than three pages criticizing both avenues of the *Lancaster* opinion. *Id.* at 1004-08.

131. *Id.* at 1012-14.

132. *Id.* at 1013-15.

133. Instead, the court cited a number of cases in which state-law-based constructive trusts are recognized in bankruptcy. *Id.* at 1014.

end, like the warning that easy cases make bad laws, an impeccable analysis leading to a blatant assumption of nonexistent power will probably do less harm to the law than the blatantly poor analysis of the *Lancaster* court. As will be seen, a preferable tactic, which may be catching on, is to selectively refuse to apply section 544 on the theory that in some cases it conflicts with larger bankruptcy policy.[134]

B. *Fraud Cases*

When an equitable claimant is able to show actual fraud, there is rarely any difficulty establishing the state law basis for constructive trust or equitable lien. A few states even require a showing of fraud before these remedies will be imposed.[135] The cases I discuss here are those in which it is alleged that the debtor's fraudulent intent existed at the moment the claimant was deprived of the property that is the object of the equitable claim. In the cases in which the debtor has obtained the property legitimately and later converted it, the claimants may allege fraud, but I have treated these as conversion cases.

I found fourteen[136] useful cases involving fraud-based claims. As might be expected, in most of the fraud cases the victim was initially deprived of cash. Accordingly, most of the claims were traced into personalty, although two of the claimants were able to trace their funds into realty. Of the fourteen, eleven claimants were successful and three were not. Much can be learned about the sympathy and enmity factors by studying the characteristics of winning and losing fraud victims. We may begin by asking: Why should fraud victims receive better treatment than general unsecured claimants? After all, each of the disappointed general creditors has also relied in some way on the debtor. And, why should some fraud victims receive preferred treatment, and not others? What is it about some, but not all of these fraud claims, that makes them high-sympathy claims?

Three of the eleven winning cases are easily understood; fraudulent schemes were practiced publicly on classic high-sympathy victims. Two cases involved schemes to defraud large groups of consumer-

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134. *See infra* notes 174-78, 201-02 and accompanying text.

135. *See, e.g., In re* Dexter Buick-GMC Truck Co., 2 Bankr. 251, 252 (Bankr. D.R.I. 1980); *see also In re* Minton Group, Inc., 28 Bankr. 774, 783 (Bankr. S.D.N.Y. 1983) (citing Connecticut cases requiring evidence of "actual or constructive" fraud for imposition of constructive trust).

136. One additional fraud case that was not very useful, *In re* Taylor, 8 Bankr. 806 (Bankr. D.D.C. 1981), involved the fraudulent abuse of a confidential relationship. The claimant won ostensibly because the trustee abandoned the minimally valuable property. *Id.* at 812 n.22. Absent a true controversy, the court's dictum provides little insight. Another fraud case of minimal utility is *In re* Powe, 75 Bankr. 387 (Bankr. M.D. Fla. 1987).

buyers of goods and services, one through the mail order sale of wristwatches,[137] and the other through a fraudulent insurance scheme.[138] The third classic victim was an unsophisticated elderly man whose confidence had been won and abused by a dishonest investment counsellor.[139] Interestingly, in all three cases the court dispensed with the requirement of individual tracing.[140]

In the remaining eight winning cases, the claimants were more sophisticated: commercial buyers, sellers, subcontractors, and lenders. These cases are more instructive. Not only were the eight winning claimants victorious over the trustee, but in all eight the courts went to surprising analytical lengths to ensure their success. In six of these cases, one can sympathize with the claimants' failure to protect themselves from the fraud. But in two, this failure is much more difficult to excuse; the claimants' success must be explained, if at all, in some other way.

Sympathy for the first of these winning claimants is based on the fact that, having dealt repeatedly with the debtor without difficulty, he had no reason to be wary of fraud. In *In re Investment Sales Diversified, Inc.*,[141] the debtor had been in the business of brokering and managing real estate debt instruments, including mortgages and vendors' interest in contracts for deed. Normally, when the debtor sold such an interest to an investor/buyer, the debtor would record the transfer and manage the property. Claimant Beutel had previously purchased six of these instruments without incident. However, due to a cash flow problem, the debtor failed to record the seventh. The court called this failure "borderline fraud."[142] Emphasizing that Beutel

137. *In re* Teltronics, Ltd., 649 F.2d 1236 (7th Cir. 1981).

138. Reliance Ins. Co. v. Brown, 40 Bankr. 214 (Bankr. W.D. Mo. 1984).

139. *In re* Kritt, Bankr. No. LA 81-03860-JB, slip op. (Bankr. C.D. Cal. Apr. 1, 1983). The facts in the memorandum opinion are quite sketchy, referring only to an agreed statement of facts in the plaintiff's trial brief and the stipulation between the parties as to the defendant's fraud and breach of fiduciary duty. I obtained additional information from the plaintiff's attorney who said the claimant was an unsophisticated man in his eighties who had a continuing confidential relationship with Kritt as his investment counselor. On Kritt's advice, claimant had loaned $30,000 to a syndicate that was to purchase land. Claimant would receive interest on the loan when the land was resold. Instead, using the powers of attorney he had obtained from his clients, Kritt fraudulently transferred the land to a third party. When Kritt filed bankruptcy, claimant sought to impose a constructive trust on the proceeds of that transfer — certain promissory notes. Paying no attention to competing claims, the remedy was granted on the authority of § 541(d).

140. *In re* Teltronics, Ltd., 649 F.2d at 1241; *Reliance Ins. Co.*, 40 Bankr. at 217; *In re* Kritt, Bankr. No. LA81-03860-JB, slip op. (Bankr. C.D. Cal. Apr. 1, 1983).

141. 38 Bankr. 446 (Bankr. D. Minn. 1984).

142. *Id.* at 451.

was justified in relying on the debtor to record based on the previous six transactions, the court imposed a constructive trust on the proceeds of the contract for deed in favor of Beutel, and then held in a strained opinion that constructive notice defeated the trustee's BFP power.[143]

Sympathy for the second winning claimant lies in the fact that it was betrayed by its own insider. In *In re General Coffee*,[144] the claimant bank had placed its trust in an individual who was simultaneously an officer and director of both the bank and the corporation that controlled the debtor. By pledging the bank's $8,000,000 certificate of deposit, he obtained a loan of funds from a third party, which the debtor deposited in its account at the bank. The debtor then purchased $6,488,011 worth of coffee inventory with a check drawn against those funds. When the loan went unpaid, the third-party lender set off the certificate, leaving the bank $8,000,000 poorer. The bank asserted a $6,488,011 constructive trust in the debtor's Chapter 11 proceeding against the debtor's coffee inventory. Ultimately, the Eleventh Circuit upheld the bank's claim of constructive trust on the unfortunate theory that constructive trusts, being different from equitable liens, are not

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143. The court's constructive notice analysis is necessarily complex. Crystal had sold the house to the Burghardts, who took possession and signed a contract for deed. Crystal retained the vendor's interest in the contract for deed. The contract was filed, showing Crystal as the record owner of the vendor's interest, which ultimately became the disputed asset in ISD's bankruptcy. That same day, Crystal assigned the vendor's interest to ISD, which assigned it to Beutel the next day. Neither of these assignments was recorded until after ISD filed bankruptcy. As usual, ISD was to manage the contract for deed on behalf of Beutel, so the Burghardts began making payments to an ISD affiliate. The court held there was constructive notice by hypothesizing that a purchaser from ISD of its unrecorded vendor's interest would ask ISD about its title to the interest, and further, that ISD would truthfully admit that it did not own the asset it was selling. *Id.* at 455-56. Quoting a 73-year-old case, Teal v. Scandinavian-American Bank, 114 Minn. 435, 131 N.W. 486 (1911), the court said that without the possessors' testimony, it would not speculate on what may happen if inquiry were made, but would presume the true situation would be made known. A less generous court would not presume that a person engaged in fraud would not lie. *See, e.g., In Re* Plunkett, 89 Bankr. 776, 784-85 (Bankr. E.D. Wis. 1988) (rejecting a similar constructive notice argument).

The court need not have gone to these lengths to find for Beutel. Section 541(d) explicitly protects buyers in the secondary mortgage market, and the legislative history suggests this protection is intended to reach even buyers whose interests are unrecorded. S. REP. NO. 989, 95 Cong., 2d Sess. 83-84, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5869-70. On this authority, the court could have joined a number of other courts holding that at least these types of claims should be immune to the trustee's avoiding power. *See supra* note 78. *But see infra* notes 192-200 and accompanying text.

144. 828 F.2d 699 (11th Cir. 1987). The facts are described in the Bankruptcy Court opinion, *In re* General Coffee Corp., 41 Bankr. 781 (Bankr. S.D. Fla. 1984).

voidable under section 554(a)(1).[145] The court also affirmed the district court's theory that the bank could trace the proceeds of the check into its substituted form, the coffee.[146]

The next four cases are similar to one another in that the claimants were aware of the risk of fraud and took steps to protect against it. Yet all four claimants failed to anticipate the extremes to which the debtor would go, so that the steps taken proved inadequate. In *In re Jones*,[147] Michael Cass was a young man in the oil business who had developed a working relationship with Jones by participating in previous joint oil-drilling programs. Jones found an oil rig for sale and Cass agreed to split the $1,000,000 purchase price with him. Jones never intended to buy the rig. When he fraudulently told Cass he had bought it, Cass insisted on seeing the bill of sale. When Jones sent him a forged bill of sale and a rig inventory evidencing that the purchase had occurred, Cass transferred the $500,000 to Jones. Jones withdrew the funds immediately and within days placed the funds in an extensive range of investments, real and personal. Eventually, Jones filed a Chapter 7 petition and Cass asserted his claim. The bankruptcy court generously imposed a constructive trust on "all property into which any portion of the Cass money was diverted."[148]

Another forgery by a person with whom the claimant's previous dealings had been successful appears in *In re Preston*.[149] The debtor, a general contractor, constructed two apartment complexes; the parties' dealings and interim payments had gone smoothly during the construction. In applying for the final payment on the projects, the

145. Relying on the enlightened Fifth Circuit opinion in *In re* Quality Holstein Leasing, 752 F.2d 1009 (5th Cir. 1985), the district court decided the tension between §§ 541(d) and 544(a) should be resolved in favor of the equitable claimant rather than the general creditors. *In re* General Coffee II, 64 Bankr. 702, 708 (Bankr. S.D. Fla. 1986), *aff'd*, 828 F.2d 699 (11th Cir. 1987). Unfortunately, the Eleventh Circuit felt no need to resolve the tension and affirmed. The court stated that this was a claim of constructive trust against personalty and that the trustee's only avoidance power, that of a lien creditor, does not defeat it. 828 F.2d at 704-07. The court incorrectly implied that a different result might obtain if the claim was one of equitable lien or if the claim could be traced into real property. *Id.*

146. 64 Bankr. at 709.

147. 50 Bankr. 911 (Bankr. N.D. Tex. 1985).

148. *Id.* at 922. The less generous remedy would more precisely impose an equitable lien on property only to the extent Cass's money was diverted into it. The constructive trusts imposed here are generous in two ways: first, in saving Cass from a large measure of tracing proof; and second, in permitting Cass to obtain funds that might never have been his.

149. 76 Bankr. 654 (Bankr. C.D. Ill. 1987). Most of the facts stated here were obtained in a conversation with the claimants' Peoria attorney. Telephone interview with Thomas Perkins (Apr. 24, 1988).

debtor submitted the normal affidavit and subcontractor lien waivers as required by the state mechanic's lien law. Not suspecting that the documents were forged,[150] the project financiers made final payments to the debtor of $181,000. The debtor deposited the checks in his bank, and the bank immediately withdrew the bulk of the funds to pay off his line of credit. The debtor soon filed Chapter 7, in which the trustee obtained the return of $106,000 from the bank in settlement of the trustee's claim that the payment was a voidable preference. When the owners and unpaid subcontractors asserted constructive trust claims against the fund, the court denied the trustee's motion for summary judgment, stating that it would be grossly unfair to use these funds to pay the debtor's unsecured creditors if the funds could be traced.[151] Then, noting that "there are as many decisions on tracing as there are factual situations presented, and each case is decided on its facts,"[152] the court found the funds traceable into the trustee's recovery.[153]

In *In re Triple A Coal Co.*,[154] at a time when the debtor Rhein was already in default on a sizeable loan from MAP, MAP partner Kaulkin, in a two-day meeting with Rhein, hammered out a new arrangement in which MAP would make an additional $300,000 loan secured by MAP's existing perfected security interest in all of the accounts receivable and proceeds of Rhein's business entities. In order to better police the funds, a joint checking account was set up requiring the signatures of both Rhein and Kaulkin. Two days later, after reviewing a list of the creditors beating down Rhein's door, Kaulkin agreed to advance the $132,000 needed to pay them, and signed a blank check for that purpose. Rhein immediately withdrew the entire $300,000 and applied it to his own purposes. When some $90,000 was traced, it had been sufficiently commingled to be beyond the reach of

150. Three types of forgery are possible. First, the contractor can list itself as the supplier of subcontracted materials or services. Second, the contractor can forge subcontractor signatures on lien waiver forms. Finally, the contractor can obtain the signature of an unpaid subcontractor on a lien waiver form by promising to make payment later and then failing to do so. Any of these devices leave the property subject to the subcontractor's valid lien. This debtor engaged in all three forms of forgery. Interview with Thomas Perkins (Apr. 24, 1988). *See supra* note 149.

151. 76 Bankr. at 656.

152. *Id.* at 658.

153. *Id.* The matter was set for trial on the issue of whether the bank was a bona fide transferee, which ordinarily cuts off equitable claims. If so, the court held, the avoided transfer could be preserved for the benefit of the estate under § 551. *Cf. In re* First Capital Mortgage Loan Corp., 60 Bankr. 915 (Bankr. D. Utah 1986) (much broader holding discussed *infra* note 196 and accompanying text).

154. 55 Bankr. 806 (Bankr. S.D. Ohio 1985).

MAP's perfected security interest,[155] though it was still traceable under common law rules. Stating that the blank check was undoubtedly given on the basis of misrepresentations, the court imposed a constructive trust on the funds. Disregarding UCC policy, the court said, "it would be clearly inequitable to allow the trustee and the creditors to profit from Rhein's wrongful deposit and retention of MAP's money . . . ."[156]

In *In re Garland Corp.*,[157] the claimant had performed services on $112,000 worth of the debtor's goods and refused to release them without payment, possession being crucial to the claimant's statutory lien. The debtor then gave the claimant a check for payment, knowing he lacked sufficient funds and that he was about to file a Chapter 11 bankruptcy petition. The claimant released the goods on receipt of the check, only to discover that the check was bad and the debtor was in bankruptcy. Citing no authority other than substantial right and justice, the court permitted the claimant to prove its equitable lien on the goods over the debtor's motion to dismiss.[158]

The last two winning cases are harder to fit into my sympathy/enmity model. In *In re Storage Technology Corp.*,[159] the facts assumed for the purpose of a motion to dismiss involved a complex lending arrangement in which a number of banks, reluctant to lend to STC, insisted on forming STFC, a separate captive financing subsidiary. Free of the competing claims of STC's creditors, the banks made unsecured loans to STFC, which then used those funds to buy STC's accounts receivable. Extensive policing devices were put in place under an Operating Agreement between STC and STFC of which the banks were made express third-party beneficiaries. Pursuant to the terms of the Operating Agreement, STFC took a perfected security interest in STC's receivables, proceeds of which were to be deposited in a segregated account, with periodic documentation required certifying continued compliance with the Operating Agreement.[160] When, after five years, STC fraudulently failed to file a continuation statement, STFC's perfection lapsed without the banks' knowledge. When STC and STFC filed Chapter 11 two years later, STFC's interest in the receivables became voidable by STC, as debtor in possession, claiming the sole asset on which the banks relied. The court held that the banks had sufficiently pled their right to imposition of a constructive trust

155. *Id.* at 811-12.
156. *Id.* at 814.
157. 6 Bankr. 452 (Bankr. D. Mass. 1980).
158. *Id.* at 456.
159. 55 Bankr. 479 (Bankr. D. Colo. 1985).
160. *Id.* at 481-82.

on the receivables, and that under state law, "a beneficiary of a constructive trust or other equitable lien prevails over a judicial lien creditor."[161] Like the three previously discussed cases, these banks had gone to some lengths to protect themselves from the defalcations of the debtor by instituting complex structural changes, contractual obligations, and policing procedures. Yet the customary practice of the diligent lender to assure itself of proper recording is so familiar that these banks' escape from the consequence of a two-year lapse in perfection is extraordinary indeed. Perhaps if the debtor had filed its Chapter 11 petition immediately after intentionally permitting the lapse to occur, one could sympathize with the banks. But after two years, one would expect much of that sympathy to have eroded in favor of the general creditors.[162]

The last winning fraud-based claim, *In re Shepard*,[163] is even more difficult to fathom. There, the debtor, Shepard, told the bank he was going to engage in a new business venture and within a few days signed a standard merchant servicing agreement that allowed him to deposit MasterCharge and VISA charge slips into his account and receive instant credit. Within a mere twenty days, he had deposited fraudulent charge slips worth $274,000, withdrawn some $250,000 in cash, and taken off for parts unknown. In his haste to leave, he had left behind $30,000 in cash, still "strapped" in the bank's wrappers, in his filing cabinet. The court held that the cash never became part of Shepard's estate and ordered it turned over to the bank.[164] The court never gave a thought to the interests of the general creditors or the trustee. Any sympathy for the bank's claim here must flow primarily from the ease of tracing. The cash was never mingled with the debtor's financial affairs, and, even after recovering the $30,000, the bank still lost a great deal. On the other hand, it is hard to imagine a bank doing a poorer job of protecting itself from fraud; the bank's security division never suspected anything until Shepard was long gone.[165]

161. *Id.* at 484.

162. Perhaps the court's enmity towards the debtor in possession facilitated the bank's success. Had the bank's claims been avoided, the assets would have been applied toward the debtor's continuation in business, which is always a precarious investment. If this case had been a liquidation where avoidance of claims more directly benefits the general creditors, the case might have been decided differently.

163. 29 Bankr. 928 (Bankr. M.D. Fla. 1983).

164. *Id.* at 932.

165. *Id.* at 930.

Additional information is provided by the three losing fraud-based claims,[166] two of which involve nearly identical claimants: groups of investors who were duped at a distance into investing in fraudulent schemes. In *In re Independent Clearing House Co.*,[167] some two thousand investors, lured by promises of huge returns, invested in a totally fraudulent Ponzi scheme.[168] Their equitable claims were denied on the grounds that recognizing them would violate bankruptcy policy and that they were inadequately traced.[169] In *In re Carter*,[170] the Carters had received millions of dollars for investment in, among other things, a fictitious medical factoring business. On behalf of the defrauded public investors, the Securities Exchange Commission sought imposition of a constructive trust on the funds remaining in the debtors' frozen bank accounts.[171] Like the court in *Independent Clearing House*, the Bankruptcy Court denied the claim both on the theory that imposition of a constructive trust would violate bankruptcy policy and on the overstated theory that *individual* investors' money was required to be traced.[172] Clearly, passive investors who are defrauded in large numbers into sending their money to strangers in hopes of inflated returns are no more sympathetic than ordinary creditors.[173]

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166. A fourth case presenting a losing fraud-based claim, *In re* Powe, 75 Bankr. 387 (Bankr. M.D. Fla. 1987), provided too few facts to be of use here. The court said simply, "As a result of an ongoing fraudulent scheme the Debtor defrauded [a number of plaintiffs]." *Id.* at 388. The court denied the claims of constructive trust on the ground that there was no traceable res. However, the case's true conflict was not between equitable claims and the general creditors' claims. Because the Internal Revenue Service had filed a priority tax claim exhausting the assets of the estate, the fraud victims sought to obtain a kind of "super" priority. The fraud victims asserted that there should be no tax priority over income obtained partly through fraud. Having failed here, their attempt to assert an equitable claim to funds whose "source . . . has nothing to do whatsoever with the funds obtained by the Debtor through fraud from the Plaintiff" was doomed. *Id.* at 393.

167. 41 Bankr. 985 (Bankr. D. Utah 1984).

168. *Id.* at 991-92. A Ponzi scheme is one in which funds received from later investors are used to pay "interest" to earlier investors. *Id.* at 994 n.12.

169. *Id.* at 1002-05. In so concluding, the court took care to distinguish *In re* Teltronics, 649 F.2d 1236 (7th Cir. 1981), which relied on the state consumer fraud act in its tracing analysis. *Id.* at 1003.

170. 55 Bankr. 543 (Bankr. C.D. Cal. 1985).

171. *Id.* at 544-45.

172. *Id.* at 547. Courts more sympathetic to the claims of a large group have not been concerned about tracing *individual* funds. *See, e.g.*, Reliance Ins. Co. v. Brown, 40 Bankr. 214, 218 (Bankr. W.D. Mo. 1984).

173. There is something intriguing about the distinct treatment of large groups of defrauded consumer buyers and large groups of defrauded investors. In many respects, the two groups are quite similar, having been recruited at a distance to place their money in an apparently good deal. In terms of gullibility, the groups may be identical. Yet the law has historically

The third losing fraud case involved a defrauded lender rather than an investor. In *In re Quality Holstein Leasing*,[174] the claimant, Borg-Warner, had financed McKenzie's acquisition of an airplane that was later swapped for another plane subject to the security interest of a bank. Through inadvertence, Borg-Warner's security interest in the new plane was not filed. When Borg-Warner discovered the error, it took no immediate action, relying somehow on the bank's perfected lien.[175] When the bank's release of lien was mysteriously filed and McKenzie fraudulently transferred the plane to his wholly owned subsidiary, Quality Holstein Leasing (QHL), Borg-Warner's interest in the plane became even more tenuous. When, as the court terms it, "Borg-Warner belatedly sent additional documentation to the FAA in an effort to perfect,"[176] it was too late; QHL had just filed Chapter 11.

In an opinion that is both insightful and confusing, owing in part to the poor work of Borg-Warner's lawyers,[177] the Fifth Circuit denied the equitable claim. It held that even if state law would grant Borg-Warner a constructive trust, and even though such claims normally overpower the trustee's avoiding power, the claim may nevertheless be denied when to do otherwise would contravene larger bankruptcy policy.[178] Though the court purports to be concerned about the remoteness of Borg-Warner's claim,[179] which requires Borg-Warner to trace through McKenzie into the QHL estate, the argument is unconvincing; few sympathetic courts would be daunted by such a straightforward tracing task. For our purposes, the case better stands for the proposition that a secured creditor who sits placidly knowing its perfection documents have not been filed and then "belatedly" sends additional documents that arrive after bankruptcy has been filed is not a very sympathetic claimant, despite the occurrence of some intervening fraud. The opinion is important also as one of the first that confronts

treated buyers and investors distinctly. Just as investors receive no implied warranties of product quality, apparently they also receive no implied priority over general creditors when defrauded.

174. 752 F.2d 1009 (5th Cir. 1985).

175. *Id.* at 1011.

176. *Id.*

177. The court goes to some length to point out that Borg-Warner argued the wrong theory. *Id.* at 1011-12 n.5. A greater source of confusion lies in the fact that the court's opinion purports to rest on the distinction between McKenzie and his wholly owned subsidiary, QHL. Because the opinion does not mention the possibility of attributing QHL's acts to McKenzie, I assume the issue was not raised. The effect is that the court's opinion rests on a curiously specious ground, rendering its insightful dictum less forceful.

178. *Id.* at 1012-15.

179. "Section 544 prevents such piggybacking." *Id.* at 1015.

the fact that strict application of the trustee's strong arm powers to equitable claims may yield results that are inconsistent with fundamental bankruptcy policy. The lasting value of the opinion is that it lights the way toward treating these claims directly, developing standards for determining their validity that are rooted in bankruptcy policy rather than in a statute that was designed for other tasks.

In six of the eight winning cases not involving the consumer-buyers, the claimants had taken steps to protect their claim against the debtor. Yet to prevent the fraud, further steps should have been taken. In *ISD*, Beutel should have checked to see that his purchase was recorded. In *STC*, the banks should have checked to see that the continuation statement was filed. In *Jones*, Cass should have participated personally in the purchase of the oil rig. In *Triple A*, Kaulkin should never have given Rhein the blank check. In *Garland*, the claimant should have kept the goods until the debtor's check cleared, and in *Preston*, the project financiers should have verified the mechanic's lien affidavit. In *General Coffee*, we are not told whether the bank had taken steps to protect itself, but it presumably had reason to trust its own officer and director. Looking retrospectively, all of these claimants may be criticized. But this is true of virtually all frauds; all could have been prevented by victims who, despite having presumably relied reasonably on the perpetrator's misrepresentation, might not have relied at all. Perhaps what differentiates these fraud victims from general creditors, who knowingly risk the debtor's insolvency, or parties to imperfect transfers, who like fraud victims do not knowingly assume that risk, is that, having shown a healthy mistrust for the debtor, these claimants were victimized for having then shown some trust. After six successful purchases, or after lengthy policing procedures are put in place, or after two days of debt adjustment meetings, or after demanding and receiving what looks like adequate documentation or a good check, perhaps the courts are sympathetic to the claimant who, based on face-to-face dealings, believes he has gone far enough. There is something very personal about the fraudulent acts in these cases — especially as compared to frauds practiced on public investors, which do not result in winning claims.

There are other factors at work in some of these cases as well. In *Shepard*, *Garland*, *Preston*, and *Triple A*, the frauds culminated on the eve of bankruptcy, so that the funds were never integrated into the debtor's affairs. Other creditors were never misled by the debtor's ill-gotten assets. In *Jones*, *STC*, and *Garland*, there were elements indicative of high enmity at work: Jones seeking to exempt some of the disputed property, and STC and Garland having filed Chapter 11 petitions.

By comparison, the defrauded investors in *Independent Clearing House* and *In re Carter* had taken no apparent steps to protect against the debtor's fraud. Moreover, large groups of indistinct claimants, whose mistake lies in trusting the debtor with their money, sound and feel very much like the mass of general creditors. The lack of sympathy for Borg-Warner in *Quality Holstein* which, knowing it was unperfected, did nothing, is surely no surprise. It is only the allegation of fraud that distinguishes this case from the ordinary imperfect transfer. The greater surprise is that the banks in *STC*, who should have known they were unperfected, were not treated as harshly as Borg-Warner was treated. As suggested above, the *STC* outcome may have been influenced by enmity factors. On the other hand, it may best be viewed as a case that cannot be explained in terms of a sympathy/enmity model.

C. *Cases Based on Conversion of Funds Placed for Investment*

The observation in the preceding cases that passive investors are not sympathetic claimants gains added support in the cases involving the conversion of funds placed for investment. It is a rare investor that manages to obtain better treatment than general creditors. Moreover, it seems to make no difference that the conversion might be fraudulent. In most cases in which funds placed for investment are converted, the claimant's funds are commingled either with the funds of other investors, or with the property of the debtor. Thus, courts may easily deny the equitable claims on the ground that tracing is inadequate — a route many of them take. In the thirteen such cases I found, virtually all investor claims were denied. Only two types of investors managed to do better than the general creditors. Notably, the courts denying these claims did so with confidence, frequently stating that enforcement of the equitable claim would violate the bankruptcy policy of equal treatment of claims. In essence, because these claimants are ordinarily no more sympathetic than general creditors, the bases of their equitable claims, the tracing devices they propose, and their attempts to resist the trustee's avoiding powers all receive the strictest scrutiny.

Seven of the thirteen cases involved groups of participants in some form of joint investment scheme. Five of the seven cases arose out of virtually the same circumstances: groups of investors paid money over to the debtor to acquire a share of specified real property, which the debtor either owned or later acquired. For various reasons, the transfer was either not made or not recorded and the claimants sought to trace their investments into the realty in the debtor's hands. In *In* *re Minton Group, Inc.*,[180] the court held that the funds could not be traced into the realty because a "simple case of misappropriated funds," even by a fiduciary, could not serve as the basis of an equitable lien or constructive trust. Furthermore, even if the claimants' equitable interests were shown, the trustee's BFP power would be superior to those interests.[181] In *In re Janis*,[182] the court held that the claimants had failed to trace their funds, and implied in dictum that the trustee's BFP power would also defeat their claims.[183] In *In re Great Plains Western Ranch Co.*,[184] the court bypassed the tracing issue and held that even assuming the claimants had been victims of fraud, the trustee's BFP power would defeat their equitable claims.[185] Similarly, two later courts relying on *Great Plains* held that the claimants' unrecorded interests[186] were invalid against the trustee's BFP power.

The remaining two joint venture cases presented the first type of successful investor-claimant. The courts' sympathy here is consistent with the most traditional values in debtor-creditor law: these investors succeeded because of their unusual diligence in getting their claims in the public record. In *In re Omni Development & Services Inc.*,[187] Harry Hall was one of many investors in a joint venture. Omni retained title to the realty for the benefit of the venture. Harry was the only investor who filed an affidavit of his interest in the real estate records. His was also the only equitable claim to succeed in bankruptcy, on the theory that the recorded affidavit of his equitable interest provided sufficient constructive notice to defeat the trustee's BFP power.[188] *In re Gurs*[189] is similar. As part of a "complicated series of transactions" among individuals and two limited partnerships, the debtors converted

180. 28 Bankr. 774 (Bankr. S.D.N.Y. 1983).

181. *Id.* at 782-88.

182. 45 Bankr. 295 (Bankr. S.D. Fla. 1985).

183. *Id.* at 296-97.

184. 38 Bankr. 899 (Bankr. C.D. Cal. 1984).

185. *Id.* at 903-06. All three of these cases either stated or implied that the equitable claim would be defeated by the trustee's BFP power. Curiously, not one mentioned that § 544(a)(3), by its terms, is effective only against claims that state law permits to be perfected, nor did one mention how a person with a claim based in conversion or fraud might perfect such a claim under state law.

186. *In re* Plunkett, 89 Bankr. 776, 781 (Bankr. E.D. Wis. 1988); *In re* Cascade Oil Co., 65 Bankr. 35 (Bankr. D. Kan. 1986).

187. 31 Bankr. 482 (Bankr. S.D. Fla. 1983).

188. *Id.* at 485. The court explicitly noted the lack of diligence of one of Harry Hall's losing fellow claimants, SERVICIOS, which "never bargained for a mortgage or lien to protect its interests." *Id.* at 484.

189. 27 Bankr. 163 (Bankr. 9th Cir. 1983).

real property. Shortly before bankruptcy, Saghi filed a civil action in state court and recorded a *lis pendens* asserting various claims to the realty. The Ninth Circuit held that the constructive notice provided by the recording would defeat the trustee's BFP power as to Saghi. Any of Saghi's fellow investors fortunate enough to have been adequately described in his notice would also defeat the trustee.[190] Saghi's remaining fellow investors, and all those of Harry Hall were treated as general claimants.[191]

Another type of investor appearing in the losing column is one who gives money to a mortgage broker for investment in mortgages. In *In re First Fidelity Financial Services, Inc.*,[192] hundreds of individual investors had paid money to the debtor to be invested in mortgages that were never transferred. When two of the investors claimed an equitable interest in the remains of the debtor's general account, the court refused to apply the familiar lowest-balance tracing method. Weighing its obligation to do equity for all claimants, the court said "it is not appropriate . . . to indulge in a legal fiction as a substitute for tracing of plaintiff's actual funds, in order to impose a constructive trust."[193]

In *In re First Capital Mortgage Loan Corp.*,[194] claimant Research-Planning had placed $260,000 in escrow with the debtor to be loaned, along with a loan by the debtor, to R.K. Buie & Associates. Buie was to take title to certain property that would secure payment of these loans.[195] The funds were misapplied during the 90 days prior to the filing of the involuntary Chapter 7. The court's denial of Research-Planning's equitable claim rested on the basic bankruptcy policy of treating general creditors equally.[196]

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190. *Id.* at 165-66. Because it was not asserted at trial, the court did not consider the argument that § 547 negates the effect of the *lis pendens* as a voidable preference. *Id.* at 166.

191. *Id.* Strictly speaking, those of Saghi's fellow claimants not protected by his *lis pendens* were left to fend for themselves on remand. *Id.*

192. 36 Bankr. 508 (Bankr. S.D. Fla. 1983).

193. *Id.* at 514.

194. 60 Bankr. 915 (Bankr. D. Utah 1986).

195. The facts stated in the opinion are not extensive. I obtained more information about the nature of the transaction from the trial documents and communication with the lawyers.

196. The denial did not rest explicitly on this ground alone. The court purported to deny the claim on two other grounds: inadequate tracing and denial of constructive trust. However, the court's analysis of these two grounds was weak. Tracing was denied on the theory that if the debtor used the claimant's funds to make a preferential transfer and the trustee avoided that transfer, then the proceeds received by the trustee belong to the estate. *Id.* at 920. Other claimants have had no difficulty tracing into a fund obtained through the trustee's avoidance powers. *See In re* Construction Gen., Inc., 737 F.2d 416, 420 (4th Cir. 1984). In denying the

In *In re Atlantic Mortgage Corp.*,[197] a small portion of Atlantic's two hundred disappointed investors managed to dodge the trustee's avoidance power. Atlantic's general practice had been to assign to each investor Atlantic's interest in a specific note and mortgage. Some investors received actual possession of the note. The court held that the investors' interest in the "underlying" note and mortgage was personal property and that except for those investors who had actual possession of the note, all held mere unperfected security interests.[198] On the authority of section 544(a)(1), the court granted summary judgment against all the unperfected claimants.[199] However, on a number of analytically shaky grounds, the court denied summary judgment against nine individuals whose affidavits raised factual issues that might support a finding of constructive trust, such as misrepresentation and forgery.[200]

Another type of investor whose funds are converted is the investor who sends money to an insolvent broker or fund that fails to execute the intended transaction. In two of these three cases, another small group of successful investor-claimants appears. In the third case, *In re North American Coin & Currency, Ltd.*,[201] the investor-claimants all lost. In this case, the debtor was a precious metals broker. Numerous customers placed and paid for nearly $600,000 worth of orders

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claim of constructive trust, the court claimed lack of Utah precedent and purported to adopt the minority view that a constructive trust originates when a court says it does. *First Capital Mortgage*, 20 Bankr. at 919. The weakness of these conclusions strongly suggests that the decision truly rests on the policy of treating general creditors equally. *Id.* at 918-19. In adopting this policy, the court was strongly influenced by the Ninth Circuit opinion in *North American Coin & Currency*. *See infra* notes 201-02 and accompanying text.

197. 69 Bankr. 321 (Bankr. E.D. Mich. 1987).

198. *Id.* at 323-25.

199. *Id.* at 326-28.

200. The court dismissed the argument that these claimants held mere voidable equitable liens on specious grounds. The court stated that the cases on which the argument was based apply only to equitable liens and not to constructive trusts. *Id.* at 330. In holding that a constructive trust interest is not voidable under § 544, the court quoted the dictum in *Quality Holstein Leasing*, 752 F.2d 1009 (5th Cir. 1985), but articulated no policy reasons why § 541(d) should overpower § 544 in this case. 60 Bankr. at 330-31. Without those reasons, *Quality Holstein Leasing* provides little support, as the court in that case denied the equitable claim. *See supra* notes 174-79 and accompanying text. The court also stated that Congress intended to protect the secondary mortgage market through § 541(d), but not to protect or remedy fraud. 60 Bankr. at 332. If correct, this would dictate the opposite result in this case by protecting the ordinary unperfected claimants, but *not* those claiming to have been the victims of fraud. Many other courts have protected ordinary unperfected claims of this sort. *See supra* note 78.

201. 767 F.2d 1573 (9th Cir.), *amended by* 774 F.2d 1390 (9th Cir. 1985), *cert. denied*, 475 U.S. 1083 (1986).

during the week before the debtor filed Chapter 11. The funds were placed in a special account, but the commodities were never received; thus, the claimants sought to impose a constructive trust on the special account. Unlike most of these cases involving large groups of indistinct claimants, tracing here did not present even a slight problem to the claimants. Nevertheless, the Ninth Circuit held that even if state law would impose a constructive trust in such a case, the bankruptcy estate should not be deprived of the funds.[202] Like the insightful Fifth Circuit opinion in *Quality Holstein Leasing*, the case presents an example of a recent opinion that eschews strict application of the statute and looks directly to the strong bankruptcy policy of ratable distribution among all creditors to decide the case.

The two successful claims against an insolvent broker or fund appeared in *In re Bengal Trading Corp.*[203] and *In re Vermont Real Estate Investment Trust.*[204] Investors sent money to a commodities broker for the purchase of commodities and to a real estate investment trust to purchase shares of the trust. The funds were deposited in commingled accounts, despite the fact that in both instances they had been received after the debtor had suspended its securities activities.[205] The two courts reasoned that because the debtor was unable to do business when the funds were received, the funds should be returned to the claimant.[206]

How might these few successes among the huge mass of losing investors be explained? Perhaps the message of the insolvent broker/fund cases is that while a passive investor may assume the risk that the broker will convert the funds, he does not assume the additional risk that the broker is not doing business. One must choose a point between the moment when the conversion of money committed for investment creates an ordinary debt and the moment when the receipt of money by a defunct entity should not benefit its existing creditors. The moment when the entity becomes technically impotent to apply the money to its intended purpose may well define that point. However, because the moment of the filing of the bankruptcy petition has

202. *Id.* at 1575.

203. 12 Bankr. 695 (Bankr. S.D. Fla. 1981).

204. 25 Bankr. 813 (Bankr. D. Vt. 1982).

205. *Bengal Trading*, 12 Bankr. at 696; *Vermont Real Estate Inv. Trust*, 25 Bankr. at 816. Because the trust received the check the day before being instructed to suspend business and then deposited the check the next day, the Vermont court struggled in concluding the funds were "received" after the trust ceased doing business. Having won that struggle, the court then simply pointed to *Bengal Trading* for the meaning in bankruptcy of that conclusion.

206. *Bengal Trading*, 12 Bankr. at 696; *Vermont Real Estate Inv. Trust*, 25 Bankr. at 816-17.

historically marked the point at which transferred property ceases to become part of the estate, one would expect an explanation for use of an earlier point. From the view of the two successful claimants, the timing of the moment of cessation was quite fortuitous. Perhaps a better explanation for the results in these three cases is that little could rationally be done for the large numbers of similar investors in *North American Coin*, whereas a court may more easily give preferential treatment to an investor whose claim is somehow factually distinct. The individual claimants in *Bengal Trading* and *Vermont Real Estate Investment Trust* were the only claimants of their kind — each having uniquely sent money to the debtor just at the moment when the debtor ceased doing business. Had they sent the money a little earlier or later, their transactions would have been executed or their checks returned. By comparison, the investors in *North American Coin* were quite numerous, making it much more difficult for a court to treat them with greater sympathy than it would the general claimants. Similarly, while generalized allegations of fraud and breach of fiduciary duty are routine in these cases, they normally fall on deaf ears. The nine claimants who escaped summary judgment in *Atlantic Mortgage*, however, seem to have appeared both factually distinct from the hundreds of other claimants and few enough in number to manageably receive special treatment without consuming the entire estate.

In sum, then, except for the diligent investor who gets his claim on record and the fortunate investor whose claim is in some other way factually distinct, passive investors are likely to receive very little sympathy, even if their funds are readily identifiable, and even if they characterize the debtor's conduct as fraudulent. Any sympathy a court might feel for passive investors will be smothered by the administrative infeasibility of singling them out, and the undesirability of elevating them all above general claims. By comparison, although consumer-buyers also appear in large indistinct groups, courts have been willing to treat the entire group preferentially.[207]

D. *Cases Based on Conversion of Property Entrusted to Agents*

The investors discussed in the previous section are not the only persons who rely on agents to effect transactions with third parties. Agents are frequently used to collect payments from or make payments

207. *See supra* notes 137-38 & 140 and accompanying text. This added sympathy is evidenced also in § 507(a)(6) giving priority in distribution to claims of consumer-buyers of goods and services. No such priority is available to disappointed investors.

to third parties. Sometimes the agent plays a minor role in the underlying transaction, such as making or arranging a sale or delivering goods. The payment or collection of money for the client, however, is primary. These cases should not be confused with those in which the collection of money from a third party is but an incidental part of a more substantial transaction between claimant and debtor, such as contracts between general contractors and subcontractors. There, both parties depend to a degree on payments from owner to general contractor, but the general contractor is far more than the subcontractor's agent for collection.[208] Unlike the investors, who also entrust funds to an agent, these claimants are often treated quite sympathetically in their equitable battle with the general creditors. In the six such cases I found, only two claimants were treated as clear losers, and a third would likely have succeeded but for an impossible tracing problem.

The key to asserting a successful equitable claim against these types of agents seems to lie in avoiding characterization as a party to a "mere debtor-creditor" relationship. Courts here often focus on how the funds were to be treated under the contract. If the debtor was free to treat the money as his own, the claimant is likely to lose on the ground that there was a mere debtor-creditor relationship. In contrast, the investor claims are not analyzed in this way. Agents for the purpose of investment are never authorized to treat the money as their own, but the investors lose their claims, despite their nonparticipation in "mere debtor-creditor relationships," because investors are risk-takers and they are usually indistinct. Noninvestors who entrust property to agents are more sympathetic, in my view, because they are not risk-takers and because they tend to be more distinctive. It is helpful, of course, to have a special arrangement with the agent as to how the funds will be treated, because courts tend to look for these arrangements and analyze the cases in terms of them. But they are neither crucial nor foolproof. Even without such an agreement,

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208. *See, e.g.*, Georgia Pac. Corp. v. Sigma Serv. Corp., 712 F.2d 962 (5th Cir. 1983). Sigma was a bankrupt general contractor whose owners owed money for services rendered on two construction jobs. Sigma had not paid the materials suppliers on those jobs. Sigma had arranged with the owners (not the suppliers) for some checks to be issued jointly to both Sigma and the suppliers, but Sigma revoked the arrangement before cashing any joint checks. The court held that this brief arrangement did not place the funds in a constructive trust held for the suppliers. *Id.* at 971-72. Because general contractors are normally thought to be the true buyers from materials suppliers, and special protections such as mechanic's liens and payment bonds are available to the suppliers, it would be highly unusual for a court to presume any duty on the part of the general contractor to treat the owner's payments specially. A very strong showing of such an agreement with the subcontractor would be required. *See In re* Bob Cooper, 65 Bankr. 609 (Bankr. M.D. Fla. 1986).

courts may presume an intention to keep the funds separate.[209] Or, courts may find no such intention despite language implying the contrary.[210] The secret of these cases, then, is to identify the characteristics of relationships in which, lacking an agreement for special treatment of funds, a court will presume the relationship to be special. As in the investor cases, I believe the key lies in the distinctiveness of the position of the claimant. Courts may indulge in the presumption that the agent could not treat the funds as its own if the claimant-agent transaction is sufficiently distinctive. But this indulgence evaporates when the claimant is but the customer of, say, a common carrier or freight forwarder whose insolvency has left numerous similar customers in the lurch.

Of the four examples of winning claimants I found,[211] none had specifically arranged for the disputed funds to be placed in a segregated

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209. Using general principles akin to those found in the Restatement of Trusts and Restatement of Restitution, one court in 1932 stated two axioms:

> 1. The technique of approach to the solution of this question seems to me to be this: When A turns over to B some of his property to be sold or evidence of debts owed to him which he wishes to have collected, the presumed intention of both parties is that B is to keep the funds which are proceeds of the sale or of the collection intact and turn them over in due course to A, and not that B may use them for his own purposes and later pay other moneys over to A.
>
> 2. . . . [I]f by a long-established course of dealing between them, or by the custom of the particular business in which they are jointly participating, B has the right to commingle A's money, when collected, with his own and use it for his own purposes as would a bank in which A was a depositor and which had collected notes for him, the relation is that of debtor and creditor.

Harvey Brokerage Co. v. Ambassador Hotel Corp., 57 F.2d 727, 729 (S.D.N.Y. 1932).

210. *See, e.g., In re* Morales Travel Agency, 667 F.2d 1069 (1st Cir. 1981) (bankrupt travel agent's assets were held not subject to a trust in favor of the air carrier for unpaid ticket sales despite use of the word "trust" in the contract authorizing ticket sales).

211. Another winning claimant succeeded on grounds too ambiguous to be directly useful. In the case of *In re* Auto-Train Corp., 810 F.2d 270 (D.C. Cir. 1987), the claimant, Midland-Ross, had sold railway equipment to a Canadian buyer. The buyer made payment through Railway, a subsidiary of the bankrupt. Most of the funds flowed through a special account and Midland-Ross received full payment over a five-week period that fell within the 90-day period before the bankruptcy of Railway's parent corporation. Two months later, and more than 90 days after completion of the payments, Railway was consolidated in bankruptcy with the parent when the court issued a *nunc pro tunc* order backdating Railway's bankruptcy to the date of the parent's. Two years later, the trustee noticed that the backdating's effect brought Railway's payments to Midland-Ross within the 90 days before Railway's bankruptcy. The trustee sued to recover the payments as a voidable preference. The Bankruptcy Court, author of the *nunc pro tunc* order, held in favor of the trustee. The district court, however, reversed on the theory that the transferred funds were subject to a constructive trust. The separation of the funds played an important role in the district court's analysis. *Id.* at 273. On appeal, the D.C. Circuit agreed that Midland-Ross should keep the payments, but on another theory —

account. However, three had a contractual understanding as to how quickly the funds were to be paid. The fourth had no such understanding, distinguishing itself, in my opinion, through extraordinary tracing luck.

In the case of *In re Specialized Installers*,[212] claimant Climax contracted with the debtor for the purchase of gravel. The debtor arranged for delivery by a gravel supplier, contracting to pay the supplier the same day debtor received payment from Climax. Climax then gave the debtor a check, ninety percent of which was to go to the supplier, but within five days, debtor had applied the funds to its own use and filed Chapter 11. Climax was forced to pay the supplier to obtain release of its mechanic's lien, and asserted a constructive trust claim to the check proceeds. The court held Climax was entitled to expect the debtor to carry out its legal and contractual obligation to remit the funds to the supplier, saying, "This is more than a mere debtor creditor relationship."[213] Though there was no express agreement between Climax and the debtor as to how the funds were to be treated, the court referred twice to the requirement in the contract between the debtor and supplier that payment be made the *same day* it was received from Climax.[214]

In *In re Construction General Inc.*,[215] the claimant, Angeles, was the assignee of one-half of the proceeds of a note. Debtor, who owned the other half and had possession of the note, was to collect the proceeds and pay Angeles its half within seven days after payment by the obligor. Instead, when the debtor collected the note, it used

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that the *nunc pro tunc* order was improper, so that the payments were not voidable. 810 F.2d at 277-78. Not content to leave well enough alone, the circuit court went to great lengths to disapprove the district court's constructive trust theory. Because Railway had used the special account "rather randomly" and the account itself was "only a vestige of an abandoned scheme," the court held that Midland-Ross "failed to take the formal steps necessary to meet its burden of establishing a constructive trust." Recognizing that it was imposing formalistic requirements for a constructive trust, the court rationalized the requirements as entirely appropriate because constructive trust doctrine creates the equivalent of a perfected security interest that undercuts the U.C.C. statutory scheme.

The court's reluctance to approve a theory that threatens to undermine the U.C.C. is understandable. Yet I severely doubt that the court would have taken the fund from a claimant as distinctive and sympathetic as Midland-Ross if the court did not have an alternative theory at its disposal. Surely, the case illustrates the need for clearer grounds on which to afford relief to sympathetic claimants.

212. 12 Bankr. 546 (Bankr. D. Colo. 1981).

213. *Id.* at 553.

214. *Id.* at 549-50.

215. 737 F.2d 416 (4th Cir. 1984).

the money to pay an antecedent debt. Bankruptcy followed, and the trustee avoided the preferential transfer. Angeles then asserted its equitable claim to that fund. Because Angeles, the assignee, had demanded and received "more than a mere promise to pay from those proceeds," the court thought the most reasonable construction was that the parties had intended the assignee to obtain a lien on half the proceeds. Concluding that an equitable lien arose and recovery of the preference was a recovery of the proceeds, Angeles recovered. In the only one of these cases to give the slightest mention to the trustee's avoiding powers, Angeles defeated the trustee "because a judgment lien creditor in Maryland takes subject to equitable charges against the debtor."[216]

The third case involved two claimants who would certainly have succeeded but for an impossible tracing burden. Consequently, I believe they provide information about the characteristics of winning claims and have treated them as such. In *In re Treiling*,[217] the debtor was in the business of brokering businesses, that is, soliciting buyers and sellers of businesses and bringing them together. Prospective buyers would give the debtor an earnest money check, which, according to debtor's signed form, was to be held until a more formal contract was signed. The debtor had deposited the checks of four prospective buyers in his general account and spent the money. When the debtor filed bankruptcy jointly with his wife, two of the four prospective buyers asserted equitable claims. By that time, the debtors had no bank accounts, their only asset being an anticipated income tax return "in excess of $3,000." Stating that the claimants could claim the funds as their own if they could trace them, the court could find no way to trace the claims of two of the four buyers into an income tax return.[218]

The fourth case presenting winning claimants was *In re Martin Fein & Co.*[219] The case involved eight claims against the estate of a bankrupt auctioneering firm. The firm's practice was to deposit the proceeds of all auction sales in a general account and to pay creditors and customers alike from that fund. By happenstance, two of the eight claimants were able to identify the proceeds of their goods in segregated, labeled envelopes in a safe deposit box.[220] These two asserted

216. *Id.* at 420.

217. 21 Bankr. 940 (Bankr. E.D.N.Y. 1982).

218. *Id.* at 943-44.

219. The claims described are treated in two separate opinions. 34 Bankr. 333 (Bankr. S.D.N.Y. 1983); 43 Bankr. 623 (Bankr. S.D.N.Y. 1984).

220. 34 Bankr. at 333.

claims to the envelopes. The court stated that an auctioneer is primarily an agent of the seller who does not have title to a principal's goods and should not commingle those goods with the agent's property.[221] The court recognized that auctioneers can sometimes commingle the principal's funds with their own, especially for business expediency if the amounts are small and separate funds would be inconvenient. However, because the funds were not commingled in this instance, the court ruled the trustee could not deny them to the plaintiffs.[222] Nearly a year later, though five of the remaining six trust claims had been dismissed, the sixth remained, still seeking imposition of a constructive trust on the debtor's general account.[223] Seeming to forget the importance of the segregated envelopes in its earlier decision, the court said it had previously ruled that a trust relationship is imposed as a matter of law against an auctioneer and its principals.[224] Finding that the claimant had satisfactorily traced its proceeds to the general account, the court not only granted judgment for the claimant, but invited the five previously dismissed claimants to restore their complaints and assert whatever interests they may have had in the general account.[225]

The two losing equitable claims were asserted against a freight forwarder and a common carrier. In *In re Black & Geddes, Inc.*,[226] an ocean carrier had transported cargo for a shipper who had paid the freight charges to the debtor, a freight forwarder.[227] The carrier was one of at least thirty-seven parties making constructive trust claims, amounting to hundreds of thousands of dollars, against the forwarder's bankruptcy estate.[228] Focusing on the fact that the debtor had no duty to segregate the funds received by the shipper, and citing numerous cases involving bankrupt common carriers, freight forwarders, and travel agencies, all of whom collect funds for large numbers of indistinct customers with no duty to segregate,[229] the court found

221. *Id.* at 336-37.

222. *Id.* at 337.

223. 43 Bankr. at 625-26.

224. *Id.* at 626.

225. *Id.* at 628-29.

226. 35 Bankr. 830 (Bankr. S.D.N.Y. 1984).

227. *Id.* at 832. A freight forwarder acts as an intermediary, arranging for ocean transportation and receiving compensation for its services from both shipper and carrier. *Id.*

228. *Id.* at 837. The other 36 parties raised constructive trust arguments as a defense to the preference counterclaims asserted by trustee. *Id.*

229. *Id.* at 836-37; *see In re* Morales Travel Agency, 667 F.2d 1069 (1st Cir. 1981); *In re* Schulman Trans. Enters., Inc., 21 Bankr. 548 (Bankr. S.D.N.Y. 1982), *aff'd*, 744 F.2d 293 (2d Cir. 1984); *In re* Allbrand Appliance & Television Co., 16 Bankr. 10 (Bankr. S.D.N.Y. 1980); *In re* Penn-Dixie Steel Corp., 6 Bankr. 817 (Bankr. S.D.N.Y. 1980).

that a mere debtor-creditor relationship existed and denied the claim.[230] The court added that the other thirty-six constructive trust claims would also be denied, and that it would make no difference if the claimant were a disappointed shipper rather than a carrier. The court also noted that its denial of the claim on substantive grounds eliminated the need to reach the difficult tracing questions presented.[231] The second losing equitable claim case, *In re Mid-American Lines*,[232] involved the claim of a shipper against a common carrier that had collected funds due the shipper. According to usual procedures, the funds were deposited in the carrier's general account, the balance of which became negative at least once before bankruptcy. Holding simply that the claimant's monies were no longer in the estate, the claim was denied.[233] Because the most common theory for tracing an equitable claim into a commingled account, the lowest intermediate balance method, served as a basis for denial, the court was saved the trouble of analyzing the substantive claim. As has been demonstrated above, had the claim been a more sympathetic one, the court might well have indulged in a more generous tracing fiction.[234]

In summary, though neither mandatory nor foolproof, an explicit agreement prohibiting an agent from treating the funds as his own will strengthen a claimant's cause. But the more telling characteristic seems to be the relative uniqueness of the claim.[235] All claimants whose

230. 35 Bankr. at 837.

231. *Id.* at 838.

232. 24 Bankr. 52 (Bankr. W.D. Mo. 1982).

233. *Id.* at 53.

234. The tracing problem faced by the *Treiling* court, in contrast, was a much tougher one. For example, a less popular but well-known fiction is that when the debtor, having breached its trust obligation to the claimant, made subsequent deposits in the account, they were intended to replace the misappropriated funds. *See, e.g., In re* Mahan & Rowsey, Inc., 35 Bankr. 898, 903-04 (Bankr. W.D. Okla. 1981), *aff'd*, 817 F.2d 682 (10th Cir. 1987). Some courts, when sufficiently certain of the substantive basis for imposing a constructive trust, require virtually no tracing at all. *See supra* note 140 and accompanying text.

235. Of the claims I have discussed in this section, the only ones that do not fit comfortably into this generalization are those of the six customers in *Martin Fein* whose funds were deposited in the auctioneer's general account. *See supra* notes 219-24 and accompanying text. Of course, the two claimants whose funds were found in the envelopes were distinguished from the general creditors by the extreme tangibility of their proceeds. *In re* Shepard is similar in that respect. *See supra* notes 163-65 and accompanying text. However, absent the earlier decision in favor of the envelope claimants, the remaining six claims might well have been denied. In fact, five of the six claims had been denied earlier without any explanation as to how the sixth mysteriously survived. Perhaps this case illustrates the phenomenon of a claimant with an indistinct claim being carried by a claimant with a distinct claim. Because the equities of all eight were the same and the distinctiveness was a matter of sheer luck, the court felt obliged to treat them all equally.

agents in three-party transactions become bankrupt are entitled to sympathy. But the general creditors are entitled to sympathy, too. Only if a claimant's circumstances are relatively unusual is a court able to distinguish the equitable claim from those of the great mass of general claims.

As mentioned above, the inferences I have drawn here are the same as the ones I drew in the discussion of the investors who have entrusted money to agents. The difference between the investors, who usually lose, and the noninvestors, who often win, seems to be that it is very difficult for most investors to separate themselves from the mass; some spectacular form of diligence or luck is required. By comparison, except for the customers of common carriers, freight forwarders, and the like, noninvestor customers of bankrupt agents tend to show up in more distinctive circumstances, making it administratively feasible to single them out for preferential treatment.

E. *Intentional Misrecording Cases*

Seven cases in which the claimant was dispatched without a hint of sympathy involved persons who owned real estate, yet who intentionally left record title in the debtor. The motivation for doing so was never salutary, including the desire to avoid existing creditors, the desire to mislead prospective creditors, various mistaken assumptions, and sheer inattention. Predictably, the uniform result was that not a single claimant was successful. Moreover, these cases nicely illustrate how a court's lack of sympathy for a claimant may strongly influence its receptiveness to constructive notice arguments; the courts in these cases frequently rejected arguments that, if made by a more sympathetic claimant, might well have succeeded.

Four of these cases arose in the family context. The first, *In re Steele*,[236] was a case in which the purchasers of a house intentionally left title in their son's name in order to avoid taxes.[237] A document had been filed that referred to the parents at length, stating that they had provided financing for the property, limiting the son's power to control the property, and including a copy of the son's $72,000 note to the parents.[238] When the son filed Chapter 7, the parents claimed an ownership interest, which the trustee sought to avoid under section 544(a)(3). Despite the recorded document, the court managed to find that there was no constructive notice of the parents' ownership claim.

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236. 27 Bankr. 474 (Bankr. W.D. Wis. 1983).
237. *Id.* at 475.
238. *Id.* at 476.

"Where possession of property is not inconsistent with record title, a purchaser need not make inquiry into the possessor's interest."[239] In more sympathetic cases, courts have had no difficulty finding that nearly any type of record uncertainty provides notice of what might be discovered on inquiry.[240]

In re Mazetti[241] is another case in which the parents purchased a house, then deeded it to their son, who assumed the mortgage and promised to repay the parents' down payment. The son's deed was recorded, but the parents were apparently satisfied at the time with the son's unsecured promise of repayment. Sixteen months later, just before filing bankruptcy, the son conveyed a second mortgage to the parents, which the trustee attacked as a preferential transfer. The parents' defensive claim of equitable mortgage was held invalid against the trustee's BFP power.[242]

The remaining two family cases in which the trustee defeated an intentionally misrecorded claim, *In re Trotta*,[243] and *In re Mitchell*,[244] arose out of bankruptcies in which husband and wife filed jointly (the Trotta's in Chapter 13, and the Mitchell's in Chapter 7). In both, the sole recorded interest in the family home was in the wife's name.[245] The husbands, having contributed to the down payment, the mortgage payments, and so on, claimed equitable interests in the houses. The purpose in both cases was to make a second homestead claim, one in the bankruptcy of each spouse. Neither court had any difficulty finding that such unrecorded claims would fall to the BFP power of the trustee.

Three of the misrecorded claim cases arose in the commercial setting. One is *In re Hardway Restaurant, Inc.*,[246] a case involving three consecutive failures to record four contiguous leaseholds. Stove, Inc. had sold a restaurant in New York City to Hardway for $570,000, assigning Stove's four unrecorded leaseholds that made up the restaurant premises to Hardway. Hardway left his interest in the leaseholds unrecorded, as well. Most of Hardway's purchase price was payable

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239. *Id.* at 478.

240. *See, e.g.*, *In re* Elin, 20 Bankr. 1012 (Bankr. D.N.J. 1982); *In re* Chateau Royale, Ltd., 6 Bankr. 8 (Bankr. N.D. Fla. 1980); *see also supra* notes 102-05 and accompanying text.

241. 22 Bankr. 538 (Bankr. E.D. Mich. 1982).

242. *Id.* at 540.

243. 12 Bankr. 843 (Bankr. D. Conn. 1981).

244. 9 Bankr. 577 (Bankr. D. Or. 1981).

245. The court does not state why the Trottas did this. The Mitchells were worried about the husband's creditors from a prior marriage. *Id.* at 578.

246. 31 Bankr. 322 (Bankr. S.D.N.Y. 1983).

over a period of seven years. As security, Stove took a perfected UCC security interest in the equipment and fixtures and a reassignment of the leaseholds. As was apparently the custom, these reassignments were not recorded, leaving Stove's lien on the leaseholds vulnerable to attack under section 544(a)(3) when Hardway later filed bankruptcy. Purportedly taking the "broad view" of constructive notice, the court nevertheless found none. Because Hardway, a complete stranger to the record, had possession, "further inquiry would be needed to ascertain the nature and genuineness of Hardway's lease interest."[247] However, the court found that this inquiry would lead only to the determination that as part of the complex sale from Stove to Hardway, the landlords had consented to the assignments of the leaseholds from Stove to Hardway. The inquiry would not lead further, the court said, to discovery of Stove's reassignment interest.[248] In this court's conception, a diligent inquirer bent on purchasing these leaseholds from Hardway would not have been curious as to whether Hardway had paid cash for the leaseholds (which represented over 60 percent of the purchase price of the restaurant) or whether the purchase had been financed. It is not difficult to imagine another court, also taking the broad view of constructive notice, hypothesizing the slightly more extensive inquiry required to protect the interests of a more sympathetic claimant. However, Stove, a sophisticated entity that did not bother to record the transfer of a $364,000 interest in realty, was a poor candidate for such indulgence.

The second case arising in the commercial context was also one in which a court rejected allegations of constructive notice. In *In re Harter*,[249] the court's lack of difficulty in dispatching the claim paralleled perfectly the lack of sympathy for a claimant whose unrecorded transfer from his wholly owned corporation left him vulnerable when the corporation filed bankruptcy.[250] In the third commercial case, *In*

247. *Id.* at 330.

248. *Id.*

249. 31 Bankr. 1015 (Bankr. D. Kan. 1983).

250. Because the claimant had previously transferred the condominium to the corporation as collateral for loans to the corporation, the transfer back to the claimant amounts to a transfer to the corporation's grantor. In denying the claim that Harter's continued possession gave constructive notice of his claim, the court stated simply that "possession by grantor does not impart notice to purchaser from grantee of any equities that grantor may have." *Id.* at 1020.

Another low-sympathy case, *In re* Belize Airways, Ltd., 12 Bankr. 387 (Bankr. S.D. Fla. 1981), involved a commercial lessee that had failed to record its interest. Despite the fact that the claimant openly occupied the premises, a circumstance normally giving clear rise to constructive notice, the court voided the claim under § 544(a)(3) without the slightest reference to the doctrine. *Id.* at 389-90. The *Hardway* court characterized this curious opinion as "a more narrow reading of the requisite inquiry by a bona fide purchaser . . . ." 31 Bankr. at 328.

re Phillips,[251] the claimant and the debtor had been involved in various joint enterprises, including the sale on credit of a piece of the claimant's realty to the Sullivans. Though the commercial motivations were disputed at trial, the claimant's own attorney drafted the mortgage and note, making them payable to the debtor. When the debtor filed bankruptcy two years later, the claimant's unrecorded interest in the note and mortgage was defeated by the trustee's BFP power.[252]

F. *Mistaken Payment Cases*

Among the cases giving the courts the least difficulty are those involving the mistaken transfer of funds on the eve of bankruptcy due to clerical error. In *In re Country Club Casuals*,[253] the claimant had accidentally transferred funds intended for two other clients electronically to the debtor just hours before bankruptcy was filed. Stating that the equitable principles are too fundamental to require extended analysis,[254] the court awarded return of the funds to the claimant.[255] In *In re Mahan & Rowsey, Inc.*,[256] the claimant was "participating" in the drilling of an oil well by the debtor. During the five months prior to bankruptcy, the debtor mistakenly overbilled the claimant for his share of the venture by some $42,000. The Tenth Circuit affirmed the imposition of a constructive trust on the account into which the payments had been deposited.[257] The court in *In re Angus*[258] had a similarly easy time. Claimant insurance company, having paid for a diamond ring mistakenly thought to be lost, obtained the ring from the debtor's estate on the theory of constructive trust.[259]

Because persons who err accidentally, as distinct from those who err in judgment, have traditionally received sympathetic treatment in our law, the courts' high sympathy for these claimants is easy to understand. It is well-illustrated by the courts' lack of insistence on

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251. 21 Bankr. 565 (Bankr. D. Conn. 1982).

252. *Id.* at 568.

253. 1 Bankr. 274 (Bankr. S.D. Fla. 1979); *see also In re* Computer Input Servs., Inc., 33 Bankr. 292 (Bankr. E.D. Pa. 1983) (mistaken post-bankruptcy transfer to debtor in possession returned on constructive trust theory).

254. 1 Bankr. at 276.

255. *Id.* at 277.

256. 817 F.2d 682 (10th Cir. 1987).

257. The Tenth Circuit affirmed the district court's reversal of the Bankruptcy Court's judgment awarding the claimant recovery of the entire overpayment. Instead, recovery was limited to the lowest intermediate balance. *Id.* at 684-85.

258. 9 Bankr. 769 (Bankr. D. Or. 1981).

259. *Id.* at 771.

rigor regarding either the basis for the equitable claim or tracing, and also by the failure of these courts to give the faintest mention to the powers of the trustee.

Two mistaken payment cases involved innocent contributors to the debtor's equity in a home.[260] Enmity for the two debtors who attempted to retain the benefit received through a homestead exemption may also play a role here. In *In re Linderman*,[261] the debtor's closely held corporation had made payments on the debtor's home mortgage. The house was sold just prior to both the debtor and the corporation filing Chapter 7 petitions. The debtor claimed the proceeds of the sale as exempt, but the trustee for the corporation asserted an equitable claim to $5,400 of the sale proceeds based on the "mistaken" contribution to the debtor's equity. The claimant corporation won, its creditors rather than the debtor getting the $5,400.[262] *In re Lodek*[263] is a similar case in which $3,000 of the claimant Adelia Traub's funds had been applied to improve the debtor's homestead.[264] The unique aspect of the case is that the claimant had successfully sued the debtor in state court, obtained a judgment granting her an equitable lien, and recorded an abstract of the judgment in the real estate records. Holding that an equitable lien is not a judicial lien under the Code, the court denied the debtor's attempt to avoid it as a lien impairing an exemption under section 522(f).[265] Of course, Traub is a sympathetic claimant, if only for her tenacity and diligence. In both cases, the claimant is also aided by the court's natural desire to prohibit the debtor from retaining the benefit of the improperly gotten funds.

G. *Divorce Cases*

One distinct group of cases is comprised of nine claims arising out of divorce proceedings. Normally, a judgment is thought to create an ordinary debt. But when a disappointed divorcee can trace an unperformed divorce obligation into an asset of the bankrupt obligor's estate,

260. These claimants who innocently make payments against the debtor's mortgage are distinguishable from those who intentionally do not record their interests and make payments on a mortgage held in the name of another. Those cases are discussed in the section on intentional misrecording. *See supra* notes 236-45 and accompanying text.

261. 20 Bankr. 826 (Bankr. W.D. Wash. 1982).

262. *Id.* at 829. The court did not mention the possibility that the debtor might assert the trustee's avoidance powers under § 522.

263. 61 Bankr. 66 (Bankr. W.D. Tex. 1986).

264. The opinion did not explain this result. Because fraud or wrongdoing were not mentioned, I have treated it as a mistake case.

265. *Id.* at 68.

the special societal interest in marriage and divorce seems to add a high-sympathy rating to the divorcee's equitable claim. Eight of the nine scorned spouses succeeded, with only one court mentioning the policy of equal treatment of unsecured claims. The ninth claimant encountered some difficulty, but considering the special circumstances in which the claim arose, she did not do badly. The courts' sympathy toward these claims also shows up in the frequently lax attitude toward the tracing requirement. No divorce-based claim was denied for either lack of adequate basis for an equitable claim or lack of tracing.

Four of these cases were nearly identical. *In re Bailey,*[266] *In re Kinder,*[267] *In re Albritton,*[268] and *In re Richardson,*[269] all arose out of divorce awards in which the husband retained the family home and was ordered to make payments to the former wife over a period of time, or to sell the house and pay half of the proceeds to the former wife.[270] When the former husbands filed bankruptcy expecting these property division awards to be discharged,[271] the wives asserted equitable claims to the houses. In all four cases, the courts granted equitable liens on the houses to the extent of the unpaid debts. Although no particular source of payment had been identified, the claims were "traced" into the homes. One court said that although the facts did not neatly fit the elements for an equitable lien, it would allow "considerable latitude in structuring the remedy to achieve what was or ought to have been intended."[272]

Two cases present a variation on the fight over the family home. In *In re Cubbler,*[273] the divorce settlement left title to the house in

266. 20 Bankr. 906 (Bankr. W.D. Wis. 1982).

267. Bankr. No. MN13-81-00277, slip op. (Bankr. W.D. Wis. Jan. 6, 1982) (discussed at length in *Bailey,* 20 Bankr. at 910-12).

268. 17 Bankr. 555 (Bankr. M.D. Fla. 1982).

269. 75 Bankr. 601 (Bankr. C.D. Ill. 1987).

270. The facts in *Albritton* and *Richardson* were slightly different. Instead of a divorce judgment, the obligation flowed from a settlement agreement that was never filed. 17 Bankr. at 556-57; 75 Bankr. at 602-04.

271. Although alimony and support obligations are excepted from discharge, property divisions are not. *See* 11 U.S.C. § 523(a)(5) (1982). In *Bailey,* the former husband waited only nine days after the divorce was final to file bankruptcy. 20 Bankr. at 908. The debtor in *Albritton* made three monthly payments before filing. 17 Bankr. at 557.

272. *Bailey,* 20 Bankr. at 911 (quoting *In re* Kinder, *supra* note 267). The sympathy for the ex-wife here is dramatized by the fact that, because the husband had not yet quitclaimed the claimant's half interest in the house, the court could have used her legal half interest as a tracing tool. However, that would have been worth only $10,650. Instead, the court imposed an equitable lien to the extent of her entire $23,100 claim. *Id.* at 912.

273. 17 Bankr. 674 (Bankr. E.D. Penn. 1982).

the husband's employer, but only for the benefit of Miriam Cubbler and her five children. The next year, the husband obtained title from his employer and eventually twice remortgaged the house without Miriam's knowledge. She discovered the mortgages eleven years later when her former husband and his current wife filed a joint Chapter 13 petition. Despite the debtor's argument that the house was now part of his estate and should be applied to the claims of his creditors, the court imposed a constructive trust on the house.[274] Another unauthorized transfer appears in *In re Crabtree*.[275] At a time when they were contemplating divorce, David obtained his wife Brenda's signature without her consent on two warranty deeds, transferring two lots held by the entireties to a holding company owned by David. The divorce decree and property settlement called for transfer of the lots to Brenda, and David executed an invalid quitclaim deed to that effect. In David's subsequent bankruptcy,[276] the court imposed a constructive trust on an undivided one-half interest in the lots for Brenda's benefit.[277] The only curious aspect of the case is that the court limited the remedy to one-half interest in the lots, rather than their entirety as specified in the divorce settlement.[278]

In the three remaining divorce-based cases, the court had designated a specific asset out of which the post-divorce obligation was to be paid, eliminating any awkwardness about tracing. In *In re Graham*,[279] the decree incorporated a stipulation agreement in which the husband was to pay certain joint debts by liquidating specified stocks and insurance policies. Instead, he used those proceeds to buy a house and filed bankruptcy, expecting to retain the house as exempt property and obtain discharge of the debts. The former wife, who remained liable for the debts, asserted an equitable claim to the house. "Because liens are illusive creatures and lien avoidance in this case [was] a

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274. Assuming the two mortgagees were bona fide purchasers, the claimant presumably took subject to their claims, totaling $66,000. Because neither the trustee nor the debtor raised the possibility of avoiding the claimant's interest, the court did not consider it. *Id.* at 676.

275. 76 Bankr. 632 (Bankr. E.D. Tenn. 1987).

276. The true parties in interest were Brenda and the holding company. The bankruptcy estate was interested only in that the value of the holding company stock, which, as an asset of the estate, reflected ownership of the lots.

277. *Id.* at 636.

278. The court explains that the two warranty deeds effectively transferred David's half interest to the holding company, and that there was no showing at that time of any agreement by David to transfer his interest to Brenda. *Id.* at 634-35. In failing to give full effect to the terms of the property settlement, the court is less sympathetic to the divorced wife than most courts.

279. 28 Bankr. 928 (Bankr. N.D. Iowa 1983).

complex issue, this court [was] not content to find only that Patsy Smith has a lien on the homestead of the Debtor."[280] Apparently believing avoidance issues could be sidestepped by characterizing the equitable claim as one of constructive trust, the court imposed one on the house.[281] *In re Elrod*[282] was a case in which a divorce court had attached a specific investment account of the former husband and enjoined him from applying it to any purpose other than paying child support to his former wife. When he filed bankruptcy, the critical inquiry was the extent of the former wife's property interest in the account. The court held that the state court had effectively created an express trust on the account, which would defeat a judicial lien creditor, and thus the trustee.[283]

The only divorce-based claim to lose to the trustee arose in the case of *In re McWhorter*,[284] but the circumstances leading to that result were somewhat unusual. Prior to both the divorce and the bankruptcy, South Carolina National Bank (SCN) held a perfected purchase money security interest in Jimmy McWhorter's car. The next year, the divorce decree required Jimmy to transfer title to the car to his former wife, Brenda, and to continue making the payments to SCN. Jimmy did not transfer the title, but Brenda retained possession. A few months later, Jimmy defaulted on the car payments and two things happened: SCN put a "hold" on one of Jimmy's checking accounts, and Brenda obtained a Family Court order holding Jimmy in contempt and ordering him to transfer title to the Buick to her. Three days later, Jimmy filed Chapter 7, but, despite the automatic stay, the Family Court threatened Jimmy with ninety days in jail. This finally motivated Jimmy to execute an assignment of his rights in the car to Brenda, who then pledged her interest in the car to SCN. Jimmy later transferred legal title to Brenda and SCN. Without obtaining relief from the automatic stay, SCN set off the $3,500 balance on the car loan against Jimmy's frozen checking account. Believing its lien to have been satisfied, SCN then relinquished its lien on the Buick by delivering the certificate of title to Brenda.

280. *Id.* at 931.

281. *Id.* at 931-32. This odd conduct shows the clear misunderstanding of the substantive identity between equitable liens and constructive trusts. It also shows the lengths to which courts are sometimes willing to go in protecting the interests of a highly sympathetic claimant.

282. 42 Bankr. 468 (Bankr. D. Tenn. 1984).

283. *Id.* at 472-73. The court might have more conveniently considered a constructive trust theory had this case not been brought in Tennessee, a state where equitable claims may be defeated by the trustee's lien creditor power. *See In re* Hurst, 27 Bankr. 740 (Bankr. E.D. Tenn. 1983).

284. 37 Bankr. 742 (Bankr. D.S.C. 1984).

This was a crucial mistake, because when the court later held SCN's set-off invalid and ordered it to turn over the funds in the checking account,[285] SCN found itself with an unsecured claim against Jimmy's estate. Accordingly, there were three claims in bankruptcy to the car: the trustee's claim based on Jimmy's title at the time of bankruptcy, Brenda's claim of equitable ownership, and SCN's request to have its briefly satisfied lien reinstated. Holding that Brenda's equity interest at most "constitutes an equitable lien, which is an unperfected security interest,"[286] the court ruled that Brenda's claim was voidable under section 544 and invited SCN to seek relief from the automatic stay.[287] Given the unusual facts of this case, the court's conclusion, despite its analytical flaws,[288] should not be criticized as lacking sympathy for the divorce-based claim. Rather, it simply shows greater sympathy for a bank that relinquished its perfected purchase money security interest due to a mistaken belief regarding the effect of a bankruptcy petition. Neither the Family Court nor Brenda ever expected that she would get the car free of SCN's lien.[289]

H. *Miscellaneous Claims Cases*

I was left with fourteen cases that did not fit into any of the above categories. For the most part, they involve failures to execute promised transfers, nonpayment for services rendered, or failures to perform other sorts of contractual obligations. In most of them, there is nothing in the nature of the transactions that would justify treating the claimants better than the general creditors. Yet the claimants in ten of these cases succeeded, four because the claimants were classic high-sympathy victims, three because of their diligence, and three because they were the beneficiaries of the court's enmity toward the debtor.

The four claimants accorded high sympathy because of their position of vulnerability in the transaction were (yes) a widow, a group of employees, and two groups of consumer-buyers seeking return of their down payments. In the first of these,[290] the widow had transferred

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285. *Id.* at 744-45.

286. *Id.* at 746.

287. *Id.* at 747.

288. The court confuses those equitable liens arising out of unperfected security interests with *all* equitable liens, which are not all unperfected security interests. Moreover, the normal equitable claim *does* defeat lien creditors. *See supra* notes 17-20 and accompanying text.

289. 37 Bankr. at 744. The Family Court held she was entitled to all *equity* interest in the Buick, obviously intending that she get whatever value remained after SNC was paid. *Id.* Otherwise, she would have been the party unjustly enriched.

290. *In re* Wyatt, 6 Bankr. 947 (Bankr. E.D.N.Y. 1980).

the proceeds of her insurance to the debtors in exchange for a promise of support for life. When the debtors breached, she sued them in state court and obtained an order of constructive trust against the realty the debtors had purchased with the funds. When the debtors filed a Chapter 13 petition, the Bankruptcy Court upheld the constructive trust on the authority of section 541.[291] The second case concerned the claims of employees who had been promised royalty interests in certain oil leases as part of their employment contracts. At first, the interests were properly assigned and recorded, but later they were not. When the employer filed a Chapter 11 petition, the employees sought imposition of a constructive trust against the unassigned interests.[292] The United States District Court upheld the mysterious and unexplained Bankruptcy Court holding that section 544(a)(3) provides no basis for avoiding these claims to realty.[293] In the last two classic high-sympathy-victim cases, groups of consumer-buyers sought return of their down payments.[294] The claimants faced severe tracing difficulties in both cases, yet the consumers were treated well, receiving full payment in one case,[295] and judgments against the nonbankrupt officers and agents of the bankrupt corporation in the other.[296]

291. *Id.* at 951-53. By imposing a constructive trust to a limited extent, the court demonstrated a common misunderstanding about the difference between equitable liens and constructive trusts. Of course, a limited equitable interest in the property is just a lien. However, the court felt the need to characterize it as a trust to defeat the estate. The claimant's diligence in pursuing the debtors in state court coupled with the debtors' attempt to retain the property through Chapter 13 undoubtedly added unnecessary strength to her claim.

292. Don Boyd v. Martin Exploration Co., 56 Bankr. 776 (Bankr. E.D. La. 1986). Although the employees in this case were senior management personnel, they are properly viewed as vulnerable parties in the transaction. It would have been very difficult for them to protect themselves. They had no role in the execution of the assignments, probably did not know the assignments had ceased, and probably would not threaten a work stoppage due to some sloppy bookkeeping.

293. *Id.* at 781. Because only the creditors' committee appealed the Bankruptcy Court holding, and the committee lacked standing, the holding was not reviewed. Also unexplained is why the debtors in possession inexplicably did not appeal. Perhaps they felt greater sympathy for the employees than for the creditors' committee. The committee should have sought appointment of a trustee.

294. *In re* Wholesale Furniture Mart, Inc., 24 Bankr. 240 (Bankr. W.D. Mo. 1982); *In re* Fieldcrest Homes, Inc., 18 Bankr. 678 (Bankr. N.D. Ill. 1982).

295. In *Fieldcrest*, the claimant was the insurance underwriter of the debtor's closely related title insurance company. When the debtor misappropriated the escrowed funds received from the home buyers, claimant had to pay off more than $300,000 in claims on the policies. Thus, the home buyers were treated well. On the other hand, the insurer who asserted those claims via subrogation was not treated so well. While the court held that a constructive trust may be imposed on the assets of the debtor, it added that there was considerable doubt whether claimant could trace. 18 Bankr. at 679. Insurers are in the business of assuming these risks. Even though

I believe the next three claimants were treated more sympathetically than the general creditors because they made substantial efforts to protect themselves, yet fell just short of "immaculate protection." The claimant in *In re Moore*[297] had been supplying inventory on unsecured credit for Moores' store. When the Moores' balance got too high, the claimant obtained both a perfected security interest in inventory and equipment and a deed of trust on the realty. The Moores were contractually required to insure claimant's interest, but did not understand the need to add claimant to its omnibus policy as a loss payee. When the store burned down and the Moores filed Chapter 11, the claimant had no legal claim to the proceeds of the policy attributable to the realty.[298] Holding that a debtor in possession should not have quite all of the trustee's BFP power despite section 1107,[299] the court imposed an equitable lien on the insurance proceeds.[300]

In the second case, *In re American International Airways, Inc.*,[301] claimant Goldberg leased his Boeing 727 airplane to AIA for six years. Two months later, AIA subleased it to American Airlines (American). American's sublease was made explicitly subordinate to the terms of the master lease, and Goldberg sent American a "non-disturbance letter" consenting to the sublease and promising not to disturb American's quiet enjoyment of the 727, provided, in the event of default by AIA, payments under the sublease would be made directly to Goldberg.[302] When AIA filed Chapter 11, Goldberg sought to impose a constructive trust on American's payments under the sublease. Citing only section 541, the court said distribution of these funds to other

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they are subrogated to the claims of the paid-off home buyers, they do not inherit the home buyers' position of sympathy over general creditors.

296. *Wholesale Furniture*, 24 Bankr. at 243-44.

297. 54 Bankr. 781 (Bankr. E.D.N.C. 1985).

298. Of course, the perfected security interest in the inventory and equipment automatically gave the claimant a perfected security interest in the insurance proceeds attributable to the damaged personalty. U.C.C. §§ 9-306(1), (3). Unfortunately for the claimant, real estate security law is not as enlightened.

299. 54 Bankr. at 783-84. This unsupported holding dramatically demonstrates the unexpressed feeling shared by a number of courts. Where there is a Chapter 11 debtor in possession, the debtor is perceived to benefit from the avoidance of the claim rather than the general creditors. The resulting enmity toward the debtor often improves the chances of an equitable claimant's success, making it easier to win in Chapter 11 than Chapter 7. Because the debtor in Chapter 13 retains the property of the estate, there may be a similar phenomenon at work there, as well.

300. *Id.* at 784.

301. 44 Bankr. 143 (Bankr. E.D. Pa. 1984).

302. *Id.* at 145 n.2.

administrative claimants would be inequitable and imposed a constructive trust.[303]

In *In re Crotts*,[304] the claimant temporarily entrusted his car to debtor and transferred title to her so she could obtain proper insurance. When she refused to return the car, claimant sued and obtained a judgment awarding him possession. Claimant immediately attempted unsuccessfully to recover the car through writs of possession and *fieri facias*. These attempts were stayed when debtor filed a Chapter 13 petition. The court held that the judgment order imposed a clear constructive trust on the car and that under section 541(d), the car should not have been treated as property of the estate.[305]

In all three of these cases, the claimant had taken nearly all the steps necessary to assure success in bankruptcy. In *Moore*, the claimant should have made certain its name was added to the loss payable clause. In *AIA*, Goldberg should have taken and perfected a security interest in either the 727 or the receivables from American. In *Crotts*, the claimant had nearly completed the process of judicially recovering his car. But in the circumstances of the transactions, having already taken substantial protective steps, these courts did not require the last impeccable one. Enough had been done to distinguish the claimant from the ordinary unsecured creditors.[306]

The last three of the ten successful claimants owe at least a portion of their success to the court's enmity for the debtor. *In re Adametz*,[307] claimant Mumm was in a joint farming venture with the debtor, where Mumm provided the farms and purchased some equipment the debtor would use in managing the farming operation. A year later, the debtor traded in the equipment for a new harvester, taking title in his own name. When he phoned Mumm about the trade, Mumm agreed to "call the debt off" if the debtor would put the harvester in

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303. *Id.* at 147-48.

304. 87 Bankr. 418 (Bankr. E.D. Va. 1988).

305. *Id.* at 420. To vindicate the claim, the court ordered the trustee to recover the proceeds of the car that had been distributed to other claimants.

306. It is interesting that under Article 9 of the U.C.C., these additional steps are not required. The drafters of Article 9 adopted the policy in § 9-306 that with minor exceptions, a perfected claim to an item of collateral automatically continues as a perfected claim to the proceeds of that collateral. In *Moore*, claimant had a perfected claim to the real estate, and in *A.I.A.*, claimant had a perfected claim to the payments under the master lease. Unfortunately, both found themselves pursuing the proceeds of the original collateral outside the protection of Article 9. Perhaps the familiar policy of Article 9 has created something of an ethic among commercial judges as to how much diligence should be expected of commercial claimants. These two, having met that standard, were treated sympathetically.

307. 53 Bankr. 299 (Bankr. W.D. Wis. 1985).

Mumm's name. The debtor never did. Another year later, the debtor filed bankruptcy, claiming the harvester as exempt property, and Mumm claimed the harvester.[308] Although the debtor's conduct was wrongful, it was not deceitful, and ordinarily a claimant who does nothing for a year following discovery that his property has been converted would be treated no more sympathetically than general creditors. Here, however, Mumm was granted an equitable lien on the harvester.[309] Otherwise, the debtor, who is variously referred to in the opinion as an embezzler and willful malicious converter, would have retained the proceeds as exempt property.

In re Daves[310] presents a second fortunate claimant, but the claimant's success was substantially moderated by Texas's extensive constitutional protection of homestead claims. In that case, the claimant bank had granted the debtor, a lawyer, a $55,000 unsecured line of credit. During the discussions regarding the line of credit, the parties "mentioned the idea that the debtor could obtain a permanent loan on his home . . . or that he could place a second lien on [his] office building . . . ."[311] When the loan went into default, the debtor promised the bank a lien,[312] but then prevented either of the properties from being available for lien purposes.[313] The bank sued, and the debtor filed a Chapter 13 petition. The Bankruptcy Court granted the bank an equitable lien on both the debtor's residence and the office building.[314]

On appeal, the Fifth Circuit held that the Texas Constitution prohibits both constructive trusts and equitable liens on homestead property, but affirmed the equitable lien on the office building to the extent loan proceeds could be traced into the purchase of the building.[315] A bank that "mentions the idea" of a lien while extending unsecured credit is hardly more sympathetic than other unsecured claimants, and probably less sympathetic than most. Yet, such a claimant is more sympathetic than this unsavory debtor whose Chapter 13 estate stood

308. *Id.* at 301.
309. *Id.* at 307.
310. 770 F.2d 1363 (5th Cir. 1985).
311. *Id.* at 1365.
312. *Id.*
313. He prevented the properties' availability for lien by releasing a "sham lien" on the residence and impressing the office building with a lien in favor of another bank. *Id.* at 1367.
314. *Id.* at 1366.
315. The court characterized the equitable lien as an implied vendor's lien. *Id.* at 1370. This characterization effectively meant only that the funds must be traced.

to benefit if the bank's equitable claim was denied.[316] Feeling bound by the extremely solicitous Texas Constitution, the only asset the court could remove from the estate was the office building.[317]

In re Niland[318] is another example of a Texas claimant whose claim, but for the generosity of Texas homestead law, might have succeeded because of a very high-enmity debtor. The debtor, in desperate financial straits, had managed to obtain a $300,000 nonpurchase money mortgage loan from Continental Savings Association by bribing one of its employees and falsely representing that his home was not his homestead. Continental eventually foreclosed on its mortgage. Just days before the foreclosure sale, claimant Deason looked at the house through a realtor. Failing to come to agreement on the purchase (the asking price was $495,000), Deason was told of the foreclosure sale two days hence. Deason purchased the house at the sale for $320,000, and when he later brought an action to evict the debtor, the debtor filed Chapter 13 and claimed the entire property as exempt. Applying the familiar rule that a purchaser at foreclosure acquires the interest of the foreclosing creditor, the Bankruptcy Court held that Deason was subrogated to Continental's valid lien. But because the lien was only valid as to the excess over one acre under the Texas homestead law, Deason would receive no legal lien on the property protected by the debtor's homestead claim. Therefore, the Bankruptcy Court granted Deason an equitable lien to the extent of the debtor's homestead interest.[319] On appeal, both the Federal District Court and the Fifth Circuit reversed the imposition of an equitable lien on the authority of *Daves*.[320] Though the Fifth Circuit characterized Deason as a less than innocent purchaser,[321] it is clear that the court would have affirmed Deason's equitable lien if it could have found a way around the homestead law.[322] Purchasers at foreclosure sales are speculators

316. Several factors pointed to the unsavoriness of this debtor. First, he continued building his home without the approval of the development's architectural committee, causing a savings and loan to refuse to finance construction costs. *Id.* at 1364. Second, he placed a "sham lien" on the house. *Id.* at 1367 n.6. Third, he borrowed money against the office building to pay off claimant, then misapplied the funds. *Id.* at 1365. Finally, he "claimed ignorance of the act of his wife in recording the release of lien." *Id.* at 1365 (wife did not testify).

317. Because the debtor had subjected the building to a prior $55,000 mortgage, adding a $10,000 equitable lien probably ate up all the remaining equity in the building, effectively removing it from the estate.

318. 825 F.2d 801 (5th Cir. 1987).

319. 50 Bankr. 468, 480 (Bankr. N.D. Tex. 1985).

320. 825 F.2d at 814.

321. *Id.* at 812-13.

322. The court had tried to do just that in its first opinion, holding that the debtor's dishonest actions estopped him from claiming his Texas homestead exemption. *See In re* Niland,

who are certainly no more deserving than other types of unsecured claimants. However, as against a debtor who "caps his spree of frauds by sticking a would-be homeowner,"[323] most courts would happily impose an equitable lien rather than permit the debtor to keep the property.

The first of the four losing claims was much like *Daves*, but it lacked the enmity factors that benefitted the bank there. In *In re Harbor House*,[324] claimant Cataldo had a complex contract with the debtor to manage the lounge in the Harbor House Hotel. When a fire destroyed the lounge, Cataldo agreed to rebuild the lounge in exchange for $300,000 to be paid out of the insurance proceeds. The parties again signed a complex management agreement that was lengthily negotiated with the assistance of counsel. At that time, the $300,000 payment was left as an unsecured obligation. After the repairs were under way, the parties signed an addendum providing that Cataldo could "request" a note secured by a mortgage on the property after reconstruction was complete. Thereafter, when neither payment nor the mortgage was forthcoming, Cataldo sued, filing a *lis pendens*. While suit was pending, the debtor filed bankruptcy, and Cataldo claimed an equitable lien on the realty. Despite the *lis pendens*, the court denied Cataldo's equitable claim on the specious theory that even though Cataldo "might well have an unperfected right to a mortgage,"[325] the claim falls to the trustee's section 544 power.[326] The court's willingness to go to such lengths to deny Cataldo's claim can be explained only on the basis of the profound lack of sympathy for a sophisticated claimant who fails to protect himself in a transaction as carefully conceived as this one.[327]

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809 F.2d 272 (5th Cir. 1987). On rehearing, however, the panel reluctantly concluded that the earlier opinion would "not fly under Texas skies." 825 F.2d at 816.

323. 825 F.2d at 816.

324. 26 Bankr. 324 (Bankr. D. Mass. 1982).

325. *Id.* at 330.

326. *Id.* at 330-32. The speciousness of the theory lies in the highly unusual conclusion that the notice supplied by a *lis pendens* would not affect the trustee's BFP power because the trustee acts "without regard to any knowledge . . . of any creditor." *Id.* at 331. The majority view holds that the trustee's BFP power is subject to the defense of constructive notice. *See supra* notes 95-112 and accompanying text. The speciousness of the court's theory is compounded by the unsupported statement that a *lis pendens* would not defeat a levying judgment creditor. 26 Bankr. at 331.

327. Not only had the parties dealt intimately with one another at great length with the assistance of counsel, which reduces sympathy, but the court noted that the documents were carefully drafted to avoid the transfer of a liquor license, and Cataldo was advised he was "crazy" to enter the deal. *Id.* at 328-30. The subsequent suit and *lis pendens* do little to blanket him with the aura of diligence.

The last three cases involving losing claims are unspectacular. Surely, a common carrier has no equitable claim to the bankrupt shipper's accounts receivable when no security interest in them has been retained.[328] Ordinary materials suppliers who fail to avail themselves of the protection of a mechanic's lien have no equitable claim to the payments received by the general contractor.[329] Finally, an attorney, whose common law lien for services rendered on realty would be defeated by a bona fide purchaser, has no equitable lien superior to the BFP power of the trustee.[330]

IV. Summary of the Cases

A number of inferences may be drawn from the cases.

A. *Characteristics of High-Sympathy Claims*

The first group of claimants accorded high sympathy by the courts included those claimants commonly treated with kid gloves in contract law — persons in relatively poor bargaining position, or persons thought generally not capable of adequately protecting themselves in a commercial transaction. These are the consumer-buyers of goods and services, the elderly, employees, and parties to confidential relationships. Another group regularly accorded deference in these cases includes divorcees whose ex-spouses have failed to perform some obligation arising from the divorce. A third set of sure winners is comprised of persons whose clerical errors caused a benefit to be mistakenly conferred on the debtor. A group that is harder to define, and probably somewhat less certain to win, includes distinctive persons who have entrusted money or property to agents to be applied to some specific purpose. Distinctiveness may exist either because there are very few other claimants in the same predicament, or because the claimants have taken some extraordinarily diligent action not taken by the otherwise similar mass of claimants. Another amorphous but sympathetic group, whose equities also spring from diligence, is the group of careful persons who took protective steps that turned out to

328. *In re* Penn-Dixie Steel Corp., 6 Bankr. 817 (Bankr. S.D.N.Y. 1980).

329. Georgia Pac. Corp. v. Sigma Serv. Corp., 712 F.2d 962 (5th Cir. 1983). The temporary arrangement for convenience between the general contractor and the owner in which payments for materials would be made to the general contractor in the form of checks made out jointly to the general contractor and the supplier created no lien on behalf of the supplier. Perhaps, if there were a basis for lien, this would aid in tracing, but it does not assist such an otherwise unsympathetic claimant.

330. *In re* Fidelity Standard Mortgage Corp., 43 Bankr. 654 (Bankr. S.D. Fla. 1984).

be surprisingly inadequate. Finally, there are the lucky ones — those either able to trace their property *in specie*, or those who are legally so indistinct from some highly sympathetic claimant that the court is forced to treat them well in order to also treat the sympathetic one well.

B. *Characteristics of Low-Sympathy Claims*

Probably the least sympathetic claimants are those who knowingly permit the misrecording or nonrecording of their interest in realty. Close on their heels at the bottom of the sympathy scale are the commercially sophisticated entities that take a lackadaisical attitude toward protecting their interests. Most investors, regardless of whether they are victims of fraud, are treated no better than general creditors. This is just the inverse of the distinctiveness proposition stated above. Large homogeneous groups that entrust money or property to agents are unlikely to be treated better than general creditors.

C. *The Role of Enmity*

When the circumstances are such that the claimant seems truly to be competing with the debtor rather than the general creditors, the claimant may win. This circumstance most obviously exists when the debtor claims the subject asset as exempt. It may also appear to exist, but its effect is less predictable, when the debtor is in possession in a Chapter 11 reorganization, or the debtor is in Chapter 13 and confirmation or completion of the plan will be facilitated by retaining the asset, or retention of the asset will substantially reduce a nondischargeable debt.

D. *Tracing*

The traceability of the disputed asset, meaning the ease with which the claimant can establish the required connection between the benefit conferred on the debtor and the asset claimed, rarely influences the outcome of cases. Though courts often deny low-sympathy claims on the ground of inadequate tracing, poor traceability rarely causes courts to deny high-sympathy claims. Courts are usually willing to accept weak tracing theories, or even to dispense entirely with the tracing requirement, in order to hold in favor of a highly sympathetic claimant. However, when not even a colorable tracing theory can be conjured up, courts will deny a sympathetic claim. At the other extreme, a claimant who can identify the lost property *in specie* will be aided by such high traceability. In such instances, claims no more sympathetic than those of general creditors may win.

E. *Constructive Notice*

When a claim is made against realty, constructive notice may theoretically defeat the trustee's BFP power. But the cases show that such claims do not influence outcomes at all. When a high-sympathy claim to realty competes with the trustee, courts have no difficulty defeating the trustee. Some courts are willing to go to extremes to find constructive notice; others simply find another theory. When a low-sympathy claim to realty is made, courts will reject solid constructive notice arguments or ignore the doctrine entirely in denying the claim. I found no cases in which constructive notice seemed to force a court to decide in favor of an unsympathetic claimant or against a sympathetic one. There may have been an instance of a moderately sympathetic claim that was bolstered by a decent constructive notice argument, but the primary role of this doctrine has been to provide the courts with a convenient way to defeat the trustees' attacks on sympathetic equitable claims to realty.

F. *The Disparate Treatment of Realty and Personalty*

In cases in which the claimant can trace the claim into both realty and personalty, the separate tests of subsections 544(a)(1) and (a)(3) create the possibility of winning as to one and losing as to the other. Nevertheless, in such cases, courts have unerringly found a way to avoid this senseless result, except when state exemption law protects realty and not personalty.

G. *Fraud and Breach of Fiduciary Duty*

Allegations of fraud or breach of fiduciary duty are easy to make in many of the circumstances giving rise to restitutionary claims. In general, these allegations have little effect on the outcome. However, where the claimant and the debtor have had a personal, face-to-face relationship, especially one that has continued for some time, the existence of fraud or breached fiduciary duty may provide added sympathy for the claim. Perhaps the bankruptcy judges feel that everybody risks being fooled, fraud victims and general creditors alike, but that not everybody risks the personal affront of being defrauded by a person with whom a long-term personal relationship has existed.

H. *Opportunity to Protect One's Interest*

The permitted-to-be-perfected clause, which limits the trustee's BFP power, has been totally ignored by the courts, probably because its precise meaning is too obscure to be of any use in close cases. The idea of the clause is not difficult to grasp: people who have enriched the estate and who have had no opportunity to protect themselves against competing claims might justifiably receive better treatment than general creditors. Though the clause has been ignored by the courts, hints of its ethic are pervasive. The ethic shows up clearly in the imperfect transfer cases. People who pass up the opportunity to protect themselves through the simple ministerial act of proper recording have been treated poorly, as have people who knowingly or lackadaisically fail to straighten out inaccuracies in the record. More generally, the courts seem to be influenced by the extent to which any avenues for self-protection have been pursued. It seems to be particularly helpful to take steps to get notice of the claim in the public record, such as by filing some sort of notice of interest, or bringing suit and recording a *lis pendens*. Further, a number of cases seem to be explainable only on the basis of the court's sympathy for a diligent claimant who took protective steps, only to find out that those steps were not enough. Clearly, the extent to which a claimant has taken advantage of available means to protect its interest is one of the most powerful influences in the resolution of these disputes.

V. Conclusions and Recommendations

The cases I have discussed here test the limits of a number of fundamental distributional policies: the policy that the estate for distribution to general creditors is to be comprised of only the debtor's property, or the debtor's interest in property; the policy against recognition of secret claims; and the policy of equal distribution among all general claims except for the few specified priority claims. These cases call into question the extent to which the estate should include (and general creditors benefit from) property unjustly acquired by the debtor. When such property should not remain in the estate, they question whether general creditors should benefit when the debtor fortuitously commingles it beyond the point of traceability. They question whether the make-up of the estate should be influenced by the possibility that the debtor in a Chapter 11 or 13 proceeding might personally benefit from retention of the property more than the general creditors would. This question is most pointedly posed when the debtor claims the unjustly acquired property as exempt. They question whether the lack of publication of a deserving claim should undermine its worthiness. They also question whether a few distributional priorities (the list of priority claims includes certain employees, grain producers, fishermen, and consumer buyers[331]) and one of the exemp-

331. 11 U.S.C. 507(a)(3), (4), (5), and (6) (1982). The fourth priority for certain employee benefit plans is intended chiefly to benefit employees. The remaining priorities are provided for other

tions from discharge (alimony and child support[332]) provide sufficiently favorable treatment to the more deserving claimants. A correlative question posed by these cases is this: Does the single fact that the estate contains property for distribution that was unjustly obtained from a specific claimant make that claimant more deserving than the rest?

In a sense, it is fortunate that Congress produced such unrestrained confusion over the treatment of restitutionary claims, for it has provided a unique opportunity to assess the attitudes of the judiciary toward these difficult issues. By looking at the cases as a whole, we may discover the collective distributional values of hundreds of bankruptcy judges — the people who deal daily with the entire range of bankruptcy claims. The judges have shown they believe the estate often should not contain improperly obtained property, especially if the property will benefit the debtor more than the general creditors, and that when disgorgement is appropriate, tracing difficulties should rarely interfere. They believe the secret nature of equitable claims should not necessarily make them ineligible for preferred treatment. They also believe that the current, few statutory advantages (priority and nondischargeability) fail to reach many of the more deserving claims. Accordingly, restitutionary claims should be examined with regard to a number of factors in order to single out the ones entitled to special treatment.

Despite the profound analytical confusion in the opinions, I believe the courts have reached appropriate results on the whole, generally finding in favor of claimants more deserving than general creditors and denying the rest. But the Code's current treatment of equitable claims should not be left to stand, nor should its repair be left to the painstaking judicial process. The Code should be amended in a way that preserves the fundamental values courts have displayed, and that permits courts to treat equitable claims predictably, coherently, and efficiently.

Probably the most straightforward repair would be achieved by adding a section that empowers the trustee to defeat all equitable claims to both realty and personalty that would not under state law defeat both lien creditors and bona fide purchasers. This would require

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purposes: the first and second priorities for administrative expenses are obviously pragmatic, and the seventh priority for tax claims serves the public interest.

332. 11 U.S.C. § 523(a)(5) (1982). Enmity for the debtor also finds current expression in the exception from discharge of claims based on fraud, breach of fiduciary duty, willful or malicious injury, and drunk driving. *Id.* §§ 523(a)(2), (4), (6), and (9) (1982).

the estate to disgorge at least some improperly obtained property and substantially reduce the effectiveness of secret restitutionary claims. Furthermore, favorable treatment of sympathetic claims could be bolstered by expanding the categories of claims entitled to distributional priority or nondischargeability.

While this approach would improve coherence and reduce litigation, I do not favor it for a number of reasons. First, it defers too greatly to the policy against secret liens. The premise supporting the policy that publication would have protected subsequent general creditors is largely fanciful and in most cases probably wrong.[333] I believe the ease of publication and the reasonableness of expecting the particular claimant to have taken steps to publish should be treated as factors in assessing the relative worthiness of the claim. Second, it would leave too much judicial leeway in application of the constructive notice and tracing doctrines, permitting further covert judicial vindication of highly sympathetic claims. The temptation for courts to recognize these claims to property has been demonstrated in the extreme, and the availability of other advantages, such as priority or nondischargeability,[334] has not blunted their willingness to do so. If bamboozled widows and mistaken payment-makers are to get their property back, it should be returned for reasons that are openly articulated under statutory authority. Thirdly, I do not favor the above solution because I am skeptical about the desirability of adding new categories to the current list of priority claims, which already leaves precious little for general creditors. Moreover, there is the obvious difficulty in defining new high-sympathy priority claims with enough precision to avoid including virtually all general claims. Finally, the "advantage" of nondischargeability is often an empty victory if the debtor's prospects of future assets are uncertain. Return of the property is a much more reliable remedy. Courts should be empowered to return it directly under a statute that provides real guidance in sorting out who the deserving claimants are.

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333. Most general creditors, who hypothetically do not obtain security, rely on credit reports and prior dealings with the debtor rather than a record check. Many submit claims that predate the equitable claim, and many would have extended credit despite publication of the equitable claim. Of course, tort victims and other nonprofessional claimants do not check the records. If put to their proof, I suspect the great majority of general claimants would be unable to show reliance on the bare record.

334. Some claimants' priority did not affect the court's favorable treatment. *See, e.g.*, Don Boyd v. Martin Exploration Co., 56 Bankr. 776 (Bankr. E.D. La. 1986) (employees); *In re* Teltronics, Ltd., 699 F.2d 1236 (7th Cir. 1981) (consumer-buyers). An example of a nondischargeable claim that received favorable treatment appeared in *In re* Jones, 50 Bankr. 911 (Bankr. N.D. Tex. 1985).

Though I have never seen it articulated, the theory on which certain equitable claims defeat general claims seems to be: 1) like general creditors, their property has enriched the estate; 2) they can identify the property that would not be part of the estate had they not provided it; and 3) something about the way in which the benefit was conferred makes them more sympathetic than general creditors. That is, usually with no intent to gamble on the debtor's insolvency, they enriched the debtor in circumstances under which they would not reasonably be expected to have protected themselves better than they did. They are more deserving than ordinary creditors because ordinary creditors knowingly assume the risk of the debtor's insolvency. They are more deserving than general tort claimants because tort victims ordinarily do not enrich the estate.

The first step in amending the Code should be to discard the hypothetical competing claim as the tool for discriminating among equitable claims. This will help to eliminate the pervasive confusion between equitable liens and constructive trusts. It will permit consistent treatment of both realty and personalty and avoid state-to-state variations as to validity against competing claims. Finally, it will eliminate needless litigation over constructive notice. Of course, the threshold question as to the existence of a viable claim against the debtor's property must remain a matter of state law. The filing of bankruptcy should not serve to create new property interests that did not previously exist.

In determining whether a viable equitable claim exists under state law, it will be necessary to retain the venerable requirement of tracing. The requirement serves a useful purpose in restraining those sympathetic claimants who can show no connection between their claims and the property of the estate. Granted, there is some arbitrariness here, because traceability often turns on how the debtor happened to handle the property obtained from the claimant. But a line must be drawn somewhere to protect against the danger that sympathetic claims will become a form of superpriority claim, and tracing seems as good a tool as any for this purpose.[335] But if tracing is to do this

335. The appeal of tracing as a device to limit sympathetic claims lies not merely in the fact that it has historically been used for just this purpose. It is well-suited to this purpose because it defines the point at which ordinary people understand arbitrary losses to be final. Most people understand that when something disappears, it is lost. As long as something can be seen or identified, one might keep striving to retrieve it. But disappearance and the helplessness of not knowing where to look carry a certain finality that permits one to give it up for lost. Conversely, as seen in *In re* Shepard, 29 Bankr. 928 (Bankr. M.D. Fla. 1983), and *In re* Martin Fein & Co., 34 Bankr. 333 (Bankr. S.D.N.Y. 1984), I believe the identification of property *in*

job properly, equitable claimants should be required to identify their property with at least reasonable certainty. Substantial weight should be placed on traceability — more than is placed there now. Courts should not be so free to treat high-sympathy equitable claims as super-priority claims to the detriment of general creditors by the adoption of ultra-fanciful tracing fictions.[336]

Finally, as Professor Gilmore said, "[B]eyond the area of institutionalized transaction, there stretches a no-man's land, in which strange creatures do strange things. For these strange things there are no rules . . . ."[337] Precision in handling these claims should not be sought; the statute must be flexible enough to permit judges to continue to sort, yet clear enough as to the factors to be considered to assist meaningfully in the sorting, leading ultimately to enhanced predictability and coherence, reduced litigation, and perhaps an even better understanding of the values that make some claims more deserving than the general claims.

With these grand objectives in mind, and with no small measure of trepidation, I offer the following suggestion for addition to the trustee's avoiding powers.

> Section 545A. Equitable Claims—
>
> (a) In this section "equitable claim" means any claim valid under other law to restitution of property of the debtor, regardless of whether the claim is characterized as constructive trust, equitable lien, equitable mortgage, equitable assignment, or otherwise.
>
> (b) Except as provided in subsection (c) of this section, the trustee may avoid any equitable claim to the property of the debtor.
>
> (c) (1) The trustee may not avoid any equitable claim that is based on the unjust enrichment of the debtor, where:

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specie seems to add an inchoate kind of credence to a claim of entitlement. Of course, emphasizing the requirement of tracing will encourage courts deciding cases like *Shepard* and *Martin Fein* in which a mildly sympathetic claim is successful because the property is traced *in specie*. This should not be a source of great concern, first, because these cases are rare, and second, because it would probably not be worth the trouble to try through careful drafting to undermine the primitive appeal of a claimant who can point to an item and say "That's my envelope," or "That's my bundle of bills."

336. Examples of excessively generous tracing theories abound. *See, e.g., In re* Mahan & Rowsey, Inc., 817 F.2d 682 (10th Cir. 1987) (the court held that the depleted fund had been replenished *after* bankruptcy had been filed); *see also supra* notes 266-72 and accompanying text. Most generous of all the courts holding that defrauded consumer-buyers need not trace at all. *See supra* notes 137-40 and accompanying text.

337. 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 337 (1965).

(A) the claimant's position of high vulnerability in the transaction excuses his failure to protect against the unjust enrichment of the debtor,

(B) the unjust enrichment was the result of the claimant's clerical error or similar mistake,

(C) the unjust enrichment occurred despite the claimant's diligent efforts to prevent it, or

(D) the claimant is otherwise entitled to be treated more favorably than the general creditors.

(2) In applying subsection (c)(1) of this section, the court may consider the following:

(A) the reasonable identifiability of the property;

(B) the distinctiveness of the claim and the effect granting of the claim will have on general claims, especially where the claimant is one of a large group of indistinct claimants and elevating them all above the general claims would substantially reduce the distribution to general claimants, and

(C) the egregiousness of the debtor's conduct taken together with the likelihood that denial of the claim will ultimately benefit the debtor personally rather than the general claimants.

The section is modeled after current section 547, and is intended to be placed among the trustee's other avoidance powers. Subsections (a) and (b) define its scope, making clear that constructive trusts are to be treated the same as equitable liens, and that none are valid except as provided. Of course, the legislative history should show that property subject to a claim of constructive trust is not intended to be excluded from the estate under section 541(d). Subsection (c)(1) lists the three clearest characteristics of high sympathy plus the catchall for the unspecified but otherwise entitled claims. The legislative history should show that "vulnerability in the transaction" is intended to encompass such classic favorites under the law as victims of unconscionable sales techniques, elderly persons whose confidence has been violated, employees, and divorcees. Subsection (c)(2) authorizes the court to consider three fudge factors. The first, identifiability, I believe should play a more prominent role than it has, and the remaining two are my attempts to describe the distinctiveness and enmity factors, which I believe already play influential roles.

In the meantime, I recommend that courts follow the lead of the Fifth Circuit in *Quality Holstein Leasing*[338] and the Ninth Circuit in

338. 752 F.2d 1009 (5th Cir. 1985).

North American Coin & Currency.[339] Those cases suggest that courts are authorized to depart from strict application of Sections 541 and 544 to equitable claims when such strict application would lead to results contrary to bankruptcy policy. Those two cases denied equitable claims in order to further the basic policy of equal treatment of general claims. However, because the premise of these cases is that the Code provides inadequate guidance for proper treatment of equitable claims, they might also properly serve as authority for *validating* an equitable claim on policy grounds. In looking directly at the policies to be served in validating or invalidating equitable claims, the courts will begin to flesh out a body of case law that will serve as a useful guide to future courts and litigants, and may also further assist Congress in reassessing the limits of bankruptcy distribution policy to provide coherent and effective treatment of these claims.

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339. 767 F.2d 1573 (9th Cir.), *amended by* 774 F.2d 1390 (9th Cir. 1985), *cert. denied*, 475 U.S. 1083 (1986).