BANKRUPTCY CODE SECTION 544(a) AND CONSTRUCTIVE TRUSTS: THE TRUSTEE'S STRONG ARM POWERS SHOULD PREVAIL

*Carlos J. Cuevas**

I. INTRODUCTION

The Bankruptcy Code (the Code) is a comprehensive statute which establishes the framework within which the rights of debtors and creditors may be determined in bankruptcy cases.[1] The Code provides a collective proceeding where creditors enforce claims against the debtor's assets.[2]

The Code is based on several policies. One important policy underlying the Code is that creditors should be treated equally.[3]

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* Associate Professor of Law, New York Law School. B.A., New York University, 1979; J.D., Yale Law School, 1982. Michael Arce, Lisa Frankel, and Elisa Valasquez provided invaluable research assistance. Professor Quintin Johnstone made insightful comments on an earlier draft of this article. New York Law School provided a research grant which facilitated the writing of this article. Copyright 1991 by Carlos J. Cuevas.

[1] *See* 11 U.S.C. §§ 101-1330 (1988). Different chapters of the Code regulate different types of bankruptcies. Chapter 7 of the Code governs liquidation. *See id.* at §§ 701-766. In a chapter 7 case a trustee is appointed, and he or she is responsible for collecting and liquidating the assets of the estate. *Id.* at § 704. The trustee then distributes to the creditors the proceeds from the sale of the assets. *Id.* at § 726. Chapter 11 of the Code regulates corporate reorganizations. *See id.* at §§ 1101-1174. The purpose of a corporate reorganization is to transform a debtor's contractual obligations and capital structure to improve profitability. In a chapter 11 case there is a presumption that pre-petition management will continue to operate the enterprise. *Id.* at § 1108. The debtor is granted a 120 day exclusive period to file a plan of reorganization. *Id.* at § 1121(b). In a chapter 11 case a debtor can confirm a plan of reorganization over the objections of dissident creditors. *See id.* at 1129(b). Chapter 12 governs the adjustment of debts of family farmers. *See id.* at §§ 1201-1231. Chapter 12 assists family farmers in retaining their farms by extending the payment of their debts. *Id.* at 1202(b). Chapter 13 of the Code governs the adjustment of debts of individuals with regular income. *See id.* at §§ 1301-1330. In a chapter 13 case an individual submits a plan to repay his or her creditors. *Id.* at § 1321. In a chapter 13 case the creditors do not vote on whether to accept a plan; rather, the court determines whether a plan should be confirmed. *See id.* at § 1325(a). This article will focus primarily on chapters 7 and 11, and there will be a limited discussion of chapter 13.

[2] *See* Butner v. United States, 440 U.S. 48, 54-57 (1979); *In re* American Reserve Corp., 840 F.2d 487, 489 (7th Cir. 1988); Boston and Maine Corp. v. Chicago Pacific Corp., 758 F.2d 562, 565 (7th Cir. 1986); T. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7-35 (1986).

[3] M. BIENENSTOCK, BANKRUPTCY REORGANIZATION 1 (1987). To further this

Another significant tenet is that the concept of property of the estate should be construed broadly so as to facilitate corporate reorganizations.[4] In addition, a bankruptcy court is a court of equity, which a debtor may not use to perpetrate a fraud or to violate public policy.[5] Finally, a bankruptcy court may not use its equitable powers to ignore the specific dictates of a bankruptcy statute.[6]

Various courts are in disagreement as to whether a bankruptcy court may, through the imposition of a constructive trust, prevent a trustee from utilizing section 544(a)[7] to avoid un-

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goal, sections 547 and 550 authorize a trustee to recover preferences. 11 U.S.C. §§ 547, 550 (1988). A preference is a transaction which allows a creditor to receive a greater distribution than other creditors in the same class had the debtor been liquidated in a hypothetical chapter 7 case. By allowing a trustee to avoid transactions which constitute preferences, sections 547 and 550 insure that creditors are treated equally.

[4] United States v. Whiting Pools, Inc., 462 U.S. 198, 204-06 (1983); Gold Leaf Corp. v. Hamilton Projects, Inc., 78 Bankr. 1018, 1021 (Bankr. N.D. Fla. 1987); *cf.* Jim Walter Homes, Inc. v. Saylors (*In re* Saylors), 869 F.2d 1434, 1437 (11th Cir. 1989).

[5] *See* Kelly v. Robinson, 107 S. Ct. 353, 360 (1986) ("federal bankruptcy courts should not vindicate the results of state criminal proceedings"); Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection, 474 U.S. 494, 507 (1986) ("Congress did not intend the abandonment provision of the Bankruptcy Code . . . to pre-empt 'certain state and local laws.' "); Bank of Marin v. England, 385 U.S. 99 (1966) ("[I]t would be inequitable to hold liable a drawee who pays checks of the bankrupt duly drawn but presented after bankruptcy, where no actual revocation of its authority has been made and it has no notice or knowledge of the bankruptcy."); E.E.O.C. v. McLean Trucking Co., 834 F.2d 398, 402 (4th Cir. 1987) ("[W]hen EEOC sues to enjoin violations of [t]itle VII or ADEA and seeks reinstatement of the victims of alleged discrimination and adoption of an affirmative action plan in a [t]itle VII case, and couples these prayers for relief with a claim for back pay, EEOC . . . is not subject to the automatic stay until its monetary claims are reduced to judgment."); United States v. Wheeling-Pittsburgh Steel Corp., 818 F.2d 1077, 1086 (3d Cir. 1987) ("Congress expressly provided that the automatic stay provisions of the Bankruptcy Code do not apply when the government is seeking to enforce its police or regulatory power.").

[6] Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206-07 (1988); *In re* J.M. Wells, Inc., 575 F.2d 329, 331 (1st Cir. 1978); Scott v. Almiro Fur Fashion (*In re* Fisher), 100 Bankr. 351, 356-57 (Bankr. S.D. Ohio 1989); Amatex Corp. v. Aetna Casualty and Surety Co. (*In re* Amatex Corp.), 97 Bankr. 220, 225-26 (Bankr. E.D. Pa. 1989), *aff'd,* Amatex Corp. v. Stonewall Ins. Co., 102 Bankr. 411 (E.D. Pa. 1989).

[7] Section 544(a) states:

> (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—
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> (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a credi-

perfected security interests or unrecorded interests in real property.[8] The resolution of whether a trustee using section 544(a) is subject to the affirmative defense of a constructive trust is important for a number of reasons. If a debtor is able to employ section 544(a) to avoid an unperfected security interest or unrecorded interest in real property, the debtor is then free to use the personal or real property to fund a reorganization plan.[9] If a creditor with an unperfected security interest is able to impose a constructive trust to defeat the application of section 544(a), the creditor will receive a larger distribution of the estate.[10] The imposition of a constructive trust to defeat the use of

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tor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

(2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such creditor exists; or

(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 a purchaser exists.

11 U.S.C. § 544(a) (1988).

[8] Some courts have held that a trustee using section 544(a) is not subject to the affirmative defense of a constructive trust. *E.g.*, National Bank of Alaska, N.A. v. Seaway Express Corp. (*In re* Seaway Express Corp.), 912 F.2d 1125 (9th Cir. 1990); Belisle v. Plunkett, 877 F.2d 512 (7th Cir. 1989), *cert. denied*, 110 S. Ct. 241 (1989); Chbat v. Tleel (*In re* Tleel), 876 F.2d 769 (9th Cir. 1989); D & F Petroleum v. Cascade Oil Co. (*In re* Cascade Oil Co.), 65 Bankr. 35 (Bankr. D. Kan. 1986); Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899 (Bankr. C.D. Cal. 1984); Clark v. Kahn (*In re* Dlott), 43 Bankr. 789 (Bankr. D. Mass. 1983); *In re* Anderson, 30 Bankr. 995 (M.D. Tenn. 1983); Elin v. Busche (*In re* Elin), 20 Bankr. 1012 (D.N.J. 1982), *aff'd without opinion*, 707 F.2d 1400 (3d Cir. 1983). Other courts have ruled that property impressed with a constructive trust is protected from the application of section 544(a). *E.g.*, Sanyo Elec., Inc. v. Howard's Appliance Corp. (*In re* Howard's Appliance Corp.), 874 F.2d 88 (2d Cir. 1989); Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009 (5th Cir. 1985); Bavely v. Ft. Thomas Bellevue Bank (*In re* Triple A. Coal Co.), 55 Bankr. 806 (Bankr. S.D. Ohio 1985); Cook v. United States (*In re* Earl Roggenbuck Farms, Inc.), 51 Bankr. 913 (Bankr. E.D. Mich. 1985). *Cf.* Craig v. Seymour (*In re* Crabtree), 871 F.2d 36 (6th Cir. 1989); City Nat'l Bank of Miami v. General Coffee Corp. (*In re* General Coffee Corp.), 828 F.2d 699 (11th Cir. 1987), *cert. denied*, 485 U.S. 1007 (1988)(cases recognizing the conflict between sections 544(a) and 541(d) but refusing to address the issue).

[9] For example, a debtor may use section 544(a)(1) to avoid an unperfected security interest in personal property. The debtor may sell personal property and use the proceeds to fund a plan of reorganization. If the debtor avoids an unrecorded or defective mortgage the debtor can mortgage the real property and use the proceeds of the loan to finance a plan of reorganization.

[10] If a court holds that a creditor is secured then the creditor may make a motion to terminate the automatic stay and attempt to repossess and liquidate its collateral.

section 544(a) will undermine the policy of creditor equality and may result in adverse consequences that impede the successful operation of bankruptcy cases.[11] It also raises the policy issue of whether a constructive trust should be used to defeat the exercise of the trustee's strong arm powers and under what circumstances is it appropriate to employ those powers.[12]

Determining whether a constructive trust should take precedence over the trustee's strong arm powers requires statutory interpretation.[13] The imposition of a constructive trust has the effect of creating substantive rights which are contrary to bankruptcy policy.[14] Furthermore, such an action may be inconsistent with applicable state law.[15]

See 11 U.S.C. § 362(d) (1988). An unsecured creditor, in contrast, is not entitled to either adequate protection or to dissolve the automatic stay. *See, e.g., In re* Howard's Appliance Corp., 69 Bankr. 47 (Bankr.E.D.N.Y. 1986). In addition, the treatment of secured and unsecured creditors in reorganization plans are different. Obtaining secured status may mean that a creditor receives a one hundred percent distribution. *See* 11 U.S.C. § 1129(b)(2)(A) (1988). A reorganization plan may be confirmed without unsecured creditors receiving a fifty percent payment of their claims. *See id.* at §§ 1129(a)(7)(A)(ii), 1129(b)(2)(B)(ii) (1988). Therefore, it is consequential whether a creditor is secured or unsecured.

11 *See supra* note 3 and accompanying text. The imposition of a constructive trust essentially acts as a preference in that it transforms an unsecured creditor into a secured creditor and thereby deprives the unsecured creditors of the benefit of the collateral. Thus, the imposition of a constructive trust subverts the policy of creditor equality. *See* Chbat v. Tleel (*In re* Tleel), 876 F.2d 769, 773-74 (9th Cir. 1989); Elliott v. Frontier Properties, LP (*In re* Shurtleff, Inc.), 778 F.2d 1416, 1420 (9th Cir. 1985).

12 *See* 11 U.S.C. § 544(a)(1) (1988).The language of section 544(a)(1) grants a trustee the status of a hypothetical lien creditor without notice. *See* Brent Explorations, Inc. v. Karst Enters., Inc. (*In re* Brent Explorations, Inc.), 31 Bankr. 745, 747 (Bankr. D. Colo. 1983). But, prior to the commencement of the case the debtor may have committed acts which would form the basis for the imposition of a constructive trust. A bankruptcy court is a court of equity. Thus, the issue arises as to whether a debtor should be permitted to use the Bankruptcy Code to avoid transactions which would give rise to a constructive trust.

13 Statutory interpretation involves not only looking at the clear language and purpose of section 544(a), but also attempting to interpret section 544(a) in light of the policies and goals underlying the Code. *See infra* notes 381-404 and accompanying text.

14 A bankruptcy court may not use its equitable powers to create substantive rights. *See* Gillis v. California, 293 U.S. 62, 66 (1934) ("Congress [may] withhold from [d]istrict [c]ourts the power to authorize receivers in conservation proceedings to transact local business, contrary to state statutes obligatory upon all other."); United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986); Southern R.R. v. Johnson Bronze Co., 758 F.2d 137, 141 (3d Cir. 1985).

15 The imposition of a constructive trust to defeat a hypothetical lien creditor and a bona fide purchaser without notice may be incorrect under state law. Further, the recognition of a secret lien is contrary to the policy underlying the state filing and recording statutes. *See infra* notes 405-12 and accompanying text.

This article will analyze the controversy concerning the imposition of a constructive trust to defeat the application of section 544(a). Part II examines the court of appeals' decisions addressing whether a constructive trust can defeat the use of the trustee's strong arm powers and the policies underlying these decisions. Part III discusses and analyzes three important concepts central to the resolution of whether a constructive trust may defeat the trustee's strong arm powers: property of the estate, the trustee's strong arm powers, and constructive trusts. Part IV sets forth the reasons why, under bankruptcy and nonbankruptcy law, a trustee using the strong arm powers should prevail over a constructive trust claimant. Part V describes the circumstances under which a court should refrain from employing section 544(a) to avoid an unperfected security interest or unrecorded interest in real property. Finally, Part VI summarizes the reasons why the imposition of a constructive trust should not preclude the application of section 544(a).

II. CONSTRUCTIVE TRUSTS AND THE TRUSTEE'S STRONG ARM POWERS: TWO PERSPECTIVES

A. Introduction

The principal issue that has developed under the Code involving constructive trusts is whether a constructive trust may defeat the use of the trustee's strong arm powers.[16] Some courts, focusing on the policies of equitable distribution and ostensible ownership, have held that a trustee using section 544(a) prevails over a constructive trust claimant.[17] Other courts have held that property subject to a constructive trust is exempt from section 544(a), because property impressed by a constructive trust is not property of the estate.[18]

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[16] *See supra* note 8 and accompanying text.

[17] *See, e.g.*, Belisle v. Plunkett, 877 F.2d 512 (7th Cir. 1989), *cert. denied*, 110 S. Ct. 241 (1989); Chbat v. Tleel (*In re* Tleel), 876 F.2d 769 (9th Cir. 1989); Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899 (Bankr. C.D. Cal. 1984).

[18] *See, e.g.* Sanyo Elec., Inc. v. Howard's Appliance Corp. (*In re* Howard's Appliance Corp.), 874 F.2d 88 (2d Cir. 1989); Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009 (5th Cir. 1985).

B. *Bankruptcy Code Section 544(a) Can be Used to Avoid an Unperfected Security Interest in Property Impressed with a Constructive Trust*

Section 544(a) allows a trustee to avoid an unperfected security interest in personal or real property.[19] In order to prevent a trustee from using section 544(a), some creditors have asserted that the estate held the property in constructive trust.[20] Various courts have rejected the argument that property impressed with a constructive trust is immune from section 544(a).[21] One court rejecting this argument is the United States Court of Appeals for the Seventh Circuit.

In *Belisle v. Plunkett*,[22] the issue before the Seventh Circuit was whether a trustee may bring property held by the debtor in constructive trust for victims of fraud into the bankruptcy estate. In that case, the debtor executed a contract to purchase a lease. The debtor then formed five partnerships in order to raise funds for the purchase. Although the debtor used partnership funds to purchase the lease, he both acquired the lease and recorded it in his own name. The debtor and his wife subsequently filed bankruptcy petitions.

The Seventh Circuit held that the leasehold was property of the estate because section 544(a)(3) allowed the trustee to prevail over the partners who had not recorded the partnerships' interest.[23] The court reasoned that section 544(a)(3) grants a trustee the status of a bona fide purchaser without notice of earlier claims.[24] Under most recording statutes, the court noted, a purchaser in good faith of real property, including a leasehold interest, can obtain a position superior to that of the rightful owner if the rightful owner neglected to record its interest.[25] The court posited that the status of bona fide purchaser permits the trustee to take ahead of an entity that has failed to comply with the local

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19 11 U.S.C. § 544(a) (1988); Advanced Aviation v. Vann (*In re* Advanced Aviation, Inc.), 101 Bankr. 310, 312 (Bankr. M.D. Fla. 1989); Billings v. Cinnamon Ridge, Ltd. (*In re* Granada, Inc.), 92 Bankr. 501, 504-05 (Bankr. D. Utah 1988).

20 *See* National Bank of Alaska, N.A. v. Seaway Express Corp. (*In re* Seaway Express Corp.), 105 Bankr. 28, 31 (Bankr. 9th Cir. 1989), *aff'd*, 912 F.2d 1125 (9th Cir. 1990); *Great Plains*, 38 Bankr. at 903.

21 *See, e.g.*, Belisle v. Plunkett, 877 F.2d at 516; *Tleel*, 876 F.2d at 773; *Granada, Inc.*, 92 Bankr. at 501; *Great Plains*, 38 Bankr. at 907.

22 877 F.2d 512 (7th Cir. 1989), *cert. denied*, 110 S.Ct. 241 (1989).

23 *Id.* at 514-16.

24 *Id.* at 515.

25 *Id.*

recording statutes.[26] Because the partners in *Belisle* had not recorded the partnership's interest, the trustee was able to avoid their interests under section 544(a)(3).[27]

The court rejected the partners' argument that under section 541(d) the leasehold was not part of the estate because the estate does not include property in which a debtor holds bare legal title.[28] The court explained that section 541(d) does not mention the effects of section 544(a)(3).[29] Moreover, section 541(d) is silent concerning whether property may become part of the estate pursuant to Code provisions other than section 541.[30] The court also asserted that the partners' construction of section 541(d) was implausible, because property of the estate includes equitable interests in property that the debtor does not hold.[31] Reflecting on the origin of section 541(d), the court concluded that limiting the provision to inclusions in the bankruptcy estate under section 541(a) made legal and linguistic sense.[32]

The Ninth Circuit has also held that under section 544(a)(3) a trustee prevails over a constructive trust claimant. In *Chbat v. Tleel (In re Tleel)*[33], Joseph N. Chbat initiated an adversary proceeding seeking a constructive trust imposed on the proceeds of a sale of certain real estate.[34] Chbat alleged that an oral partnership agreement with the debtor entitled him to a constructive trust. The Ninth Circuit ruled that under section 544(a)(3), the trustee could avoid Chbat's interest in the proceeds from the sale of the real property.[35] According to the court, the trustee had no

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26 *Id.*

27 *Id.* The *Belisle* court remarked:

> A bona fide purchaser from [the debtor] would have taken ahead of the partners under local law. They neglected to record the partnerships' interest, though recording is easy. (The partners could, and in retrospect should, have refused to invest funds except through an escrow agent, who would have held the cash until good title had been recorded in the partnerships' names.) One of [the debtor's] creditors, extending $100,000 against a collateral assignment of the leasehold, actually obtained a position superior to that of the partners. The [t]rustee claimed the same position for the estate (meaning the creditors collectively, including the partners).

Id.

28 *Id.* at 515-16.

29 *Id.* at 515.

30 *Id.*

31 *Id.*

32 *Id.*

33 876 F.2d 769 (9th Cir. 1989).

34 *Id.* at 770.

35 *Id.* at 773-74.

notice of Chbat's claim; therefore, as a bona fide purchaser the trustee was able to avoid Chbat's unrecorded interest.[36] The court also held that section 541(d) had no effect on section 544(a)(3).[37] The court reasoned that section 544(a)(3) was intended to avoid the type of interest Chbat was attempting to enforce.[38]

The Seventh and Ninth Circuit opinions illustrate the various policies permeating bankruptcy and commercial law.[39] For instance, the cases show that a major goal underlying section 544(a) is to combat secret liens; in furtherance of that goal, section 544(a) compels a creditor to record its interest. In *Tleel*, Chbat sought to have a secret lien recognized in a bankruptcy case. Recognition of Chbat's secret lien, however, would have been contrary to bankruptcy policy.[40] The cases also reflect that another goal of bankruptcy law is to treat creditor's equally. The courts have relied upon the concept of creditor equality in denying relief to constructive trust claimants.[41] Constructive trust theory mitigates this concept, because a constructive trust claimant receives preferred treatment at the expense of the other general unsecured creditors.[42] The courts in these cases also recognize that the trustee's strong arm powers are to be construed broadly.[43] Therefore, the rulings allowing a trustee to avoid unperfected security interests in personal and real property

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36 *Id.* at 772.

37 *Id.* at 773-74.

38 *Id.* at 773.

39 The policies involved in decisions holding that section 544(a) defeats a creditor with an unperfected security interest in personal property or unrecorded interest in real property imposed with an alleged constructive trust are the following: (1) ostensible ownership; (2) creditor equality and ratable distribution; (3) a broad construction of the trustee's avoiding powers; (4) property interests determined by state law; and (5) a broad construction of property of the estate.

40 Secret liens are prohibited because they can defraud creditors. *See* Benedict v. Ratner, 268 U.S. 353, 360 (1925); Billings v. Cinnamon (*In re* Granada, Inc.), 92 Bankr. 501, 509 (Bankr. D. Utah 1988).

41 *See Tleel*, 876 F.2d at 773-74.

42 If the court grants a constructive trust, a creditor obtains a windfall at the expense of all the other general unsecured creditors. One court has declared:

> The reluctance of [b]ankruptcy [c]ourts to impose constructive trusts without a substantial reason to do so stems from the recognition that each unsecured creditor desires to have his particular claim elevated above the others. Imposition of a constructive trust clearly thwarts the policy of ratable distribution and should not be impressed cavalierly.

Neochem Corp. v. Behring Int'l, Inc. (*In re* Behring Int'l, Inc.), 61 Bankr. 896, 902 (Bankr. N.D. Tex. 1986).

43 *See* Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38

construe state law strictly.[44] Finally, these decisions reflect the position that the concept of property of the estate is to be construed broadly and include, through the reach of section 544(a), property supposedly subject to a constructive trust.[45]

C. *Bankruptcy Code Section 544(a) May Not Be Employed to Avoid an Unperfected Security Interest in Property Subject to a Constructive Trust*

Some courts have ruled that property impressed with a constructive trust is immune to section 544(a).[46] The Fifth Circuit reached this conclusion by holding that section 541(d) overrides

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Bankr. 899, 903-04 (Bankr. C.D. Cal. 1984); McAllester v. Aldridge (*In re* Anderson), 30 Bankr. 995, 1008-10 (M.D. Tenn. 1983). The *Anderson* court stated:

> In any event, a reading and comparison of § 541(d) and § 544 leads to the inescapable conclusion that § 541(d) does not represent a general limitation on the trustee's avoidance powers under § 544. Section 541(d) qualifies the trustee's right under § 541(a) to succeed to certain property interests possessed by the debtor at the time of the filing of his bankruptcy petition. In contrast, § 544(a) arms the trustee at the time of the filing of the debtor's bankruptcy petition with all the rights and powers of various creditors and transferees of the debtor so as to avoid incomplete or improperly perfected transfers of the debtor and thereby insure an equality of distribution among the debtor's general unsecured creditors. Section 544(a) in fact contemplates that the debtor has no remaining interest in the property which is the subject of the avoided transaction. The trustee is thus given the ability to bring into the estate, in addition to the debtor's property as defined by § 541(a) and limited by § 541(d), any property which he can obtain through his avoidance powers under the Bankruptcy Code, including his ability to invalidate certain transfers by the debtor under § 544(a).

Anderson, 30 Bankr. at 1009-10 (citations omitted).

[44] *See* National Bank of Alaska, N.A. v. Seaway Express Corp. (*In re* Seaway Express Corp.), 105 Bankr. 28, 30 (Bankr. 9th Cir. 1989), *aff'd*, 912 F.2d 1125 (9th Cir. 1990). In bankruptcy, property interests are governed by state law. Maine Nat'l Bank v. Morse (*In re* Morse), 30 Bankr. 52, 54 (Bankr. 1st Cir. 1983); Billings v. Cinnamon (*In re* Granada, Inc.), 92 Bankr. 501, 503 (Bankr. D. Utah 1988). The failure to comply with applicable filing recording statutes renders a creditor's interest vulnerable to a judgment creditor or bona fide purchaser. *E.g.*, Frier v. Creative Bath Products, Inc. (*In re* Measure Control Devices, Inc.), 48 Bankr. 613, 615-16 (Bankr. E.D.N.Y. 1985). The strict enforcement of state law insures uniformity of property interests and forces a creditor to follow local filing or recording statutes.

[45] *See* Elin v. Busche (*In re* Elin), 20 Bankr. 1012, 1016 (D.N.J. 1982), *aff'd without opinion*, 707 F.2d 1400 (3d Cir. 1983); D & F Petroleum v. Cascade Oil Co. (*In re* Cascade Oil Co.), 65 Bankr. 35, 39 (Bankr. D. Kan. 1986).

[46] *See, e.g.*, Sanyo Elec. Inc. v. Howard's Appliance Corp. (*In re* Howard's Appliance Corp.), 874 F.2d 88 (2d Cir. 1989); Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009 (5th Cir. 1985).

section 544(a).[47] In *Vineyard v. McKenzie (In re Quality Holstein Leasing)*, Borg-Warner Leasing (Borg-Warner) financed Clayton McKenzie's purchase of a Piper Navaho aircraft, and Borg-Warner obtained a security interest in the aircraft.[48] McKenzie took title to the aircraft in his own name. Thereafter, McKenzie desired to trade in the Piper Navaho for a Piper Seneca. McKenzie, Borg-Warner, the aircraft dealer, and the bank that had financed the dealer's purchase of the Seneca devised a procedure to preserve their security interests. Borg-Warner and the bank intended to perfect their security interests by filing the necessary documentation with the Federal Aviation Administration (FAA). The parties made arrangements to file the necessary documentation with the FAA, and McKenzie registered the Seneca in his own name. Subsequently, Borg-Warner discovered that its security interest was unperfected; however, it relied on the bank's lien which was on file with the FAA. On June 12, 1981, the FAA recorded a release of the bank's lien. The bank denied executing the release, and Borg-Warner denied sending the release. Also on June 12, McKenzie transferred title of the Seneca from himself to Quality Holstein Leasing even though McKenzie has promised Borg-Warner that he would take title in his personal capacity. Borg-Warner attempted to perfect its security interest by sending additional documentation to the FAA. The day before the FAA received the documentation, however, Quality Holstein Leasing filed for chapter 11. The chapter 11 trustee attempted to sell the Seneca. Borg-Warner did not object to the sale but asserted that its interest in the proceeds of the sale was superior to that of the trustee. Borg-Warner contended that the Seneca did not enter the estate because of the imposition of a constructive trust.

The Fifth Circuit held that section 544(a) does not allow a trustee to obtain for the estate property that the debtor has obtained through fraud and upon which a constructive trust has been imposed under state law.[49] The Fifth Circuit also held, however, that an individual who seeks to avoid the trustee's strong arm powers by claiming an interest in property through a constructive trust must be the direct victim of the fraud.[50] The

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[47] *Quality Holstein Leasing*, 752 F.2d at 1013. The Fifth Circuit was the first circuit to hold that section 541(d) overrode section 544(a).

[48] *Id.* at 1010.

[49] *Id.* at 1015.

[50] *Id.* The court thought that a contrary holding would have bad policy consequences, and it posited:

court concluded, therefore, that even if Borg-Warner's allegations of fraud were true, they did not entitle the company to prevail over the trustee.[51]

In its reasoning, the court noted that the imposition of a constructive trust upon a debtor's property generally confers on the true owner of the property an equitable interest which is superior to that of the trustee.[52] Under section 541(d), a trustee is required to turn over property held in constructive trust because a constructive trust beneficiary holds an interest in the property superior to that of a judgment lien creditor.[53] The Fifth Circuit thus determined that section 541(d) overrides the trustee's strong arm powers.[54] Despite this conclusion, the court decided that Borg-Warner's interest in the Seneca was subject to the trustee's strong arm powers.[55] The court reasoned that Borg-Warner never alleged it was the direct victim of fraud.[56] According to Borg-Warner, Quality Holstein Leasing defrauded McKenzie rather than Borg-Warner.

The Second Circuit has also ruled that property impressed with a constructive trust is immune from the application of the trustee's avoiding powers. In *Sanyo Electric, Inc. v. Howard's Appli-*

> A contrary holding would lead to untoward results and hinder the purposes of section 544. It seems likely that creditors of third parties from whom a debtor fraudulently procured property would unduly burden the bankruptcy courts with claims similar to Borg-Warner's. Such claims would prove no less insidious to the orderly workings of the bankruptcy structure than hidden interests and unperfected liens that section 544 in the main authorizes the trustee to avoid. The policy consists in doing equity among creditors. Remote creditors such as Borg-Warner should do no better than direct but unperfected security holders.

Id.

51 *Id.* at 1014-15.

52 *Id.* at 1013-14.

53 *Id.* at 1012.

54 The court opined:

> As a general rule, it must be held that section 541(d) prevails over the trustee's strong arm powers. Although those powers allow a trustee to assert rights the debtor itself could not claim to property, Congress did not mean to authorize a bankruptcy estate to benefit from property that the debtor did not own. Where state law impresses property that a debtor holds with a constructive trust in favor of another, and the trust attaches prior to the petition date, the trust beneficiary normally may recover its equitable interest in the property through bankruptcy court proceedings.

Id. at 1013-14 (citations omitted).

55 *Id.* at 1014-15.

56 *Id.* at 1014.

ance Corp. (In re Howard's Appliance Corp.),[57] the debtor operated a retail appliance store in Suffolk County, New York. The debtor entered into an agreement with Sanyo Electric, Inc. (Sanyo) in which the debtor granted Sanyo a security interest in all air conditioners manufactured by Sanyo. The security agreement required the debtor to store the air conditioners in Nassau County, New York. Sanyo filed its financing statements with Nassau County and the New York Secretary of State. Six months prior to filing its voluntary chapter 11 petition, the debtor commenced warehousing the Sanyo air conditioners in New Jersey without formally informing Sanyo of this fact. Sanyo failed to file a financing statement in New Jersey. Under the New Jersey Uniform Commercial Code, Sanyo's security interest was unperfected.[58] Sanyo sought to terminate the automatic stay and to foreclose on its purported security interest.

The Second Circuit ruled that under New Jersey law Sanyo had a constructive trust impressed on the air conditioners, making Sanyo's interest in the air conditioners superior to that of the debtor's interest.[59] The court reasoned that property in which the debtor holds bare legal title does not become property of the estate.[60] When a debtor holds property subject to a constructive trust, a bankruptcy estate takes the property subject to the same restrictions.[61] State law determines a debtor's interest in property in a bankruptcy case, and one must look to state law to determine whether a constructive trust should be imposed.[62] The court noted that under New Jersey law, a constructive trust should be imposed where failure to take judicial action would result in a party being unjustly enriched.[63] The court held that the debtor's acts of warehousing the goods in New Jersey and failing to inform Sanyo that the goods would be stored in New Jersey warranted the imposition of a constructive trust.[64] In construing

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57 874 F.2d 88 (2d Cir. 1989).

58 *Id.* at 91 (citing 12A N.J. STAT. ANN. § 9-401(1)(c)(West 1986).

59 *Id.* at 95.

60 *Id.* at 93.

61 *Id.*

62 *Id.*

63 *Id.* at 94.

64 *Id.* The Second Circuit stated:

> It is noteworthy that until approximately six months prior to the filing of its chapter 11 petition, Howard had always stored its inventory at its Nassau County location, as required by the security agreement, and its Suffolk County stores. While Howard's contentions that the decision to warehouse in New Jersey was [influenced by necessity and not sinister motives] do not fall upon deaf ears, we agree with the

section 544, the court concluded that because the constructive trust was impressed prior to the commencement of the chapter 11 case, Sanyo could prevail over the trustee's strong arm powers.[65]

The cases, which hold that property impressed with a constructive trust prior to the commencement of a chapter 11 case is immune from the trustee's avoiding powers, reflect several policies underlying the Code. The major policy underlying these decisions is that a bankruptcy court should be a court of equity.[66] A debtor who has committed fraud has unclean hands, and therefore may not use section 544(a) to avoid an unperfected security interest.[67] Another important policy is that state law should determine property rights in bankruptcy.[68] Under state law, a person who has been defrauded may seek the equitable remedy of a constructive trust.[69] The enforcement of a constructive trust insures not only that state law is enforced, but also that property interests are treated uniformly.[70] Strict enforcement of state law prevents a debtor from expanding its property rights to the detriment of other parties.[71] Finally, these decisions reflect reliance upon section 541(d) and a footnote in *United States v. Whiting*

> bankruptcy court that Howard, in light of its conduct, "acted with the expectation that Sanyo would not perfect its security interest in this inventory by filing a financing statement in New Jersey" . . . . Certainly, Howard must have known that, under the terms of the security agreement, it was obligated to keep its Sanyo merchandise at its Nassau County location, and that by storing its inventory in New Jersey, it would frustrate Sanyo's interest in those goods.

Id. (citing *In re* Howard's Appliance Corp., 69 Bankr. 1015, 1023 (Bankr. E.D.N.Y. 1987)).

65 *Id.*

66 A bankruptcy court's equitable imposition of a constructive trust prevents the property from entering the bankruptcy estate. Therefore, pursuant to the court's equitable powers the debtor is prevented from benefitting from any fraud that it may have committed. *See Howard's Appliance Corp.*, 874 F.2d at 93.

67 In essence, the court is employing a bad faith argument similar to those used to dismiss bankruptcy petitions. The debtor's misconduct renders it ineligible to use the benefits of the bankruptcy process. *See* Shell Oil Co. v. Waldron (*In re* Waldron), 785 F.2d 936, 939-40 (11th Cir. 1986) (per curiam), *cert. denied*, 478 U.S. 1028 (1986).

68 *Howard's Appliance Corp.*, 874 F.2d at 93.

69 *See* N.S. Garrot & Sons v. Union Planters Nat'l Bank of Memphis, (*In re* N.S. Garrot & Sons), 772 F.2d 462, 467 (8th Cir. 1985); Francois v. Francois, 599 F.2d 1286, 1291 (3d Cir. 1979), *cert. denied*, 44 U.S. 1021 (1980); G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 473 (2d rev. ed. 1978) [hereinafter G. BOGERT].

70 Vinyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1013-14 (5th Cir. 1985).

71 *See Howard's Appliance Corp.*, 874 F.2d at 93-94.

Pools[72], which posited that property held in trust should never become part of a bankruptcy estate.[73]

III. Property of the Estate, the Trustee's Strong Arm Powers, and Constructive Trusts

A. Introduction

The concepts of property of the estate, the trustee's strong arm powers, and constructive trusts are central to the resolution of whether a constructive trust may defeat the use of the trustee's strong arm powers. Two major questions concerning property of the estate focus on how to construe the scope of section 541(a), and whether section 541(d) excludes property subject to a constructive trust from the application of the trustee's strong arm powers.[74] This section of this article concerning property of the estate discusses the policies and legislative history underlying sections 541(a) and 541(d) in an effort to address these issues.

Determining whether a constructive trust defeats the use of the trustee's strong arm powers is also dependent on the scope of section 544(a), which sets forth the trustee's strong arm powers. It is important to understand the history and the policies underlying section 544(a) to resolve this constructive trust controversy. This article's analysis of the trustee's strong arm powers attempts to shed light on whether the imposition of a constructive trust to protect a creditor with an unperfected lien is consistent with the policies underlying section 544(a).

The concept of a constructive trust is also explored below. This article discusses the policy underlying a constructive trust and the historical use of constructive trusts in bankruptcy cases. The examination of a constructive trust is intended to provide insight as to whether its imposition is consistent with bankruptcy policy.

B. Property of the Estate

1. Introduction

Upon the commencement of a bankruptcy case, the bank-

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72 462 U.S. 198, 205 n.10 (1983).

73 *Id.* In *Whiting Pools*, the Supreme Court specifically stated that "[w]e do not now decide the outer boundaries of the bankruptcy estate. We note only that Congress plainly excluded property of others held by the debtor in trust at the time of the filing of the petition." *Id.*

74 *See Howard's Appliance Corp.*, 874 F.2d at 93; *Quality Holstein Leasing*, 752 F.2d at 1013-14.

ruptcy court obtains jurisdiction over the debtor's property.[75] Section 541(a) governs the determination of what constitutes property of the estate.[76]

2. Property Rights are Defined by Nonbankruptcy Law

Section 541(a) does not define a debtor's interest in property.[77] A debtor's legal and equitable interests in property are defined by nonbankruptcy law.[78] In *Butner v. United States*[79], the issue before the Supreme Court was whether federal or state law controlled the validity of an assignment of rents during a pend-

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75 Wilson v. Bill Barry Enters., Inc., 822 F.2d 859, 861 (9th Cir. 1987); Missouri v. United States Bankruptcy Court, 647 F.2d 768, 774 (8th Cir. 1981), *cert. denied*, 454 U.S. 1162 (1982); Hoffman v. Portland Bank (*In re* Hoffman), 51 Bankr. 42, 45 (Bankr. W.D. Ark. 1985); *In re* Dawson, 13 Bankr. 107, 109 (Bankr. M.D. Ala. 1981); G. TREISTER, J. TROST, L. FORMAN, K. KLEE & R. LEVIN, FUNDAMENTALS OF BANKRUPTCY LAW § 4.01 (2d ed. 1988).

76 Section 541(a)(1) states:

> (a) The commencement of a case under section 301, 302, or 303 of this title 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 in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

11 U.S.C. § 541(a)(1) (1988).

The legislative history of section 541(a)(1) declares:

> This section defines property of the estate, and specifies what property becomes property of the estate. The commencement of a bankruptcy case creates an estate. Under paragraph (1) of subsection (a), the estate is comprised of all legal or equitable interest of the debtor in property, wherever located, as of the commencement of the case. The scope of this paragraph is broad. It includes all kinds of property, including tangible or intangible property, causes of action (*see* Bankruptcy Act § 70a(6)), and all other forms of property currently specified in section 70a of the Bankruptcy Act § 70a, as well as property recovered by the trustee under section 542 of proposed title 11, if the property recovered was merely out of the possession of the debtor, yet remained "property of the debtor." The debtor's interest in property also includes "title" to property, which is an interest, just as are a possessory interest, or leasehold interest, for example.

S. REP. No. 989, 95th Cong., 2d Sess. 82, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5868.

77 White v. White (*In re* White), 851 F.2d 170, 173 (6th Cir. 1988); California v. Farmers Markets, Inc. (*In re* Farmers Markets, Inc.), 792 F.2d 1400, 1402 (9th Cir. 1986); *In re* Sky Group Int'l, Inc., 108 Bankr. 86, 92 (Bankr. W.D. Pa. 1989); 4 R. D'AGOSTINO, M. COOK, R. MABEY, A. PEDLAR, H. SOMMER & B. ZARETSKY, COLLIER ON BANKRUPTCY ¶ 541.02 (L. King 15th ed. 1990) [hereinafter R. D'AGOSTINO].

78 Merrill v. Dietz (*In re* Universal Clearing House Co.), 62 Bankr. 118, 122 (D. Utah 1986); Kandel v. Reichel (*In re* Strabley), 96 Bankr. 785, 786 (Bankr. N.D. Ohio 1988); *In re* All-Way Servs. Inc., 73 Bankr. 556, 564 n.21 (Bankr. E.D. Wis. 1987).

79 440 U.S. 48 (1979).

ing bankruptcy case. The Court held that state law controlled whether a creditor had perfected its interest in an assignment of rents.[80] The Court reasoned that Congress failed to define a mortgagee's interest in rents and profits earned by a mortgagor in bankruptcy.[81] The Court stressed that Congress left the determination of property rights in the assets of a debtor to state law.[82] Justice Stevens wrote:

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a [s]tate serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy." The justifications for application of state law are not limited to ownership interests; they apply with equal force to security interests, including the interest of a mortgagee in rents earned by mortgaged property.[83]

Butner reflects the policy that bankruptcy does not create property rights; rather, bankruptcy is a collective proceeding in which property rights are enforced. Property rights are usually determined by state or federal nonbankruptcy law. The enforcement of state law in bankruptcy cases will lead to uniform results and consistency in commercial law.

3. Property of the Estate is to be Construed Broadly

The concept of property of the estate is to be construed broadly.[84] Property of the estate includes tangible as well as intangible property.[85] The Supreme Court addressed these related

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80 *Id.* at 54.

81 *Id.*

82 *Id.*

83 *Id.* at 55 (citation omitted).

84 *See e.g.*, Jim Walter Homes, Inc. v. Saylors (*In re* Saylors), 869 F.2d 1434 (11th Cir. 1989); Kirk v. United States (*In re* Kirk), 100 Bankr. 85, 86 (Bankr. M.D. Fla. 1989); Scott W. Putney, Trustee, Inc. v. May (*In re* May), 83 Bankr. 812, 814 (Bankr. M.D. Fla. 1986); *In re* Larson, 56 Bankr. 154, 155 (Bankr. D. Mont. 1985); Wegner Farms v. Merchants Bonding Co. (*In re* Wegner Farms Co.), 49 Bankr. 440, 443 (Bankr. N.D. Iowa 1985).

85 *See, e.g.*, Cottrell v. Schilling, (*In re* Cottrell), 876 F.2d 540, 542-43 (6th Cir. 1989) (personal injury action held to be property of the estate); Dewhirst v. Citibank (*In re* Contractors Equip. Supply Co.), 861 F.2d 241, 244 (9th Cir. 1988) (property of the estate includes personal property in which a creditor holds a security interest and was seized prior to the filing of the petition); Jones v. Harrell, 858 F.2d 667, 669 (11th Cir. 1988) (personal injury action held to be property of the

principles in *United States v. Whiting Pools, Inc.*.[86] In *Whiting Pools*, the issue before the Court was whether section 542(a)[87] authorized a bankruptcy court to direct the Internal Revenue Service (I.R.S.) to turn over property which had been seized. The respondent sold, installed and serviced swimming pools. The respondent owed the I.R.S. $92,000 and failed to answer assessments and demands by the I.R.S. A tax lien for $92,000 attached to the respondent's property. Thereafter, on January 14, 1981, the I.R.S. seized the respondent's personal property. The estimated liquidation value of the property was $35,000; however, the going concern value of the property if used by the respondent was $162,876. On January 15, 1981, the respondent filed for chapter 11.

The Supreme Court held that pursuant to section 542(a), a bankruptcy court may direct the I.R.S. to turnover property that it has seized.[88] The Court reasoned that in enacting chapter 11, Congress provided that a troubled company would continue to operate, to retain its employees, to satisfy its obligations, and to pay a return to its owners.[89] The Supreme Court stated:

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estate); National Union Fire Ins. Co. of Pittsburgh, Pa. v. Titan Energy, Inc. (*In re* Titan Energy, Inc.), 837 F.2d 325, 329 (8th Cir. 1988) (products liability insurance policy held to be property of the estate); Miller v. Jones (*In re* Jones), 102 Bankr. 730, 731 (Bankr. W.D. Mo. 1989) (lender liability action held to be property of the estate); Inslaw, Inc. v. United States (*In re* Inslaw, Inc.), 83 Bankr. 89, 165 (Bankr. D.D.C. 1988), *aff'd*, 113 Bankr. 802 (D.D.C. 1989) (trade secrets in computer software held to be property of estate); Coppa v. Security Bank of Nev. (*In re* Taylor Motors), 60 Bankr. 760, 762 (Bankr. D. Nev. 1986) (debtor's interest in dealer reserve account held to be property of the estate); Gilbert v. Osburn (*In re* Osburn), 56 Bankr. 867, 873-74 (Bankr. S.D. Ohio 1986) (chose in action based on contract held to be property of the estate); Donnelly v. Boufsko, Inc. (*In re* Boufsko, Inc.), 44 Bankr. 98, 101 (Bankr. E.D. Mich. 1984) (liquor license held to be property of the estate); Rouse v. United States (*In re* Suppliers Inc.), 41 Bankr. 520, 523 (Bankr. E.D. Ky. 1984) (accounts receivable held to be property of the estate); Lauderdale Motorcar Corp. v. Rolls-Royce Motors, Inc. (*In re* Lauderdale Motorcar Corp.), 35 Bankr. 544, 546-47 (Bankr. S.D. Fla. 1983) (automobile dealership agreement held to be property of the estate).

86 462 U.S. 198 (1983).

87 11 U.S.C. § 542(a) (1988) provides:

> Except as provided in subsection (c) or (d) of this section, an entity, other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title, or that the debtor may exempt under section 522 of this title, shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of consequential value or benefit to the estate.

Id.

88 *Whiting Pools*, 462 U.S. at 211-12.

89 *Id.* at 203.

> Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if "sold for scrap." The reorganization effort would have small chance of success, however, if property essential to running the business were excluded from the estate. Thus, to facilitate the rehabilitation of the debtor's business, all of the debtor's property must be included in the reorganization estate.[90]

The Court also noted that property of the estate includes property which is subject to a security interest.[91] Although Congress had the option of excluding property subject to a security interest from the section 541 estate, the Court thought that Congress elected to include such property and to provide secured creditors with adequate protection.[92] The Court stressed that a creditor with a secured interest in property included in the estate must rely on section 363(e) as its remedy rather than on the nonbankruptcy remedy of repossession.[93] Therefore, the goal of facilitating reorganizations and the method of protecting secured creditors indicate that Congress intended a broad range of property to be included within a bankruptcy estate, the Court determined.[94]

The Supreme Court stressed that the language of section 541(a)(1) supported the view that property of the estate was to be construed broadly.[95] The Court remarked:

> The House and Senate Reports on the Bankruptcy Code indicate that § 541(a)(1)'s scope is broad. Most important, in the context of this case, § 541(a)(1) is intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code. Several of these provisions bring into the estate property in which the debtor did not have a possessory interest at the time the bankruptcy proceedings commenced.[96]

The Court noted that section 542(a) is one of the provisions

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90 *Id.* (citations omitted).

91 *Id.* at 203.

92 *Id.* at 203-04.

93 *Id.* at 204 (citing 11 U.S.C. § 363 (e) (1976 ed. Supp. V)). Section 363(e) of the Code provided:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

11 U.S.C. § 363(e) (1976 ed. Supp. V).

94 *Whiting Pools*, 462 U.S. at 204.

95 *Id.*

96 *Id.* at 204-05 (citation omitted).

allowing a debtor to retrieve property back into the estate.[97] Section 542(a) requires an individual, other than a custodian, holding property of the estate to turn over the property to the trustee.[98] Given the broad scope of property of a reorganization estate, property repossessed by a secured creditor fell within the purview of section 542(a).[99] Moreover, the interpretation of section 542(a), requiring a secured creditor to turn over repossessed property, was consistent not only with the legislative history of the statute, but also with judicial precedent under the Bankruptcy Act.[100]

There was no reason to exclude the I.R.S. from the purview of section 542(a).[101] The language of section 542(a) specifies that the definition of "entity" encompasses a governmental unit within its meaning.[102] Thus, the Court asserted that section 542(a) applies to the I.R.S.[103] The I.R.S.'s seizure of property did not grant the I.R.S. an ownership interest, the Court articulated; rather, it brought the property into the I.R.S.'s legal custody.[104] Ownership of the seized property, the court noted, "is transferred only when the property is sold to a bona fide purchaser at a tax sale."[105]

Whiting Pools is a significant decision for several reasons. The Court emphasized that property of the estate is to be construed broadly to effectuate the policies underlying chapter 11.[106] *Whiting Pools* stressed that property of the estate includes all legal and equitable interests of the debtor in property as of the commencement of the case.[107] The Court declared that it is unnecessary for a debtor to have a possessory interest in property at the commencement of a reorganization case.[108] Further, until a secured creditor has sold the property according to applicable law, seized property is still property of the estate.[109]

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97 *Id.* at 205.

98 *Id.*

99 *Id.* at 205-06.

100 *Id.* at 207-08 (citations omitted).

101 *Id.* at 209.

102 *Id.*(citing 11 U.S.C. § 101(14) (1988)).

103 *Id.*

104 *Id.* at 211.

105 *Id.* at 211.

106 *Id.* at 203. The policy underlying chapter 11 is to reorganize distressed companies. In order to facilitate a debtor's reorganization all of the debtor's equitable and legal interests in property must be included within the estate. *Id.*

107 *Id.*

108 *Id.* at 206. Under section 541(a) possession of property is unimportant. The key factor under *Whiting Pools* is whether the debtor has a legal or equitable interest in the property.

109 *Id.* at 211.

4. Property in Which the Debtor Holds Bare Legal Title Does Not Become Property of the Estate.

a. *Introduction*

The commencement of a bankruptcy case does not expand a debtor's rights or interests in property beyond what they were as of the filing of the bankruptcy petition.[110] Section 541(d) provides that at the commencement of a case, property in which the debtor holds bare legal title and not an equitable interest does not become property of the estate.[111] Property held in trust as of the commencement of the case is also excluded from the bankruptcy estate.[112] When a debtor is in possession of property subject to a constructive, express, or statutory trust, the bankruptcy estate holds the property subject to the interest of the beneficiary.[113]

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110 Universal Coops., Inc. v. FCX, Inc. (*In re* FCX, Inc.), 853 F.2d 1149, 1153 (4th Cir. 1988), *cert. denied*, 109 S. Ct. 1118 (1989); *In re* Avery Health Center, Inc., 8 Bankr. 1016, 1019 n.10 (W.D.N.Y. 1981); Harbor Pointe Office Park, Ltd., I v. Prudential Nat'l Assurance Co. (*In re* Harbor Pointe Office Park, Ltd., I), 83 Bankr. 44, 47 (Bankr. D. Colo. 1988); *In re* McClain Airlines, Inc., 80 Bankr. 175, 179 (Bankr. D. Ariz. 1987); *In re* Mortgage Funding, Inc., 48 Bankr. 152, 154 (Bankr. D. Nev. 1985).

111 Section 541(d) states:

> Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (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.

11 U.S.C. § 541(d) (1988). *See, e.g.* Altura Partnership v. Breninc (*In re* B.I. Fin. Servs. Group, Inc.), 854 F.2d 351, 354 (9th Cir. 1988); Alithochrome Corp. v. East Coast Finishing Sales Corp. (*In re* Alithochrome Corp.), 53 Bankr. 906, 910 (Bankr. S.D.N.Y. 1985); Butts v. Butts (*In re* Butts), 46 Bankr. 292, 295 (Bankr. D.N.D. 1985). Property acquired by fraud does not become property of the estate. Lambert v. Flight Transp. Corp., FTC (*In re* Flight Transp. Secs. Litig.), 730 F.2d 1128, 1136 (8th Cir. 1984); Shipley Co. v. Darr (*In re* Tap, Inc.), 52 Bankr. 271, 279 (Bankr. D. Mass. 1985).

112 *See* United States v. Daniel (*In re* R & T Roofing Structures & Commercial Framing, Inc.), 887 F.2d 981, 984-85 (9th Cir. 1989); Georgia Pacific Corp. v. Sigma Serv. Corp., 712 F.2d 962, 968 (5th Cir. 1983); Insurance Co. of the West v. Simon (*In re* Foam Systems Co.), 92 Bankr. 406, 408-09 (Bankr. 9th Cir. 1988), *aff'd*, 893 F.2d 1338 (9th Cir. 1990); Caro Area Servs. for the Handicapped v. Michigan Dep't of Transp. (*In re* Caro Area Servs. for the Handicapped), 53 Bankr. 438, 440-41 (Bankr. E.D. Mich. 1985).

113 *See* Appeals of Illinois Dep't of Commerce and Community Affairs (*In re* Joliet-Will County Community Action Agency), 847 F.2d 430, 432-33 (7th Cir. 1988); Connecticut Gen. Life Ins. Co. v. Universal Ins. Co., 838 F.2d 612, 618 (1st Cir.

b. *Bankruptcy Code Section 541(d) and the Secondary Mortgage Market*

One of the purposes in enacting section 541(d) was to insulate the secondary mortgage market from the trustee's strong arm powers.[114] A case that illustrates the application of section 541(d) to the secondary mortgage market is *In re Columbia Pacific Mortgage, Inc.*[115] In *Columbia Pacific*, Bohemian Savings and Loan Association of Cedar Rapids (Bohemian) commenced an action to recover funds which it alleged were due to it under a loan participation agreement with the debtor. The trustee contended that pursuant to section 544(a)(3), Bohemian lacked an ownership interest, and therefore it was not entitled to any of the proceeds of the mortgages.

The bankruptcy court held that Bohemian was entitled to enforce the loan participation agreements and recover the proceeds that it was owed.[116] The court reasoned that a participation interest in property acquired in the secondary mortgage market is

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1988); Mid-Atlantic Supply, Inc. of Va. v. Three Rivers Aluminum Co. (*In re* Mid-Atlantic Supply Co.), 790 F.2d 1121, 1124 (4th Cir. 1986); N.S. Garrott & Sons v. Union Planters Nat'l Bank of Memphis (*In re* N.S. Garrot & Sons), 772 F.2d 462, 467 (8th Cir. 1985); Reliance Ins. Co. v. Brown, 40 Bankr. 214, 217 (W.D. Mo. 1984); American Express Travel Related Servs. Co. v. Felton's Foodway, Inc. (*In re* Felton's Foodway, Inc.), 49 Bankr. 106, 108 (Bankr. M.D. Fla. 1985).

114 *In re* Cambridge Mortgage Corp., 92 Bankr. 145, 151 (Bankr. D.S.C. 1988); Colin v. Fidelity Standard Mortgage Corp. (*In re* Fidelity Standard Mortgage Corp.), 36 Bankr. 496, 499 (Bankr. S.D. Fla. 1983). The Senate Report concerning the exception for the secondary mortgage market states:

> Section 541(e) [now 541(d)] confirms the current status under the Bankruptcy Act of bona fide secondary mortgage market transactions as the purchase and sale of assets. Mortgages or interests in mortgages sold in the secondary market should not be considered as part of the debtor's estate. To permit the efficient servicing of mortgages or interests in mortgages the seller often retains the original mortgage notes and related documents, and the purchaser records under [s]tate recording statutes the purchaser's ownership of the mortgages or interests in mortgages purchased. Section 541(e) makes clear that the seller's retention of the mortgage documents and the purchaser's decision not to record do not impair the asset sale character of the secondary mortgage market transactions. The committee notes that in secondary mortgage market transactions the parties may characterize their relationship as one of trust, agency, or independent contractor. The characterization adopted by the parties should not affect the [status] in bankruptcy of bona fide secondary mortgage market purchases and sales.

S. REP. No. 989, 95th Cong., 2d Sess. 83-84, *reprinted in* 1978 U.S. CODE & ADMIN. NEWS 5787, 5869-70.

115 20 Bankr. 259 (Bankr. W.D. Wash. 1981).

116 *Id.* at 264.

protected under section 541(d).[117] The court held that the debtor held in trust the notes and deeds for Bohemian.[118] The court further ruled that a participation interest in a note secured by a deed of trust was not subject to section 544(a)(3).[119]

The court declared that the purpose of section 541(d) was to eliminate uncertainty regarding the treatment of mortgage participations in bankruptcy cases.[120] The court stressed that Congress expressly provided that the seller's retention of the original loan documents and the buyer's failure to record under the applicable recording statutes would impair neither the character of the transaction nor the validity of the secondary mortgage market.[121] According to the court, the participation agreement created an express trust, and thus the proceeds of the loan participation agreement never became part of the estate.[122] The court also rejected the argument that section 544(a)(3) could be used to defeat Bohemian's interest.[123]

The legislative history and language of section 541(d) indicate that notes and mortgages in the secondary mortgage market which a debtor holds in trust for a third party are not property of the estate.[124] An entity that has an interest in a loan participation agreement need not record its interest.[125] Finally, a trustee may

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117 *Id.* at 261.

118 *Id.*

119 *Id.*

120 *Id.*

121 *Id.* at 261-62 (citing 11 U.S.C. § 541(d) (1988)).

122 *Id.* at 263.

123 *Id.* at 264. The court stated:

> This [exemption of the secondary mortgage market from compliance with recording statutes] was accomplished by eliminating from the estate the equitable interest of the participant in the property whether such interest be real or personal. No creditor has been misled by the action of the mortgage company's acquiring title. It would be a complete frustration of Congressional intent to permit the trustee to bring into the estate under his bona fide purchaser rights property that Congress had specifically eliminated from the estate. In other words the immunization from the trustee's attack granted by Congress extends to all phases of the transactions and where the debtor obtains title pursuant to its servicing contract that title cannot be challenged by the trustee.

Id.

124 *Id.* Prior to the commencement of the case, the debtor sold the asset to the loan participant. At the time the petition was filed the debtor did not have an interest in the mortgage. *Id.* Therefore, section 541(d) recognizes that an actual sale occurred prior to the commencement of the case and that a bankruptcy estate only succeeds to those interests that a debtor had in property prior to the commencement of a case.

125 One of the purposes of the recording statutes is to avoid the problem of os-

not use the strong arm powers to avoid the interest of an entity in a mortgage which was created by a transaction in the secondary mortgage market.[126]

C. *The Trustee's Strong Arm Powers*

1. Introduction

One of the major purposes of the trustee's strong arm power is to further the doctrine of ostensible[127] ownership.[128] In essence, the doctrine of ostensible ownership requires a creditor to take some action to notify other parties of its interest in personal or real property.[129] If a creditor fails to take such action, its in-

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tensible ownership. Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53, 54 (1983). The problem of ostensible ownership is not prevalent in the secondary mortgage market. *See In re* Columbia Pacific Mortgage, Inc., 20 Bankr. 259 (Bankr. W.D. 1981). Therefore the need to record an interest in the secondary mortgage market is less compelling than in an ordinary real estate transaction.

126 Congress has expressly provided that secondary mortgage transactions are immune from the trustee's strong arm powers. *In re* Cambridge Mortgage Corp., 92 Bankr. 145, 150 (Bankr. D.S.C. 1988). The purpose of the exception was to facilitate the operation of the secondary mortgage market. *Id.*

127 Ostensible ownership is defined as apparent ownership derived from an action conduct or words. BLACK'S LAW DICTIONARY 992 (5th ed. 1979).

128 P. MURPHY, CREDITORS' RIGHTS IN BANKRUPTCY 12.04 (2d ed. 1988). Ostensible ownership plays a major role in commercial and bankruptcy law. *See* Baird & Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175 (1983). *See, e.g.* Benedict v. Ratner, 268 U.S. 353 (1925) In *Benedict* a creditor alleged that it had a security interest in the bankrupt's accounts receivable. Under the agreement between the creditor and the bankrupt, the creditor was granted the right to have all amounts collected to be applied to the payment of the loan. But until the demand was made the bankrupt was not required to apply any of the collections to the payment of the loan. The bankrupt was at liberty to use the proceeds as it desired. The existence of the security interest was to be kept secret. The Supreme Court held that the arrangement was fraudulent and void. Justice Brandeis wrote:

> The results which flowed from reserving dominion inconsistent with the effective disposition of title must be the same whatever the nature of the property transferred. The doctrine which imputes fraud where full dominion is reserved must apply to assignments of accounts although the doctrine of obstensible ownership does not. There must also be the same distinction as to degrees of dominion. Thus, although an agreement that the assignor of accounts shall collect them and pay the proceeds to the assignee will not invalidate the assignment which it accompanies, the assignment must be fraudulent in law if it is agreed that the assignor may use the proceeds as he sees fit.

Id. at 364.

129 J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 21-2 (3d ed. 1988). The perfection requirements under the Uniform Commercial Code motivate secured creditors to "undertake some action, either [by] filing or possession, which would put a diligent searcher on notice of the secured party's claim." *Id.*

terest will be deemed subordinated to either other creditors or a trustee in bankruptcy.[130] Professor Ayer, formerly Judge Ayer, has stated:

> There seem to be at least two important reasons why the idea of ostensible ownership bulks so large in bankruptcy law. First, it helps to police against fraud on the part of debtors—fraud that may occur with or without the collusion of creditors. Secondly, quite apart from any imputation of fraud, it helps to permit the kind of reliance said to be essential to a dynamic commercial economy.[131]

The trustee's strong arm powers further the doctrine of ostensible ownership by prohibiting secret liens.[132]

2. The Historical Development of the Strong Arm Powers

The Bankruptcy Act of 1898 (the Act) allowed a trustee to avoid a creditor's unperfected security interest.[133] *York Manufacturing Co. v. Cassell*[134] presented the Supreme Court with an opportunity to interpret section 70a(5) of the Act of 1898.[135] In *York Manufacturing Co.*, the appellant and appellee entered into a conditional sales contract under which the appellant sold the bankrupt's machinery. The conditional sales contract was never filed. Ohio law required the appellant to file the conditional sales contract to perfect its security interest. However, under Ohio law the appellant's security interest was valid against the appellee. An involuntary bankruptcy petition was filed against the appellee, and a dispute ensued concerning the validity of the appellant's security interest. The Supreme Court held that under Section 70a(5), the appellant had a perfected security interest.[136] The Court reasoned that, under Ohio law, the conditional sales

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130 *See* Finance Co. of Am. v. Hans Mueller Corp. (*In re* Automated Bookbinding Servs., Inc.), 471 F.2d 546 (4th Cir. 1972); National Bank of Alaska, N.A. v. Seaway Express Corp. (*In re* Seaway Express Corp.), 105 Bankr. 28 (Bankr. 9th Cir. 1989), *aff'd*, 912 F.2d 1125 (9th Cir. 1990); Hale v. Kontaratos (*In re* Kontaratos), 10 Bankr. 956 (Bankr. D. Me. 1981).

131 Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899, 904 (Bankr. C.D. Cal. 1984).

132 Billings v. Cinnamon Ridge, Ltd. (*In re* Granada, Inc.), 92 Bankr. 501, 509-10 (Bankr. D. Utah 1988); P. MURPHY, *supra* note 128, at § 12.01.

133 4B J. MOORE, R. OGLEBAY, F. KENNEDY & L. KING, COLLIER ON BANKRUPTCY ¶ 70.47[1] (J. Moore 14th ed. 1978) [hereinafter J. MOORE]; J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 183 (1956).

134 201 U.S. 344 (1906).

135 BANKRUPTCY ACT OF 1898, July 1, 1898, c. 541, § 70a, 30 STAT. 565, U.S. COMP. STAT. 1901, 3451.

136 *York Manufacturing Co.* 201 U.S. at 352-53.

contract was valid between the appellant and appellee.[137] There were no judgment creditors in the case, and no attachment had been levied.[138]

The Supreme Court's decision in *York Manufacturing Co.*, was significant because it severely circumscribed the scope of section 70a(5). The Court held that the filing of a bankruptcy case did not have the effect of a judgment or attachment. Thus, the commencement of a bankruptcy case had no effect on the validity of a security interest between a creditor and a bankrupt. Congress disagreed with the holding of *York Manufacturing Co.* and it amended section 47a(2) of the Bankruptcy Act.[139] Thereafter, in order to effectuate Congressional intent, section 47a was given a broad construction.[140] A trustee was granted the status of a judi-

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137 *Id.* at 352.

138 *Id.* The Court stated:

> We are of the opinion that [adjudication in bankruptcy] did not operate as a lien upon the machinery as against the York Manufacturing Company, the vendor thereof. Under the provisions of the [B]ankruptcy [A]ct the trustee in bankruptcy is vested with no better right or title to the bankrupt's property than belonged to the bankrupt at the time when the trustee's title accrued. At that time the right, as between the bankrupt and the York Manufacturing Company, was in the latter company to take the machinery on account of default in the payment therefor. The trustee under such circumstances stands simply in the shoes of the bankrupt and as between them he has no greater right than the bankrupt.

Id.

139 The amendment stated:

> and such trustees, as to all property in the custody or coming into the custody of the bankruptcy court, shall be deemed vested with all the rights, remedies, and powers of a creditor holding a lien by equitable or legal proceedings thereon; and also, as to all property not in the custody of the bankruptcy court, shall be deemed vested with all the rights, remedies, and powers of a judgment creditor holding an execution duly returned unsatisfied.

Act of June 25, 1910, 36 STAT. 838.

The legislative history of the amendment states:

> It is evident that in the proposed amendment attempt is made it give effect to two ideas, quite distinct: First, that as to the property in the custody of the bankruptcy court the bankruptcy trustee shall be considered to have the same title that a creditor holding an execution or other lien by legal or equitable proceedings levied upon the property would have under state law; and, second, that as to property not in the custody of the bankruptcy court, the trustee should stand in the position of a judgment creditor holding an execution returned unsatisfied, thus entitling him to proceed precisely as an individual creditor might have done to subject assets.

45 CONG. REC. 2277 (1910).

140 The Eight Circuit commented:

> The better view would seem to be that the amendment was designed

cial lien creditor regardless of whether such a creditor existed in the bankruptcy case.[141] Therefore, a trustee could avoid the interest of a creditor that had failed to perfect its security interest.[142]

The development of the trustee's strong arm power was significant. The trustee's status of a hypothetical lien creditor facilitated bankruptcy policy. Under the Act, the strong arm powers enabled a trustee to avoid secret liens because the trustee was not subject to the defense of estoppel.[143]

> to reach those cases in which no creditor had acquired such a lien, and to give the trustee for the benefit of the estate, the potential rights of creditors with such liens. The language is broad and all-inclusive, and would seem to refer to such "rights, remedies and powers" as a creditor holding a lien would have under the law of the particular state, rather than to the "rights, remedies and powers" of a creditor who has actually fastened a lien upon the bankrupt's property. In other words, the amendment arms the trustee with process to the same extent that any judgment creditor would have according to the law of the particular state, and he is not necessarily concluded by an instrument or agreement which might have been good against the bankrupt had bankruptcy not intervened.

Albert Pick & Co. v. Wilson, 19 F.2d 18, 20 (8th Cir. 1927).

141 *In re* Babcock Printing Press Mfg. Co. (*In re* Press Printers & Publishers, Inc.), 23 F.2d 34, 35 (3d Cir. 1927), *cert. denied*, 276 U.S. 633 (1928); *In re* Waynesboro Motor Co., 60 F.2d 668, 669 (S.D. Miss. 1932). One court noted:

> I am constrained to hold that [the amendment] intended to place trustees in the superior position of a creditor "holding a lien by legal or equitable proceedings" upon the property and "with the remedies and powers of a judgment creditor holding an execution duly returned unsatisfied" *and with no other purpose than to cut off secret and undisclosed claims against the property* . . . .

In re Horton, 31 F.2d 795, 798-99 (W.D. La. 1928) (emphasis added).

142 *See, e.g.*, Weingarten v. Universal C.I.T. Credit Corp., 302 F.2d 1 (2d Cir. 1962); McKay v. Trusco Fin. Co. of Montgomery, Ala., 198 F.2d 431 (5th Cir. 1952); *In re* Rader, 194 F.2d 988 (2d Cir. 1952) (per curiam); *In re* Chappell, 77 F. Supp. 573 (D. Ore. 1948).

143 A leading treatise on the Bankruptcy Act stated:

> More frequently than otherwise, the bankrupt will be estopped to deny the validity of his acts, obligations and transfers. If this estoppel is imputed to the trustee, he may be helpless to avoid or set aside the results of the bankrupt's chicanery, the favoritism of certain creditors, or other acts or transfers that are in derogation of the Bankruptcy Act's paramount purpose: equality of distribution among all creditors.

J. MOORE, *supra* note 133, at ¶ 70.45, at 557-58 (14th ed. 1978).

3. The Bankruptcy Code and the Trustee's Strong Arm Powers

a. *Introduction*

Section 544(a) sets forth the trustee's strong arm powers.[144] The legislative history of section 544(a) indicates that Congress intended that the strong arm powers continue to have the broad scope they had attained under the Act.[145] Further, courts and commentators agree that section 544(a) has expanded the trustee's strong arm powers.[146] Section 544(a) vests a trustee with important powers to obtain the debtor's property to insure an equitable distribution of the debtor's estate.[147]

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144 11 U.S.C. § 544(a) (1988).

145 The legislative history states:

> Subsection (a) is the "strong arm clause" of current law, now found in Bankruptcy Act § 70c. It gives the trustee the rights of a creditor on a simple contract with a judicial lien on the property of the debtor as of the date of the petition; of a creditor with a writ of execution against the property of the debtor unsatisfied as of the date of the petition; and a bona fide purchaser of the real property of the debtor as of the date of the petition. "Simple contract" as used here is derived from Bankruptcy Act § 60a(4). The third status, that of a bona fide purchaser of real property, is new.

S. REP. No. 989, 95th Cong., 2d Sess. 85, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5871.

146 One court stated:

> It needs no elaborate citation of authorities, decisional or text, in support of the proposition that the voiding power granted to the [t]rustee by § 544(a) of the Bankruptcy Code is the voiding power of an ideal judgment lien creditor without knowledge. It has been traditionally recognized under the pre-Code law that the [t]rustee had the status of an "ideal creditor, irreproachable and without notice, armed cap-a-pie with every right and power which is conferred by the law of the state upon its most favored creditor, who has acquired a lien by legal or equitable proceeding." It is not surprising that the voiding power granted to the trustee by the pre-Code law, § 70(a) of the Act of 1898, was known as the "strong arm clause." There is nothing in the corresponding provision of Bankruptcy Code, § 544(a), which in any way dilutes or weakens the power of the trustee to void unperfected liens, liens which under the applicable local law would be defeated by a creditor who has acquired a lien by legal or equitable proceeding on the property of the debtor.

Kaye v. Williams (*In re* Munzenreider Corp.), 34 Bankr. 82, 84-85 (Bankr. M.D. Fla. 1983) (citations omitted).

147 R. D'AGOSTINO, *supra* note 77, at ¶ 544.01.

b. *Bankruptcy Code Section 544(a)(1)*

i. Introduction

Section 544(a)(1) vests a trustee with the status of a hypothetical lien creditor without notice.[148] A debtor in possession may exercise the rights of a trustee under section 544(a)(1).[149] The language of section 544(a)(1) states that a trustee shall not have knowledge of any trustee or creditor.[150] To determine a trustee's authority under section 544(a)(1), reference must be made to state law.[151] A trustee has priority over a creditor with an unperfected security interest in personal property.[152] Section 544(a)(1) is intended to benefit the general unsecured creditors, and is therefore an anti-equity statute.[153]

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148 *See infra* notes 294-305 and accompanying text.

149 11 U.S.C. § 1107(a) (1988); Vintero Corp. v. Corporation Venezolana De Fomento (*In re* Vintero Corp.). 735 F.2d 740, 741-42 (2d Cir. 1984), *cert. denied*, 469 U.S. 1087 (1984); Agritrade Corp. v. General Coffee Corp. (*In re* General Coffee Corp.), 32 Bankr. 23, 24 (Bankr. S.D. Fla. 1983); Brent Explorations, Inc. v. Karst Enters., Inc. (*In re* Brent Explorations, Inc.), 31 Bankr. 745, 747 (Bankr. D. Colo. 1983); 5 C. CYR, H. MINKEL, R. ROGERS, H. SOMMER, W. TAGGERT & A. WINKLER, COLLIER ON BANKRUPTCY ¶ 1107.02 (L. King 15th ed. 1990).

150 The language of section 544(a)(1) explicitly provides that knowledge of party may not be imputed to the trustee. 11 U.S.C. § 544(a)(1) (1988). The phrase "without knowledge" shields the trustee from any malfeasance that the debtor may have committed. *In re* Wiggs, 87 Bankr. 57, 58 (Bankr. S.D. Ill. 1988); *Brent Explorations*, 31 Bankr. at 748-49.

151 Pearson v. Salina Coffee House, Inc., 831 F.2d 1531, 1532-33 (10th Cir. 1987); Robinson v. Howard Bank (*In re* Kors, Inc.), 819 F.2d 19, 22-23 (2d Cir. 1987); Havee v. Belk, 775 F.2d 1209, 1218 (4th Cir. 1985); Maine Nat'l Bank v. Morse (*In re* Morse), 30 Bankr. 52, 54 (Bankr. 1st Cir. 1983); Ganje v. Telford (*In re* Rhine), 22 Bankr. 42, 43 (Bankr. D.S.D. 1982).

152 U.C.C. § 9-301(3) defines lien creditor as follows:

> A "lien creditor" means a creditor who has acquired a lien on the property involved by attachment, levy or the like and includes an assignee for benefit of creditors from the time of assignment, and a trustee in bankruptcy from the date of the filing of the petition or a receiver in equity from the time of appointment.

U.C.C. § 9-301(3) (1987). Under U.C.C. § 9-301(1)(b) a lien creditor has priority over a creditor with an unperfected security interest. Communications Co. of Am., Inc. v. Mitel, Inc. (*In re* Communications Co. of Am., Inc.), 84 Bankr. 822, 824 (Bankr. M.D. Fla. 1988); First Am. Bank & Trust Co. of Athens v. Harris (*In re* Stewart), 74 Bankr. 350, 353-54 (Bankr. M.D. Ga. 1987); Ahlbum v. Craig (*In re* Craig), 57 Bankr. 63, 64-65 (Bankr. D.S.C. 1985); Howison v. Rockport Nat'l Bank (*In re* Crowley), 42 Bankr. 603, 605 (Bankr. D. Me. 1984); *Rhine*, 22 Bankr. at 43.

153 In chapter 11, a debtor-in-possession is an entity distinct from the debtor. Agritrade Corp. v. General Coffee Corp. (*In re* General Coffee Corp.), 32 Bankr. 23, 24 (Bankr. S.D. Fla. 1983). In a corporate reorganization, a debtor-in-possession is a fiduciary and it operates the estate for the benefit of the creditors. *Id.* A debtor-in-possession has all the powers of a trustee. I.A. Durbin, Inc. v. Jefferson Nat'l Bank (*In re* I.A. Durbin, Inc.), 46 Bankr. 595, 602 (Bankr. S.D. Fla. 1985). The

ii. Under Bankruptcy Code Section 544(a)(1) a Trustee is Immune to Equitable Defenses Such As Equitable Estoppel.

A trustee's status as a hypothetical lien creditor without notice precludes a creditor from raising any equitable defenses against a trustee using section 544(a)(1).[154] A case in which a creditor attempted to assert the defense of equitable estoppel against a debtor-in-possession using section 544(a)(1) is *Pirsig Farms, Inc. v. John Deere Co. (In re Pirsig Farms, Inc.)*.[155] In *Pirsig Farms*, the debtor attempted to avoid various liens held by John Deere Company (Deere). The debtor had purchased several pieces of farm machinery on credit. The dealers assigned their security agreements to Deere. Although all of the financing statements had to be filed with the Minnesota Secretary of State, Deere mistakenly filed nineteen of its twenty-two financing statements with the Faribault County Recorder. Subsequently, the debtor filed for chapter 11 and as a debtor-in-possession, it sought to avoid Deere's liens. Deere raised equitable arguments why the debtor-in-possession should not be permitted to avoid the liens. The district court ruled that the unperfected liens were avoidable.[156] The court noted that under section 105(a) the bankruptcy courts do not have authority to contravene specific provisions of the Code.[157] Under state law, an unperfected se-

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powers furnished by section 544(a)(1) are significant to the bankruptcy process because the trustee's strong arm powers facilitate a debtor-in-possession's efforts to insure equitable distribution of the estate according to the provisions of the Bankruptcy Code. R. D'AGOSTINO, *supra* note 77, at ¶ 544.01. The real beneficiaries of section 544(a)(1) are the general unsecured creditors. If a court took into consideration the debtor's pre-petition malfeasance when determining whether a lien or unrecorded interest in real property should be avoided, the philosophy that bankruptcy is a collective proceeding would be undermined. General unsecured creditors would be better off pursuing their individual remedies and trying to obtain individual judgments. Thus, if they were able to obtain judgments, they would have priority over creditors with unperfected security interests. *See* U.C.C. § 9-301 (1987). Furthermore, none of the debtor's malfeasance could be imputed to individual creditors. There would be a furious race to the courthouse in order to obtain a judgment, which is contrary to the policy underlying the Bankruptcy Code. Therefore, in order for a bankruptcy proceeding to succeed for all creditors, section 544(a)(1) has to be interpreted as an anti-equity statute.

154 Pirsig Farms, Inc. v. John Deere Co. (*In re* Pirsig Farms, Inc.), 46 Bankr. 237, 242 (D. Minn. 1985); *Wiggs*, 87 Bankr. at 58; *I.A. Durbin*, 46 Bankr. at 602; Brent Explorations, Inc. v. Karst Enters., Inc. (*In re* Brent Explorations, Inc.), 31 Bankr. 745 (Bankr. D. Colo. 1983).

155 46 Bankr. 237 (D. Minn. 1985).

156 *Id.* at 244.

157 *Id.* at 240 (citing 11 U.S.C. § 105(a) (1984)).

curity interest is uneforceable against a bankruptcy trustee.[158] The court further noted that Section 544(a)(1) grants a trustee the status of lienholder without notice.[159] Therefore, the court concluded that the debtor could not be on notice of Deere's unperfected liens because section 544(a) provides that the debtor lacks such knowledge.[160]

The language of section 544(a)(1) provides that a debtor's knowledge of an unperfected security interest is irrelevant.[161] Thus, it has been held that a trustee's personal knowledge does not preclude a trustee from using section 544(a)(1).[162] In *Frier v. Creative Bath Products, Inc. (Measure Control Devices),*[163] the issue before the court was whether a trustee's knowledge of a lien prevented her from avoiding a creditor's security interest. The bankruptcy court held that the creditor had an unperfected security interest which could be avoided.[164] The court rejected the creditor's equity argument because it lacked authority to contravene the clear language of section 544(a).[165]

c. *Bankruptcy Code Section 544(a)(3)*

i. Introduction

Section 544(a)(3) is a new provision.[166] Section 544(a)(3),

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158 *Id.* at 242.

159 *Id. See also supra* note 146.

160 *Id.* The court stated:

> Moreover, a bankruptcy court's equitable powers do not allow a bankruptcy court to contravene clear statutory provisions. In fact, neither equity nor estoppel doctrines limit a trustee's avoiding powers under section 544(a).

Id. (citation omitted). The court rejected Deere's equitable arguments because the court could not use its equitable powers to circumvent the clear language of section 544(a). *Id.* at 242-43.

161 *See* 11 U.S.C. § 544(a)(1) (1988); I. SULMEYER & M. RUSH, COLLIER HANDBOOK FOR TRUSTEES AND DEBTORS IN POSSESSION ¶ 14.18[2] (1987).

162 Frier v. Creative Bath Products, Inc. (*In re* Measure Control Devices, Inc.), 48 Bankr. 613 (Bankr. E.D.N.Y. 1985).

163 *Id.*

164 *Id.* at 615-16.

165 Chief Judge Duberstein stated:

> This argument is apparently addressed to the court's equitable powers which pursuant to § 105 of the Bankruptcy Code are, indeed, broad. But, § 105 does not give bankruptcy courts the authority to contravene statutory provisions of the Bankruptcy Code. U.C.C. § 9-401(2) is inapplicable to this case since the Bankruptcy Code explicitly gives the trustee the status of a lien creditor without notice.

Id. at 615.

166 S. REP. NO. 989, 95th Cong., 2d Sess. 85, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5871. Section 544(a)(3) is another example of the expansion

like section 544(a)(1) is premised on the theory of ostensible ownership.[167] The purpose of section 544(a)(3) is to combat secret liens and unrecorded interests in real property.[168] In order for an interest in real property to be valid in a bankruptcy case, section 544(a)(3) compels an entity claiming to have an interest in real property to comply with the applicable recording statute.[169] The New York Court of Appeals has described the purpose of the recording statutes as follows:

> First, it was intended to protect the rights of innocent purchasers to acquire an interest in property without knowledge of prior encumbrances. Second, the statute was designed to establish a public record which would furnish potential purchasers with notice, or at least "constructive notice," of previous conveyances and encumbrances that might affect their interests.[170]

Section 544(a)(3) grants a trustee the status of a bona fide purchaser.[171] A bona fide purchaser is an entity that acquires an interest in real property by paying valuable consideration and acquiring legal title without notice of any prior equity in the property.[172] A trustee's rights under section 544(a)(3) are determined by state

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of the trustee's strong arm powers. Levin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANKR. L.J. 173, 175-76 (1979).

167 *See supra* notes 127-29 and accompanying text. *See also* Belisle v. Plunkett, 877 F.2d 512, 514-15 (7th Cir. 1989), *cert. denied*, 110 S. Ct. 241 (1989); Probasco v. Eads (*In re* Probasco), 839 F.2d 1352, 1354-55 (9th Cir. 1988); National Bank of Alaska, N.A. v. Seaway Express Corp. (*In re* Seaway Express Corp.), 105 Bankr. 28, 31-32 (Bankr. 9th Cir. 1989), *aff'd*, 912 F.2d 1125 (9th Cir. 1990); Billings v. Cinnamon Ridge, Ltd. (*In re* Granada, Inc.), 92 Bankr. 501, 509-10 (Bankr. D. Utah 1988).

168 *See* Lindquist v. Truwe (*In re* Keenan), 96 Bankr. 197, 200 (Bankr. D. Minn. 1989); Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899, 904-05 (Bankr. C.D. Cal. 1984).

169 *See* Stern v. Continental Assurance Co. (*In re* Ryan), 851 F.2d 502 (1st Cir. 1988); *In re* Price, 97 Bankr. 264 (Bankr. E.D.N.C. 1989); Putney v. Dalton (*In re* Dalton), 90 Bankr. 519 (Bankr. M.D. Fla. 1988); First Nat'l Bank of Poplar Bluff v. R & J Constr. Co. (*In re* R & J Constr. Co.), 43 Bankr. 29 (Bankr. E.D. Mo. 1984).

170 Andy Assocs., Inc. v. Bankers Trust Co., 49 N.Y.2d 13, 20, 424 N.Y.S.2d 139, 143, 399 N.E.2d 1160, 1164 (1979) (citations omitted).

171 11 U.S.C. § 544(a)(3) (1988); Sandy Ridge Oil Co. v. Centerre Bank Nat'l Ass'n (*In re* Sandy Ridge Oil Co.), 832 F.2d 75 (7th Cir. 1987) (per curiam); Benjamin Franklin Savs. & Loan Ass'n v. New Concept Realty & Dev., Inc. and L.D. (*In re* New Concept Reality & Dev., Inc.), 753 F.2d 804, 806 (9th Cir. 1985) (per curiam); *In re* Turner, 78 Bankr. 166, 170 (Bankr. E.D. Tenn. 1987).

172 *See* Himes v. Schiro, 711 P.2d 1281, 1283 (Colo. Ct. App. 1985); Andretta v. Fox New England Theaters, Inc., 113 Conn. 476, 482, 155 A. 848, 850 (1931); Big Four Petroleum Co. v. Quirk, 755 P.2d 632, 634 (Okla. 1988); McVean v. Coe, 12 Wash. App. 738, 741, 532 P.2d 629, 631 (Wash. Ct. App. 1975).

law.[173] Section 544(a)(3) renders the trustee's knowledge or any creditor's knowledge irrelevant.[174]

ii. Under Bankruptcy Code Section 544(a)(3) a Trustee May Avoid Unrecorded Equitable Interests in Real Property

A trustee may use section 544(a)(3) to avoid unrecorded legal or equitable interests in real property.[175] A case that involved the use of section 544(a)(3) to avoid unrecorded interests in real property is *Loup v. Great Plains Western Ranch Co. (In re Great Plains Western Ranch Co.)*[176] In *Great Plains*, there was a dispute as to the ownership of two real estate parcels. The debtor held record title to both parcels. The plaintiffs alleged that they had been defrauded, and therefore owned the parcels through a constructive trust. The court held that both parcels were property of the estate pursuant to section 544(a)(3).[177] Section 544(a)(3) provides a trustee with the powers of a bona fide purchaser and the debtor's own personal knowledge is immaterial.[178] The first parcel was located in Mississippi, so Mississippi law controlled.[179] A deed naming the plaintiff, Loup & Neider Farm & Cattle Co. (L&N), as owner of the Mississippi property was never filed.

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173 *See* Chbat v. Tleel (*In re* Tleel), 876 F.2d 769, 772 (9th Cir. 1989); Placer Savs. and Loan Ass'n v. Walsh (*In re* Marino), 813 F.2d 1562, 1565 (9th Cir. 1987); Brosco Inc. v. Toledo (*In re* Toledo), 17 Bankr. 914, 917 (D.P.R. 1982); Kirkhart v. Boardwalk Dev. Co. (*In re* Boardwalk Dev. Co.), 72 Bankr. 152, 154 (Bankr. E.D.N.C. 1987).

174 *See* Probasco v. Eads (*In re* Probasco), 839 F.2d 1352, 1354 (9th Cir. 1988); *Sandy Ridge Oil Co.*, 807 F.2d at 1335; McCannon v. Marston, 679 F.2d 13, 16-17 (3d Cir. 1982); Billings v. Cinnamon Ridge, Ltd. (*In re* Granada, Inc.), 92 Bankr. 501, 505 (Bankr. D. Utah 1988). A divided Fourth Circuit in Pyne v. Hartman Paving, Inc. (*In re* Hartman Paving, Inc.), 745 F.2d 307 (4th Cir. 1984), held that a debtor's knowledge of a defective deed of trust was imputable to the estate. The Fourth Circuit's opinion in *Hartman Paving* has been rejected by various courts. *See Sandy Ridge Oil Co.*, 807 F.2d at 1334-36; Lennington v. Graham (*In re* Graham), 110 Bankr. 408, 413 (S.D. Ind. 1990); McEvoy v. Watkins, Inc., 105 Bankr. 362, 364 (N.D. Tex. 1987); Bandell Invs., Ltd. v. Capital Fed. Savs. and Loan Ass'n of Denver (*In re* Bandell Invs., Ltd.), 80 Bankr. 210, 212 (D. Colo. 1987); Iowa-Missouri Realty Co. v. United States Small Business Admin. (*In re* Iowa-Missouri Realty Co.), 86 Bankr. 617, 619-20 (Bankr. W.D. Mo. 1988).

175 Mid-America Petroleum, Inc. v. Adkins Supply, Inc. (*In re* Mid-America Petroleum, Inc.), 83 Bankr. 937, 943 (Bankr. N.D. Tex. 1988); Stone v. Decatur Fed. Savs. and Loan Ass'n (*In re* Fleeman), 81 Bankr. 160, 163 (Bankr. M.D. Ga. 1987); *In re* Richardson, 75 Bankr. 601, 604 (Bankr. C.D. Ill. 1987).

176 38 Bankr. 899 (Bankr. C.D. Cal. 1984).

177 *Id.* at 906.

178 *Id.* at 905. This was important because the debtor had knowledge concerning the defects in title, and therefore could not be a bona fide purchaser.

179 *Id.* at 905-06.

Rather, the debtor appeared in the chain of title as the last owner of record. The court thus determined that under section 544(a)(3) the Mississippi property was property of the estate.[180] The second parcel was located in Texas. The debtor agreed that it would transfer title to the second parcel after plaintiff, Wilson County Land Co. (Wilson), had paid the final installment payment. The title to the second parcel was never transferred to Wilson.[181] Under section 544(a)(3), the debtor-in-possession had no knowledge of the prepetition status of the second parcel.[182] Hence, the court declared, the debtor-in-possession was authorized to use its powers under section 544(a)(3) to avoid Wilson's interest in the second parcel.[183] Although the debtor may have committed fraud, the court thought that its holding was consistent with the policies underlying the Bankruptcy Code.[184]

iii. Summary and Analysis

The status of bona fide purchaser without knowledge acts to purify the estate from any malfeasance that the debtor may have committed.[185] Therefore, a trustee's status as a bona fide purchaser makes a trustee immune from the use of affirmative equitable defenses.[186] The trustee's insulation from affirmative defenses is not intended to benefit the debtor; rather, it is intended to benefit the general unsecured creditors.[187] A trustee's

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180 *Id.*

181 *Id.*

182 *Id.*

183 *Id.*

184 The *Great Plains* court stated:

> There are many anomalies here. The strong-arm clause protects reliance, and protects against fraud, without any showing either of reliance or of fraud. The strong-arm clause permits an (assumed) fraud against the plaintiffs in this case to protect against a (hypothetical) fraud by the debtor in which the plaintiffs by definition might have no part. The strong-arm clause permits the alleged wrongdoer to assert the right of innocent parties against his own supposed victim. All of this is, to say the least, a remarkable result. Nonetheless, as I have tried to show, I think that it is consistent alike with the letter and spirit of the Bankruptcy Code.

Id. at 907.

185 *See* Belisle v. Plunkett, 877 F.2d 512, 513-15 (7th Cir. 1989), *cert. denied*, 110 S. Ct. 241 (1989); Billings v. Cinnamon Ridge, Ltd. (*In re* Granada, Inc.), 92 Bankr. 501, 505 (Bankr. D. Utah 1988).

186 Chbat v. Tleel (*In re* Tleel), 876 F.2d 769, 773 (9th Cir. 1989); D & F Petroleum v. Cascade Oil Co. (*In re* Cascade Oil Co.), 65 Bankr. 35, 39 (Bankr. D. Kan. 1986); Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899, 905 (Bankr. C.D. Cal. 1984).

187 National Bank of Alaska, N.A. v. Seaway Express Corp. (*In re* Seaway Express

ability to avoid unperfected interests in real estate insures that the debtor will be able to efficiently collect and distribute the assets of the estate.[188] Section 544(a)(3) gives creditors with small claims an incentive to participate in bankruptcy cases.[189] Indeed, the same argument can be made to support the position that a trustee's avoiding powers are necessary to protect major unsecured creditors.[190] Therefore, a trustee's status as a bona fide purchaser facilitates the equal distribution of the estate.[191]

D. Constructive Trusts

1. Introduction

A constructive trust is a trust created by operation of law and imposed by a court of equity, because an individual obtained legal title to money or property by fraud or violation of a legal duty owed to another individual.[192] Justice Cardozo wrote:

Corp.), 105 Bankr. 28, 31 (Bankr. 9th Cir. 1989), *aff'd*, 912 F.2d 1125 (9th Cir. 1990); McCoid, *Bankruptcy, the Avoiding Powers, and Unperfected Security Interests*, 59 AM. BANKR. L. J. 175, 190-91 (1985).

188 2 D. COWANS, BANKRUPTCY LAW AND PRACTICE § 10.4 (1989 ed.).

189 It is expensive for creditors with small claims to obtain and enforce judgments. The collective nature of a bankruptcy case attempts to protect small creditors. First of all, in chapter 11 cases a creditors' committee is appointed to protect the interests of general unsecured creditors. 11 U.S.C. § 1102(a)(1) (1988). A debtor-in-possession is a fiduciary, and it has the powers of a trustee. 11 U.S.C. § 1107(a) (1988). One of the duties of a debtor-in-possession is to use section 544(a) to avoid unperfected security interests in personal and real property. *See* Pirsig Farms, Inc. v. John Deere Co. (*In re* Pirsig Farms, Inc.), 46 Bankr. 237, 241 (D. Minn. 1985).

190 For example, imagine a single asset case in which the only asset is a parcel of real property. There are different creditors with major unsecured claims. The creditor purporting to hold a first mortgage on the property failed to record its mortgage, and therefore its interest is subordinate to a bona fide purchaser or judgment creditor. The property is worth $1,000,000 and there are four creditors each holding a claim worth $500,000. Under the present scenario, the first two creditors to obtain and execute judgments will get paid in full, and the two remaining creditors will receive nothing. Under these circumstances, the four unsecured creditors would have an incentive to file an involuntary bankruptcy petition. The trustee could employ section 544(a)(3) to avoid the unrecorded mortgage. Thereafter, the property could be sold and proceeds distributed to pay the four creditors a pro rata distribution of the proceeds. In the bankruptcy case, the creditors would share equally as compared to receiving all or nothing in the nonbankruptcy forum.

191 Chbat v. Tleel (*In re* Tleel), 876 F.2d 769, 773-74 (9th Cir. 1989); R. D'AGOSTINO, *supra* note 77, at ¶ 544.01.

192 *See, e.g.* Coupounas v. Morad, 380 So.2d 800, 803 (Ala. 1980); Burch & Cracchiolo, P.A. v. Pugliani, 144 Ariz. 281, 285-86, 697 P.2d 674, 678-79 (1985); Harmon v. Harmon, 126 Ariz. 242, 244, 613 P.2d 1298, 1300 (Ariz. Ct. App. 1980); Cohen v. Cohen, 182 Conn. 193, 201-02, 438 A.2d 55, 60 (1980); A.T. Kearney, Inc. v. Inca Int'l, Inc., 132 Ill. App. 3d 655, 477 N.E.2d 1326, 1331 (Ill. App. Ct. 1985); Sadacca v. Monhart, 128 Ill. App. 3d 250, 470 N.E.2d 589, 593 (Ill. App. Ct.

> [a] constructive trust is the formula through which the conscience of equity finds expression. When property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest, equity converts him into a trustee.[193]

The purpose of a constructive trust is to avoid unjust enrichment.[194] Constructive trusts are imposed when an individual has betrayed a confidential relationship or breached a fiduciary duty.[195] Courts will also impose a constructive trust when property is obtained through fraud, accident, mistake, duress or undue influence.[196]

A mere breach of contract, however, is an insufficient basis to impose a constructive trust.[197] In *Rochester Radiology Associates, P.C.*

1984); G. BOGERT *supra* note 69, at § 471 (2d rev. ed. 1978); D. DOBBS, LAW OF REMEDIES § 4.3 (1973).

193 Beatty v. Guggenheim Exploration Co., 225 N.Y. 380, 386, 122 N.E. 378, 380 (1919).

194 *See* David v. Russo, 119 Ill. App. 3d 290, 456 N.E.2d 342, 347 (Ill. App. Ct. 1983); Wright v. Wright, 311 N.W.2d 484, 485 (Minn. 1981); Simonds v. Simonds, 45 N.Y.2d 233, 242, 408 N.Y.S.2d 359, 364, 380 N.E.2d 189, 194 (1978); Cacy v. Cacy, 619 P.2d 200, 202 (Okla. 1980); G. BOGERT, TRUSTS § 77 (6th ed. 1987).

195 A fiduciary is a person having a duty created by an undertaking to act on behalf of another in relation to the undertaking. BLACK'S LAW DICTIONARY 563 (5th ed. 1979). For purposes of a constructive trust, a confidential relationship arises whenever an individual has gained the confidence of another person and purports to act or advise with the other's interest in mind. *See* Wimmer v. Wimmer, 287 Md. 631, 414 A.2d 1254, 1258 (Md. Ct. App. 1980); Carroll v. Daigle, 123 N.H. 495, 500-01, 463 A.2d 885, 888-89 (1983). *See, e.g.*, Funk v. Tifft, 515 F.2d 23 (9th Cir. 1975); Granik v. Perry, 418 F.2d 832 (5th Cir. 1969); Klein v. Shaw, 109 Idaho 237, 706 P.2d 1348 (Idaho Ct. App. 1985); Badger Bldg. Corp. v. Gregoric, 102 Ill. App.3d 594, 430 N.E.2d 561 (Ill. App. Ct. 1981); Plans v. Doneca, 72 Mich. App. 202, 249 N.W.2d 356 (Mich. App. Ct. 1977); Winter v. Liles, 354 N.W.2d 70 (Minn. App. Ct. 1984); Thorne v. Thorne, 66 A.D.2d 397, 414 N.Y.S.2d 1 (1st Dep't 1979).

196 *See, e.g.* Estate of Guzauskas v. Guzauskas, 171 Conn. 98, 103, 368 A.2d 193, 196 (1976); Steinberg v. Chicago Medical School, 69 Ill.2d 320, 328, 371 N.E.2d 634, 638 (1977); Mickelson v. Barnet, 390 Mass. 786, 460 N.E.2d 566 (1984); Wimmer v. Wimmer, 287 Md. 663, 414 A.2d 1254, 1258 (1980); Wright v. Wright, 311 N.W.2d 484, 485 (Minn. 1981); White v. Mulvania, 575 S.W.2d 184, 187 (Mo. 1978) (en banc); Huber v. Wagner, 284 Pa. Super. 133, 137, 425 A.2d 456, 458 (Sup. Ct. Pa. 1981); G. BOGERT, *supra* note 69, at § 475 (2d rev. ed. 1978); G. BOGERT, TRUSTS §§ 79, 80 (6th ed. 1987).

197 *Rochestor Radiology Associates, P.C. v, Aetna Life Insurance Co.*, 616 F. Supp. 985, 988-89 (W.D.N.Y. 1985); *Ashton v. Chrysler Corp.*, 261 F. Supp. 1009, 1014 (E.D.N.Y. 1965); *Presten v. Sailer*, 225 N.J. Super. 178, 542 A.2d 7, 15 (N.J. Super A.D. 1988); *Estate of Kern*, 142 Ill. App.3d 506, 96 Ill. Dec. 815, 491 N.E.2d 1275, 1281 (Ill. App. 1st Dist. 1986); *Waldman v. Englishtown Sportsware, Ltd.*, 92 A.D.2d 833, 460 N.Y.S.2d 552, 556 (1st Dep't. 1983); *Donahue v. Manifacturers Trust Co.*, 10 Misc.2d 298, 166 N.Y.S.2d 174, 178 (Sup. Ct. Westchester Cty. 1957); *Jacobs v. Seligman*, 63 So.2d 315 (Fla. 1953) (en banc); *Landram v. Robertson*, 195 S.W.2d 170, 174 (Ct. Civ. App. Tex. 1946); G.G. Bogert & G.L. Bogert, *The Law of Trusts and Trustees* § 471 (2d red. ed. 1978); 2 A.L. Corbin, *Corbin on Contracts* § 401 (1950).

v. Aetna Life Insurance Co.[198] the plaintiffs brought a lawsuit against the defendant concerning a Group Annuity Contract (the "Contract"). Under the Contract the plaintiffs had the right to discontinue the Contract and receive their account balance. If the plaintiffs elected to receive the account balance in a lump sum, a Market Value Adjustment was applied to the balance. Subsequently, the defendant advised the plaintiff of a change in the Market Value Adjustment formula because of prevailing high interest rates. The change in the Market Value Adjustment formula reduced the value of the money withdrawn from the Contract. The plaintiff decided to withdraw from the Contract with the defendant. The plaintiff determined that it had received $85,173.37 less than it would have received under the old Market Value Adjustment formula. The plaintiff brought suit for breach of fiduciary duty. The court dismissed the count in the complaint for breach of fiduciary duty.[199] The court noted that insurance companies are not fiduciaries to their policyholders.[200] The court rejected the argument that a constructive trust should be imposed, and it stated:

> A constructive trust cannot itself serve as the basis for a substantive claim or right. In order to find a constructive trust there is the critical requirement that a confidential or fiduciary relationship be present. That element is lacking here. If the relationship is not of a confidential or fiduciary nature, so 'pregnant with opportunity for abuse and unfairness' as to require equity to intervene and scrutinize the transaction, a constructive trust cannot be imposed.[201] (Citations omitted).

A mere breach of contract should not be subject the a constructive trust. One of the principal reasons for imposing a constructive trust is because one party has exploited a confidential or fiduciary relationship.[202] In a commercial transaction the parties are dealing at arms length and the parties neither have a fiduciary nor confidential relationship.[203] Furthermore, a mere breach of contract does

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198 616 F. Supp. 985 (W.D.N.Y. 1985).

199 *Id.* at 988-89.

200 *Id.* at 988.

201 *Id.* at 989.

202 *Id.Kinney v. Kinney*, 304 S.E.2d 870, 873-74 (W. Va. 1983); *Klein v. Shaw*, 109 Idaho 237, 706 P.2d 1348, 1351-52 (Idaho Ct. App. 1985).

203 A fiduciary is a person having a duty created by an undertaking to act on behalf of another in relation to the undertaking. *Black's Law Dictionary* 563 (5th ed. 1979). For purposes of a constructive trust a confidential relationship arises whenever an individual has gained the confidence of another person and purports to act or advise with the other's interest in mind. *Wimmer v. Wimmer*, 287 Md. 631, 414 A.2d 1254, 1258 (Md. Ct. App. 1980); *Carrol v. Daigle*, 123 N.H. 495, 463 A.2d 885, 888 (N.H. 1983).

not constitute fraud.[204] Therefore, absent fraud, a mere breach of contract is insufficient to justify the imposition of a constructive trust.[205]

2. Constructive Trusts and the Bankruptcy Act

a. *Introduction*

The imposition of a constructive trust was a recognized equitable remedy in cases decided under the Act.[206] The constructive trust was recognized under the Act in that property obtained by fraud did not become property of the bankrupt's estate.[207]

b. *The Tracing Requirement*

In order for a court to impose a constructive trust, it was necessary for the claimant to trace, or identify, the specific property or the proceeds which the bankrupt wrongfully obtained from the claimant.[208] In *Cunningham v. Brown*[209], various defrauded creditors sought the imposition of a resulting trust for the funds they had invested in a "Ponzi" scheme. The Supreme

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204 *General Business Machines v. National Semiconductor Datachecker/Dts,*, 664 F. Supp. 1422, 1424 (D. Utah 1987); *Carlucci v. Owens-Corning Fiberglass Corp.*, 646 F. Supp. 1486, 1491 (E.D.N.Y. 1986); *Felder v. Great American Insurance Co.*, 260 F. Supp. 575, 577 (D.S.C. 1966); *Martin v. Fidelity & Casuality Co. of New York*, 421 So.2d 109, 111 (Ala. 1982); *Weil and Associates v. Urban Renewal Agency of Wichita*, 206 Kan. 405, 479 P.2d 875, 885 (Kan. 1971); *Broaden v. Doncea*, 340 Mich. 564, 66 N.W.2d 216, 219-20 (1954); *Spellman v. Columbia Manicure Manufacturing Co., Inc.*, 111 A.D.2d 320, 489 N.T.S.2d 304, 307 (2d Dep't. 1985);

205 *Weyman v. Wilson*, 320 F. Supp. 980, 989 (M.D. Fla. 1970); *Aston v. Chrysler Corp.*, 261 F. Supp. 1009, 1014 (E.D.N.Y. 1965); *Preston v. Sailer*, 225 N.J. Super. 178, 542 A.2d 7, 16 (N.J. Super. A.D. 1988); *Jacobs v. Seligman*, 63 So.2d 315 (Fla. 1953) (en banc); G.G. Bogert & G.L. Bogert, *The Law of trusts and trustees* § 471 (2d rev. ed. 1978).

206 *See* Wisconsin v. Reese (*In re* Kennedy & Cohen, Inc.), 612 F.2d 963, 965 (5th Cir. 1980), *cert. denied*, 449 U.S. 833 (1980); *In re* Faber's Inc., 360 F. Supp. 946, 948-50 (D. Conn. 1973).

207 G.L. Nicklaus v. Bank of Russellville, 336 F.2d 144, 146 (8th Cir. 1964). In *G.L. Nicklaus* a trustee sought the turnover of certain bonds. The Eighth Circuit refused to grant the turnover order. The court stated:

> In the case at bar appellant, as Trustee in Bankruptcy, does not state even a colorable claim as to his title or right to possession of the property here considered. It is apparent that the fraud, which he admits existed, was not perpetrated against his bankrupt; or by a person who received possession of property rightfully belonging to his bankrupt. Property obtained by fraud of the bankrupt, or by other tort, is not properly a part of the assets of a bankrupt's estate.

Id. at 147.

208 *See* Cunningham v. Brown, 265 U.S. 1 (1924); Heyman v. Kemp (*In re* Teltronics Ltd.), 649 F.2d 1236, 1240 (7th Cir. 1981).

209 265 U.S. 1.

Court ruled that in order for the claimants to recover, claimants had to trace the money they had invested.[210] The Court held that the claimants' failure to trace their funds mandated that their request for the imposition of a resulting trust be denied.[211]

The tracing requirement was an important requirement for establishing a constructive trust under the Act.[212] The tracing requirement was based on the concept of creditor equality.[213] The tracing requirement insured that a trust claimant did not receive a preference at the expense of other creditors.[214] Thus, the tracing requirement ensured that if a constructive trust was imposed the distributional provisions of the Act would remain unaltered.[215]

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210 *Id.* at 11.

211 *Id.* The Supreme Court stated:

> They had one of two remedies to make them whole. They could have followed the money wherever they could trace it and have asserted possession of it on the ground that there was a resulting trust in their favor, or they could have established a lien for what was due them in any particular fund of which he had made it a part. These things they could do without violating any statutory rule against preference in bankruptcy, because they then would have been endeavoring to get their own money, and not money in the estate of the bankrupt. But to succeed they must trace the money, and therein they have failed.

Id.

212 *See In re* Morales Travel Agency, 667 F.2d 1069 (1st Cir. 1981); Chicago Cutter-Karcher v. Maley (*In re* Lord's, Inc.), 356 F.2d 456 (7th Cir. 1965), *cert. denied*, 385 U.S. 847 (1966). In *Morales Travel Agency*, an airline petitioned to recover certain funds in the possession of the bankruptcy estate. The bankrupt was supposed to hold the proceeds from ticket sales in trust for the airline. The bankrupt's principal stockholder and his associates diverted the proceeds from some ticket sales. The airline contended that under the agreement and regulations governing ticket sales the bankrupt held the proceeds in trust. The First Circuit held that the airline was not entitled to recover the funds. *Id.* at 1071. The agreement between the airline and the bankrupt failed to require the debtor to separate the funds from ticket sales. *Id.* at 1073. The failure of the bankrupt to segregate the funds made tracing impossible. *Id.* Therefore, allowing the airline to prevail would have been contrary to the policies underlying the Bankruptcy Act. *Id.* at 1074.

213 Wisconsin v. Reese (*In re* Kennedy & Cohen, Inc.), 612 F.2d 963, 965-66 (5th Cir. 1980), *cert. denied*, 449 U.S. 833 (1980); *In re* Faber's, Inc., 360 F. Supp. 946, 949-50 (D. Conn. 1973); 4A J. MOORE, R. OGLEBAY, F. KENNEDY & L. KING, COLLIER ON BANKRUPTCY ¶ 70.25 (J. Moore 14th ed. 1978) [hereinafter R. OGLEBAY].

214 Toys "R" Us v. Esgro, Inc. (*In re* Esgro, Inc.), 645 F.2d 794, 797-98 (9th Cir. 1981); Lusk Corp. v. Arizona State Tax Comm'n, 462 F.2d 187, 189 (9th Cir. 1971).

215 United States v. Randall, 401 U.S. 513, 517 (1971); Elliott v. Bumb, 356 F.2d 749, 754-55 (9th Cir. 1966), *cert. denied*, 385 U.S. 829 (1966).

c. *Under the Bankruptcy Act Courts Were Adverse to Imposing or Enforcing Trusts*

i. Courts Were Adverse to Enforcing Statutory Trusts which Interfered with the Operation of the Distribution Provisions of the Bankruptcy Act

Under the Act courts were reluctant to impose or enforce purported statutory trusts.[216] In *United States v. Randall*[217], the debtor was a debtor in possession under Chapter XI. The debtor was ordered to segregate tax indebtedness and to make the appropriate disbursements from a special account opened for this purpose. Checks for withheld taxes were to be deposited in the tax account. Withdrawals from the tax account were to be permitted only for payment of welfare obligations and withheld taxes. The debtor failed to deposit the withheld social security and income taxes into the tax account. Further, the debtor did not pay the withheld monies to the United States. The debtor was subsequently adjudicated a bankrupt. The United States sought to be paid for the chapter 11 taxes prior to the payment of the costs of the bankruptcy proceedings.

The Supreme Court held that the United States was not entitled to the imposition of a constructive trust.[218] The Court reasoned that the Act determined creditor priority in a bankruptcy case.[219] Internal Revenue Code section 7501(a), which provided

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216 *See* United States v. Randall, 401 U.S. at 513; *Lord's, Inc.*, 356 F.2d at 456. In *Lord's, Inc.*, the Seventh Circuit was adverse to enforcing contractual provisions containing purported trust clauses. In that case, the Seventh Circuit denied creditor's reclamation petition to recover monies claimed as trust funds. Those funds accumulated from sales of creditor's products in the bankrupt's department store. The court reasoned that the mere insertion of the word "trust" was insufficient to transform a commercial agreement into a trust agreement. Further, other factors militated against the finding of a trust. No separate accounts were established for the proceeds of the sales of the creditor's products, and the bankrupt had unrestricted use of those funds.

217 401 U.S. 513 (1971). The holding of *United States v. Randall* was statutorily overruled by the Bankruptcy Code. *See* Begier v. I.R.S., 110 S. Ct. 2258 (1990). The discussion of *United States v. Randall* exemplifies the importance of the distribution provisions of the Bankruptcy Code and the historical disdain of the use of a trust to interfere with the operation of the distribution provisions of the Bankruptcy Code. Thus, courts interpreting the Bankruptcy Code have cited *United States v. Randall* for the proposition that courts should be adverse to imposing constructive trusts because a constructive trust interferes with the operation of the distribution provisions of the Bankruptcy Code. *See* American Hall Insurance Syndicate v. United States Lines, Inc. (*In re* United States Lines, Inc.), 79 Bankr. 542, 547-48 (Bankr. S.D.N.Y. 1987).

218 *Randall*, 401 U.S. at 517.

219 *Id.* at 515.

that withholding taxes should be held in a special trust for the United States, could not override the Act.[220] The Court also determined that the imposition of a constructive trust would have an adverse effect on the administration of bankruptcy estates.[221]

United States v. Randall reflected that the distributional provisions of the Act were important federal laws which should not be modified.[222] The priority provisions insured that creditors and professionals would have an incentive for participating in bankruptcy cases.[223] The imposition of a trust for postpetition withholding taxes would grant the federal government a preference and alter the distributional provisions in bankruptcy cases.[224]

ii. Courts were Adverse to Imposing Constructive Trusts which Interfered with the Operation of the Bankruptcy Act

Courts were also reluctant to impose constructive trusts because constructive trusts interfered with the operation of the Act.[225] A case which reflects the judicial hostility to the imposi-

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220 *Id.*

221 *Id.* at 517. The Court stated that "[w]e think the statutory policy of subordinating taxes to costs and expenses of administration would not be served by creating or enforcing trusts which eat up an estate, leaving little or nothing for creditors and court officers whose goods and services created the assets." *Id.*

222 *See id.*

223 *See id.*

224 *See id.* The enforcement of state statutory trusts was also disfavored because they interfered with the distributive provisions of the Bankruptcy Act. Lusk Corp. v. Arizona State Tax Comm'n, 462 F.2d 187, 189 (9th Cir. 1972); Elliott v. Bumb, 356 F.2d 749 (9th Cir. 1966), *cert. denied*, 385 U.S. 829 (1966).

225 *See In re* Faber's, Inc., 360 F. Supp. 946 (D. Conn. 1973). In *Faber's, Inc.*, the bankrupt operated a chain of carpet stores. Forty-five consumers who had given cash deposits for carpets which were never delivered filed a petition to have a constructive trust imposed on their deposits. The court declined to impose a constructive trust. *Id.* at 950. One of the bases of the court's opinion was that the imposition of a constructive trust would interfere with the distributive provisions of the Bankruptcy Act. *Id.* at 948-50. The court declared:

> There is in addition a serious difficult question of whether even duly promulgated state law can protect consumers in the situation presented in this case. The courts have consistently treated the distributional priorities created by the Bankruptcy Act as a paramount congressional policy which must predominate in the face of conflicting state or even federal law.

Id. at 948-49. The district court asserted that a constructive trust was a state-created priority which had to yield to the Bankruptcy Act because of the Supremacy Clause of the United States Constitution. *Id.* at 949 (citing U.S. CONST. art. VI.). The failure of state law to require a tracing requirement rendered state law ineffective in creating a priority which obstructed the operation of the distributive provisions of the Bankruptcy Act. *Id.* at 949-50.

tion of constructive trusts in bankruptcy cases under the Act is *Wisconsin v. Reese (In re Kennedy & Cohen, Inc.)*.[226] In *Kennedy & Cohen*, class actions were brought against the trustee of a bankrupt retailer of appliances. The bankrupt had accepted payment from many customers for service contracts, and as a result of the bankrupt's liquidation many of the contracts could not be performed. The plaintiffs alleged that the bankrupt was under an implied legal duty to segregate the deposits in order to insure that there would be funds to perform these contracts. There was no express trust created by contract or statute. The plaintiffs sought the imposition of a constructive trust upon all of the bankrupt's assets for the satisfaction of their claims.

The Fifth Circuit held that the plaintiffs were not entitled to the imposition of a constructive trust.[227] The court rejected the plaintiff's argument "that the sale of maintenance contracts, without more, creates a legal duty to segregate the funds received for that purpose and imposes a constructive trust upon them. I believe that it still remains a legislative and not a judicial prerogative to mandate such a duty."[228] The court also held that the plaintiffs' failure to trace their funds militated against the imposition of a constructive trust.[229] Finally, the Fifth Circuit indicated that it was adverse to imposing a constructive trust because doing so would thwart the distributional policies of the Act.[230]

In re Kennedy & Cohen is an important case for various reasons. First, it revealed that even though bankruptcy courts are courts of equity, they are loath to create substantive rights where none exist. The courts recognize that in a commercial relationship a mere breach of contract does not create the conditions necessary for the imposition of a constructive trust. While parties to the maintenance contracts in *Kennedy & Cohen* may have been denied the benefit of their bargains, other parties who dealt with the bankrupt were also deprived of the benefit of their bargains. The parties to the maintenance contracts were not entitled to any special treatment. Second, *Kennedy & Cohen* established that the imposition of a constructive trust interfered with the distributional provisions of the Act.

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226 612 F.2d 963 (5th Cir. 1980) (per curiam), *cert. denied*, 449 U.S. 833 (1980).
227 *Id.* at 964.
228 *Id.* at 965.
229 *Id.* at 966.
230 *Id.*

iii. Summary and Analysis

Under the Act, courts were averse to enforcing trusts. The imposition or enforcement of a trust in a bankruptcy case had an adverse impact on the distributional provisions of the Act and jeopardized the success of those cases. Courts were disinclined to use the concept of a constructive trust to create substantive rights.[231]

3. Constructive Trusts and the Bankruptcy Code

a. *Constructive Trusts are Recognized in Cases Governed by the Bankruptcy Code*

In cases governed by the Code, courts have continued to recognize the concept of a constructive trust.[232] In *Reliance Insurance Co. v. Brown*,[233] Reliance Insurance Company (Reliance) commenced an adversary proceeding to have a constructive trust imposed on certain funds held by the bankruptcy estate. The debtor was an insurance agent who had perpetrated a fraudulent insurance scheme. The debtor sold insurance policies involving fictitious insurance companies. Reliance was the reinsurer of the insurance brokerage company, of which the debtor was an employee, and allegedly responsible for fraudulent acts committed by the brokerage's employees. The district court affirmed the imposition of a constructive trust.[234] When a debtor holds property subject to a trust, the estate holds the trust property subject to the interest of the beneficiaries.[235] Constructive trusts are used to correct a situation where someone has been wrongfully deprived of his or her property.[236] The court held that the claim-

231 The *Faber's, Inc.* court stated that "the role of a federal court applying trust law in a bankruptcy proceeding is rigidly circumscribed: its only task is to determine the law of the state in which it sits. It cannot create new law, however great the need may seem." *Faber's, Inc.*, 360 F.Supp at 948.

232 *See* Yonkers Board of Educ. v. Richmond Children's Center, Inc., 58 Bankr. 980 (S.D.N.Y. 1986); Reliance Ins. Co. v. Brown, 40 Bankr. 214 (W.D. Mo. 1984); *In re* Crotts, 87 Bankr. 418 (Bankr. E.D. Va. 1988); Longhorn Oil & Gas Co. v. Fox & Holland (*In re* Longhorn Oil and Gas Co.), 64 Bankr. 263 (Bankr. S.D. Tex. 1986); *In re* American Int'l Airways, Inc., 44 Bankr. 143 (Bankr. E.D. Pa. 1984); Central Trust Co. v. Shepard (*In re* Shepard), 29 Bankr. 928 (Bankr. M.D. Fla. 1983); Havee v. Rodriguez (*In re* Rodriguez), 24 Bankr. 12 (Bankr. S.D. Fla. 1982); Climax Molybdenum Co. v. Specialized Installers, Inc. (*In re* Specialized Installers, Inc.), 12 Bankr. 546 (Bankr. D. Colo. 1981); Travelers Ins. Co. v. Angus (*In re* Angus), 9 Bankr. 769 (Bankr. D. Ore. 1981).

233 40 Bankr. 214 (W.D. Mo. 1984).

234 *Id.* at 218.

235 *Id.* at 217 (citation omitted).

236 *Id.* (citation omitted).

ants had been damaged by the debtor's scheme, and that was sufficient to warrant the imposition of a constructive trust.[237]

b. *Constructive Trust Claimant Must be Able to Trace Its Property or the Proceeds*

Under the Code, the courts still require that a trust claimant trace, or identify, the specific property or the proceeds of the property to which it is entitled.[238] A constructive trust claimant's failure to trace the property or its proceeds mandates that the claimant's claim be rejected.[239] In *Shifler v. First Fidelity Financial Services, Inc. (In re First Fidelity Financial Services, Inc.)*,[240] two investors brought adversary proceedings to have constructive trusts imposed on property of the estate. The two investors sought to purchase mortgages, and they delivered checks to the debtor. The debtor did not assign any mortgages to the plaintiffs. Further, the debtor did not hold the plaintiffs' funds in a trust account. The debtor had, in fact, failed to assign mortgages to numerous investors. There was testimony that several hundred people were in positions similar to that of the plaintiffs. Also, the debtor's financial records were in disarray.

The bankruptcy court ruled that the plaintiffs failed to satisfy

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237 The court remarked:

> It seems clear, however, that the claimants were damaged by [debtor]'s scheme, because the money obtained by [debtor] was not used for the intended purpose of procuring legitimate insurance coverage, rather, the insurance claimants were the victims of an illegal scheme which deprived them of the valid insurance protection they expected. As the [b]ankruptcy [c]ourt noted, [the debtor] knew that the claimants were relying on him to obtain insurance through legitimate insurance companies, and that the fictional E & S Agency never had reserves of more than $1,000,000, an amount grossly inadequate to support a legitimate insurance company. In addition, the [b]ankruptcy [c]ourt correctly recognized that unjust enrichment would result from the failure to impose the constructive trust because the priority claims of the IRS would be satisfied out of the funds remaining in the general estate before any of the other claims of the general creditors could be satisfied.

Id. at 218.

238 *See* Turley v. Mahan & Rowsey, Inc., (*In re* Mahan & Rowsey, Inc.), 62 Bankr. 46, 47-48 (W.D. Okla. 1986), *aff'd*, 817 F.2d 682 (10th Cir. 1987); Schifler v. First Fidelity Fin. Servs., Inc. (*In re* First Fidelity Fin. Servs., Inc.), 36 Bankr. 508, 511-12 (Bankr. S.D. Fla. 1983); Henderson v. Allied (*In re* Western World Funding, Inc.), 54 Bankr. 470, 475 (Bankr. D. Nev. 1985).

239 *See* Bistate Oil Co. v. Heston Oil Co. (*In re* Heston Oil Co.), 63 Bankr. 711, 715 (Bankr. N.D. Okla. 1986); Savoy Records, Inc. v. Trafalgar Assocs. (*In re* Trafalgar Assocs.), 53 Bankr. 693, 695-96 (Bankr. S.D.N.Y. 1985); R. D'AGOSTINO, *supra* note 77, at ¶ 541.13.

240 36 Bankr. 508 (Bankr. S.D. Fla. 1983).

the burden of proof for the imposition of a constructive trust.[241] The court noted that under state law there was a tracing requirement.[242] The court held that whether a constructive trust could attach to the general assets of an estate was a matter of federal law in cases where tracing the specific property is difficult.[243] There was an established policy of not allowing a constructive trust to be imposed on the general assets of an estate because the imposition of a constructive trust would have the effect of rearranging the bankruptcy distribution scheme.[244] The plaintiffs in the case at bar were unable to trace their funds; therefore, the relief sought was denied.[245]

c. *Courts are Reluctant to Inpose Constructive Trusts Because the Imposition of a Constructive Trust Interferes with the Distributional Provisions of the Bankruptcy Code*

Under the Code, courts have been reluctant to impose constructive trusts because the imposition of a constructive trust interferes with the distributional policies of the Code.[246] In

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241 *Id.* at 514-15.

242 *Id.* at 511. The *First Fidelity* court stated:

> The reason for imposing a constructive trust is to avoid unjust enrichment to the recipient of the windfall, and to do equity for the party whose property has been misused. But a desire to do equity alone is not enough. The essence of the equitable remedy of imposing a constructive trust, as opposed to the legal remedy of damages, is the concept that the very property in question can be returned to the rightful owner. The law gradually broadened so that proceeds of the original property may be pursued, but the basic requirement of tracing the original property, albeit in its various forms, remains an element of proof for constructive trusts.

Id. (citation omitted).

243 *Id.* at 512.

244 *Id.* at 513.

245 *Id.* at 509. The court stated:

> Unfortunately for plaintiffs, not every wrong can be righted by a remedy in equity. If a wrongdoer dissipates the assets of another, no constructive trust can be imposed because there is no property on which to impose the trust. This court, in effect, concludes that plaintiffs have not proven that their property was *not* dissipated and have failed to carry their burden of proving all the elements of a constructive trust.

Id. at 514-15 (emphasis in original).

246 Neochem Corp. v. Behring Int'l, Inc. (*In re* Behring Int'l, Inc.), 61 Bankr. 896, 902 (Bankr. N.D. Tex. 1986). The Ninth Circuit has stated:

> A constructive trust is not the same kind of interest in property as a joint tenancy or a remainder. It is a remedy, flexibly fashioned in equity to provide relief where a balancing of interests in the context of a particular case seems to call for it. Moreover, in the case presented here it is an inchoate remedy; we are not dealing with property that a

National Bank of Alaska, N.A. v. Seaway Express Corp. (In re Seaway Express Corp.),[247] National Bank of Alaska, N.A. (National Bank) extended credit to the debtor for which National Bank received a perfected security in the debtor's accounts receivables and inventory. The debtor subsequently brought an action in state court to recover overdue accounts, and as part of a settlement agreement it received title to a real estate parcel in Auburn, Washington (the property). The debtor failed to execute a deed of trust on behalf of National Bank. Thereafter, the debtor filed for chapter 11, and the property was sold free and clear of all encumbrances and liens. The case was converted to chapter 7, and the trustee sought a determination that National Bank possessed no valid interest in the proceeds of the sale of the property. The Ninth Circuit Bankruptcy Appellate Panel held that National Bank had an unrecorded interest in real property which the trustee could avoid under section 544(a)(3).[248] *Seaway Express* is significant, insofar as it directs a court to balance the equities in order to "recall the trenchant policy encouraging ratable distribution among those with claims against the estate."[249]

d. *A Mere Breach of Contract or Unpaid Obligation is Inadequate to Merit the Imposition of a Constructive Trust*

Under the Code, as in nonbankruptcy proceedings[250], a mere breach of contract is insufficient to warrant the imposition of a constructive trust.[251] In so holding, one court reasoned that a debtor's avoiding part of an obligation to creditors is a necessary result in all successful bankruptcy proceedings.[252] In *In re*

> state court decree has in the past placed under a constructive trust. We necessarily act very cautiously in exercising such a relatively undefined equitable power in favor of one group of potential creditors at the expense of other creditors, for ratable distribution among all creditors is one of the strongest policies behind the bankruptcy laws.

Torres, M.D., P.C. v. Eastlick (*In re* North Am. Coin & Currency, Ltd.), 767 F.2d 1573, 1575 (9th Cir. 1985), *cert. denied*, 475 U.S. 1083 (1986) (citations omitted).

247 105 Bankr. 28 (Bankr. 9th Cir. 1989), *aff'd*, 912 F.2d 1125 (9th Cir. 1990).

248 *Id.* at 32.

249 *Id.* at 31 (citation omitted).

250 *See supra* note 198 and accompanying text.

251 *See* Turner v. Emmons & Wilson, Inc. (*In re* Minton Group, Inc.), 28 Bankr. 774, 784 (Bankr. S.D.N.Y. 1985); Gorman v. Florida Wholesale Carpet, Inc. (*In re* Listle/Shreeves Corp.), 20 Bankr. 421, 423 (Bankr. M.D. Fla. 1982); Albritton v. Albritton (*In re* Albritton), 17 Bankr. 555, 557 (Bankr. M.D. Fla. 1982); Williams v. Taylor (*In re* Taylor), 8 Bankr. 806, 810 (Bankr. D.D.C. 1981).

252 Morris v. Philadelphia Elec. Co., 45 Bankr. 350, 353 (E.D. Pa. 1984). *See also* Thunderbird Motor Freight Lines, Inc. v. Penn-Dixie Steel Corp. (*In re* Penn-Dixie

Penn-Dixie Steel Corp.[253] Thunderbird Motor Freight Lines, Inc. ("Thunderbird") entered into a contract with the debtor to ship steel at the Interstate Commerce Commission tariff rates. The debtor failed to pay Thunderbird. Chief Judge Lifland ruled that Thunderbird was not entitled to the imposition of a constructive trust.[254] The court declared:

> Applying hindsight, the largess of credit to Penn-Dixie proved a poor choice given the unanticipated intervening insolvency proceeding. There is now no equitable or other ground upon which Thunderbird can increase its status beyond that of an ordinary, general, unsecured creditor. To impress a constructive trust, there must be at a wrongdoing greater than the nonpayment of a debt. The highest court of the land has so indicated.[255]

IV. AFFIRMATIVE DEFENSE OF CONSTRUCTIVE TRUST IS IMPERMISSIBLE UNDER SECTION 544(a)

A. Introduction

There are several legal and policy arguments why a trustee should be immune from the affirmative defense of a constructive trust when using section 544(a) to avoid an unperfected security interest in personal property or unrecorded interest in real property. First, the historical development of and policy underlying section 544(a) reflect the policy that the trustee was to be immune from equitable affirmative defenses.[256] Further, the bankruptcy laws' tradition of combatting the problem of ostensible ownership also dictates that section 544(a) should be allowed to prevail over the allegation of a constructive trust.[257] Statutory construction is another reason why a constructive trust should not defeat the section 544(a).[258] When a trustee uses section

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Steel Corp.), 6 Bankr. 817 (Bankr. S.D.N.Y. 1980), *aff'd*, 10 Bankr. 878 (S.D.N.Y. 1981). In *Thunderbird* Judge Lifland noted that "to impress a constructive trust, there must be at least a wrongdoing greater than the nonpayment of a debt." *Id.* at 825.

253 6 Bankr. 617 (Bankr. S.D.N.Y. 1980) *aff'd*, 10 Bankr. 878 (S.D.N.Y. 1981).

254 *Id.* at 824-25.

255 *Id.* at 825.

256 R. D'AGOSTINO, *supra* note 77, at ¶ 544.02; P. MURPHY, *supra* note 128, at § 12.01.

257 The threat of a trustee using section 544(a) to avoid unperfected security interests or unrecorded interests in real property compels individuals to comply with applicable filing and recording statutes. J. WHITE & R. SUMMERS, *supra* note 129, at §§ 23-2 & 23-3. Therefore, the strict enforcement of section 544(a) combats the problem of ostensible ownership. *See supra* notes 127-29 and accompanying text.

258 *See infra* notes 315-38 and accompanying text.

544(a), the requirements for a constructive trust are not satisfied; therefore, a constructive trust should not be impressed.[259] Finally, when an entity fails to perfect a security interest in either personal or real property, the imposition of a constructive trust is an incorrect result under the state filing and recording statutes.[260]

B. *Under State Law a Trustee Employing Bankruptcy Code Section 544(a) Should Prevail Over a Creditor with an Unperfected Security Interest in Personal or Real Property*

1. Under Article Nine of the Uniform Commercial Code a Trustee Using Bankruptcy Code Section 544(a) Should Defeat a Defrauded Creditor with an Unperfected Security Interest in Personal Property

a. *Introduction to the Uniform Commercial Code and Article Nine*

The enactment of the Uniform Commercial Code (U.C.C.) is one of the great achievements in commercial law.[261] The U.C.C. was drafted to achieve various goals.[262] One of the goals of the U.C.C. is to clarify, simplify, and modernize commercial law.[263] Another purpose of the U.C.C. is to meet the changing needs of business.[264] The U.C.C. is also intended to replace the conflicting state laws with a commercial law which is uniform and predictable.[265]

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259 One of the requirements for imposing a constructive trust is establishing unjust enrichment. It is difficult to establish unjust enrichment in a bankruptcy case because the best interests test and absolute priority rule mandate that the creditors be paid prior to a debtor retaining an interest in property.

260 Under the U.C.C., a creditor with an unperfected security interest is subordinate to a judgment creditor. U.C.C. § 9-301(1)(b) (1987). Moreover, a bona fide purchaser prevails over an individual with an unrecorded interest in real property. Therefore, the imposition of a constructive trust to save an unperfected security interest or unrecorded interest in real property is incorrect under state law.

261 *See* J. WHITE & R. SUMMERS, *supra* note 129, at § 1.

262 *See* U.C.C. § 1-102(2) (1987).

263 U.C.C. § 1-102(2)(a) (1987). *See* A.M. Knitwear Corp. v. All America Export-Import Corp., 41 N.Y.2d 14, 21, 390 N.Y.S.2d 832, 837, 359 N.E.2d 342, 347 (1976); 1 R. ANDERSON, ANDERSON ON THE UNIFORM COMMERCIAL CODE § 1-102:45 (3d ed. 1981).

264 U.C.C. § 1-102(2)(b) (1987). *See* Richmond Fixture & Equip. Co. v. Hyman (*In re* Southern Properties, Inc.), 44 Bankr. 838, 843 (Bankr. E.D. Va. 1984); Arcuri v. Weiss, 198 Pa. Super. 506, 510, 184 A.2d 24, 26 (Pa. Super. Ct. 1962).

265 U.C.C. § 1-102(2)(c) (1987). *See* Cleveland Lumber Co. v. Proctor & Schwartz, Inc., 397 F. Supp. 1088, 1092 (N.D. Ga. 1975); Community Bank v. Jones, 278 Or. 647, 566 P.2d 470, 482 (1977).

Prior to the enactment of Article Nine of the U.C.C., there were different types of security devices for personal property.[266] The different methods of effectuating secured transactions made secured financing perilous.[267] Article Nine of the U.C.C. was enacted to simplify and consolidate the different methods of perfecting security interests in personal property.[268] Article Nine is intended to govern all transactions in which the parties intend to create a security interest in personal property.[269]

b. *Attachment of a Security Interest*

Attachment of a security interest is a prerequisite to perfecting a security interest. Attachment of a security interest enables a creditor to prevail against the debtor.[270] Attachment of a security interest occurs when the debtor has executed a security agreement that contains a description of the collateral, value has been given, and the debtor has rights in the collateral.[271] Unless a debtor has rights in the collateral, a security interest cannot attach.[272] Article Two of the U.C.C. governs whether a debtor has rights in the collateral. Title to goods customarily passes to the buyer upon delivery.[273]

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266 *See* R. ANDERSON, *supra* note 255, at § 9-101:1; Storke, *Introduction to Security*, 16 ROCKY MTN. L. REV. 27 (1944).

267 Gilmore, *The Purchase Money Priority*, 76 HARV. L. REV. 1333, 1335 (1963); Cuevas, *Lost Compensation Costs and the Undersecured Creditor: A Journey into the Inwood Forest*, 33 N.Y. L. SCH. L. REV. 1, 4 (1988).

268 *See generally* B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 1.2[1] (1980) (scope of Article Nine); 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 288-306 (1965).

269 U.C.C. § 9-102 comment (1987). *See generally* Citi-Lease Co. v. Entertainment Family Style, Inc., 825 F.2d 1497, 1499 (11th Cir. 1987); Southern Rock, Inc. v. B & B Auto Supply, 711 F.2d 683, 685 (5th Cir. 1983) (courts applying Article Nine to security interests in personal property).

270 *See* U.C.C. §§ 9-201, 9-203(2).

271 U.C.C. § 9-203(1) (1987); First Md. LeaseCorp. v. The M/V Golden Egert, 764 F.2d 749, 751 (11th Cir. 1985); Bulger v. Thorp Credit Inc. of Ill., 609 F.2d 1255, 1257 (7th Cir. 1979); *In re* Modafferi, 45 Bankr. 370, 371 (Bankr. S.D.N.Y. 1985).

272 Northwestern Bank v. First Virginia Bank of Damascus, 585 F. Supp. 425, 428-29 (W.D. Va. 1984); *In re* Sunshine Books, Ltd., 41 Bankr. 712, 715 (Bankr. E.D. Pa. 1984); Saturn Automotive v. Grant (*In re* Motorcycle Dealers Supply, Inc.), 9 Bankr. 333, 334 (Bankr. M.D. Fla. 1981).

273 *See* R. HENSON, SECURED TRANSACTIONS § 4-2 (2d ed. 1979); U.C.C. § 2-401(2) (1987); Northwestern Flyers, Inc. v. Olson Brothers Mfg. Co., 679 F.2d 1264, 1270 (8th Cir. 1982); Huskinson v. Vanderheiden, 197 Neb. 739, 251 N.W.2d 144, 147 (1977); Bank of N.Y. v. Margiotta, 99 Misc.2d 423, 425, 416 N.Y.S.2d 493, 494 (Dist. Ct. Suffolk Cty., First District 1979).

c. *Perfection of a Security Interest*

Perfection of a security interest is important because a perfected security interest is invulnerable to a bankruptcy trustee's attack as a hypothetical lien creditor.[274] The most common methods of perfection are by the creditor taking possession of the collateral or by filing a financing statement.[275] A financing statement is a document that is filed with either a state or local recording officer.[276] U.C.C. section 9-401(2) provides a safe harbor for certain filings that were made in good faith but fail to comply with U.C.C. section 9-401(1).[277] A financing statement which substantially complies with U.C.C. section 9-402(8) is valid, even though it may contain minor errors.[278] A fundamental policy of Article Nine is to discourage secret liens and to give notice to creditors of security interests in personal property.[279]

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274 *See* Forbes v. Daniels (*In re* Daniels), 93 Bankr. 601, 603 (Bankr. M.D. Tenn. 1988); J. WHITE & R. SUMMERS, *supra* note 129, at § 22-7.

275 *See* U.C.C. §§ 9-305, 9-401 (1987).

276 U.C.C. § 9-402(1) (1987). The purpose of a financing statement is to provide other creditors with information concerning the secured transaction. T. QUINN, UNIFORM COMMERCIAL CODE COMMENTARY AND LAW DIGEST ¶ 9-402[A][1] (1978). The following remarks have been made regarding the Article Nine filing system:

> Various courts have recognized that pursuant to . . . filing provisions termed "notice filing," the financing statement is not intended to enable other creditors to learn the "true nature" of the secured transaction. The purpose of the notice provision is merely to apprise other creditors that others may have a security interest in the subject collateral and that creditors should resort to the security agreement for further information.

In re Bob Schwermer & Assocs., Inc., 27 Bankr. 304, 309 (Bankr. N.D. Ill. 1983) (citations omitted); *see* Maremont Mktg. v. Centennial Indus., Inc. (*In re* Centennial Indus., Inc.), 3 Bankr. 416, 417-18 (Bankr. S.D.N.Y. 1980); Coogan, *Public Notice Under the Uniform Commercial Code and Other Recent Chattel Security Laws, Including "Notice Filing"*, 47 IOWA L. REV. 289, 317-19 (1962).

277 U.C.C. § 9-401(2) (1987).

278 U.C.C. § 9-402(8) 1987). *See also In re* Simpson Motor Co., 101 Bankr. 813 (Bankr. N.D. Ga. 1989); *In re* Pretzer, 100 Bankr. 879 (Bankr. N.D. Ohio 1989); Armstrong v. United States (*In re* Nelson), 45 Bankr. 443 (Bankr. D.N.D. 1984). U.C.C. § 9-402(8) is consistent with the policy of notice filing because as long as the financing statement substantially complies with U.C.C. § 9-402(8) and is not deceptive, the financing statement is effective.

279 *See In re* Cushman Bakery, 526 F.2d 23, 28-29 (1st Cir. 1975), *cert. denied*, 425 U.S. 937 (1976); Thico Plan, Inc. v. Maplewood Poultry Co. (*In re* Maplewood Poultry Co.), 2 Bankr. 550, 555 (Bankr. D. Me. 1980); R. ANDERSON, *supra* note 255, at § 9-401:5; Baird, *supra*, note 125, at 54; Baird & Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175, 176 (1983).

d. *A Judgment Creditor Defeats a Creditor with an Unperfected Security Interest*

A creditor with an unperfected security interest will prevail over the debtor.[280] But a creditor with an unperfected security interest is subordinate to a judgment creditor.[281] A trustee using section 544(a)(1) prevails over a creditor holding an unperfected security interest.[282]

e. *A Court May Not Resort to Employing Equity to Avoid Enforcing the Article Nine Filing Requirements*

U.C.C. section 1-103 governs the use of equity in cases controlled by the U.C.C.[283] A court may not use equity to override a particular section of the U.C.C.[284] Courts have been reluctant to employ U.C.C. section 1-103 to disregard explicit sections of Article Nine.[285] In *Uniroyal, Inc. v. Universal Tire & Auto Supply Co.*,[286]

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280 *See* Vintero Corp. v. Corporation Venezolana de Fomento (*In re* Vintero Corp.), 735 F.2d 740, 742 (2d Cir. 1984), *cert. denied*, 469 U.S. 1087, (1984); B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 3.2[2] (2d ed. 1988).

281 U.C.C. § 9-301(1)(b) (1987); Rock Hill Nat'l Bank v. York Chem. Indus., Inc. (*In re* York Chem. Indus., Inc.), 30 Bankr. 583, 586 (Bankr. D.S.C. 1983); *In re* Karachi Cab Corp., 21 Bankr. 822, 825 (Bankr. S.D.N.Y. 1982).

282 *See* Boatmen's Bank of Benton v. Wiggs (*In re* Wiggs), 87 Bankr. 57, 59 (Bankr. S.D. Ill. 1988); I.A. Durbin, Inc. v. Jefferson Nat'l Bank (*In re* I.A. Durbin, Inc.), 46 Bankr. 595, 602 (Bankr. S.D. Fla. 1985); Brent Explorations, Inc. v. Karst Enters., Inc. (*In re* Brent Explorations, Inc.), 31 Bankr. 745, 747 (Bankr. D. Colo. 1983).

283 U.C.C. Section 1-103 states:

> Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

U.C.C. § 1-103 (1987); *see also* T. QUINN, *supra*, note 268, at 1-103[A].

284 *See* Arcon Const. Co. v. S.D. Clement Plant, 349 N.W.2d 407, 412 (S.D. 1984) ("In other words, general principles of law may only supplement the U.C.C. to the extent they are not displaced; they will not be applied where they conflict with particular provisions of the U.C.C."); First Nat'l Bank of Blooming Prairie v. Olson, 403 N.W.2d 661, 666 (Minn. Ct. App. 1987); Farmers Livestock Exch. v. Ulmer, 393 N.W.2d 65, 70 (N.D. 1986); Palmer v. Idaho Peterbilt, Inc., 102 Idaho 800, 801-02, 641 P.2d 346, 347-48 (Idaho Ct. App. 1982); Kelly v. Miller, 575 P.2d 1221, 1224 (Alaska 1978); Central Nat'l Bank & Trust Co. of Enid v. Community Bank & Trust of Enid, 528 P.2d 710, 713 (Okla. 1974); National Shawmut Bank of Boston v. Vera, 352 Mass. 11, 16, 223 N.E.2d 515, 518 (1967).

285 *See In re* California Pump & Mfg. Co., 588 F.2d 717 (9th Cir. 1978); Uniroyal, Inc. v. Universal Tire & Auto Supply Co., 557 F.2d 22 (1st Cir. 1977); *In re* Pacific Trencher & Equip., Inc., 27 Bankr. 167 (Bankr. 9th Cir. 1983), *aff'd*, 735 F.2d 362 (9th Cir. 1984).

286 557 F.2d 22 (1st Cir. 1977).

the issue before the First Circuit was whether Uniroyal, Inc. (Uniroyal) had a perfected security interest. Uniroyal had filed a financing statement with the Secretary of the Commonwealth of Massachusetts and with the Clerk of the City of Boston. The debtor's sole place of business was the neighboring town of Brookline, Massachusetts.

The court held that Uniroyal was not entitled to the relief sought.[287] The court reasoned that the Article Nine filing requirements were clear and that Uniroyal had failed to comply with them.[288] The First Circuit's opinion reflects the policy that the U.C.C. was intended to facilitate commercial transactions by insuring predictability.[289] If the court had granted Uniroyal relief, it would have ignored not only the explicit language and policies of the filing statutes, but also the policies underlying the U.C.C.

The application of equity to rectify a creditor's noncompliance with the Article Nine perfection requirements is incorrect.[290] Article Nine explicitly sets forth the procedures for perfecting a security interest.[291] U.C.C. section 1-103 expressly prohibits a court from employing equity when a specific section of the U.C.C. governs a particular issue.[292] Therefore, under the U.C.C. a court may not use equity to transform an unperfected security interest into a perfected security interest.[293] The argu-

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287 *Id.* at 23.

288 *Id.* The *Uniroyal* court found no persuasive equitable arguments, stating:

> Uniroyal had come up with no workable rationale for judicial balancing of equities here, and that precedent either explicitly or implicitly rejects that approach to enforcing the Code. Efforts by courts to fashion equitable solutions to mitigate hardship on particular creditors of literal application of statutory filing requirements would have the deleterious effect of undermining the reliance which can be placed on them. The harm would be more serious than the occasional harshness resulting from strict enforcement.

Id. (citations omitted).

289 A creditor should be able to search the filing system to ascertain whether there are perfected security interests.

290 *In re* Pacific Trencher & Equip. Inc., 27 Bankr. 167 (Bankr. 9th Cir. 1983), *aff'd*, 735 F.2d 362 (9th Cir. 1984).

291 J. WHITE & R. SUMMERS, *supra*, note 129, at §§ 22-7 & 22-36.

292 U.C.C. § 1-103 (1987). *See* Johnston & Murphy Shoes, Inc. v. Meinhard Commercial Corp. (*In re* Mel Golde Shoes, Inc.), 403 F.2d 658, 660 (6th Cir. 1968); *In re* Barton, 37 Bankr. 545, 547 (Bankr. E.D. Wash. 1984); Weiner v. American Petrofina Mktg., Inc., 482 So.2d 1362, 1364 (Fla. 1986).

293 *In re* California Pump & Mfg. Co., 588 F.2d 717 (9th Cir. 1978); Uniroyal, Inc. v. Universal Tire & Auto Supply Co., 557 F.2d 22 (1st Cir. 1977). The flaw with the Second Circuit's opinion in Sanyo Elec., Inc. v. Howard's Appliance Corp. (*In re* Howard's Appliance Corp.), 874 F.2d 88 (2d Cir. 1989) is that it ignored the policy

ment that equity should not be employed to correct a creditor's failure to observe the perfection requirements of Article Nine is buttressed by the rule that it is the creditor's duty to see that it has perfected its security interest.[294] Article Nine places a duty on a creditor to make sure that its interest is perfected.[295] A creditor is usually in the best position to comply with the Article Nine filing requirements.[296] The placement of the burden of perfecting a security interest is based on the policy of preventing ostensible ownership.[297] Article Nine places the responsibility on the creditor to notify the world of its interest in the collateral.[298] The recognition of constructive trusts is contrary to the policy of combatting ostensible ownership, and therefore, courts are strongly against granting a creditor secured status when it has

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and language underlying Article Nine. Further, to exacerbate the situation the Second Circuit used equity when it was contrary to the clear language and policy of U.C.C. § 1-103.

294 *See* Aoki v. Shepherd Mach. Co. (*In re* J.A. Thompson & Son), 665 F.2d 941, 950 (9th Cir. 1982) ("It has long been the rule that creditors have a duty to acquaint themselves with the facts necessary to enable them to file in accordance with commercial codes."); General Elec. Credit Corp. v. Narduli & Sons (*In re* Nardulli & Sons), 66 Bankr. 871, 876 (Bankr. W.D. Pa. 1986) ("A secured creditor is under a continuing duty to keep advised of the location of the debtor's place of business to maintain perfection of its security agreements."); Associates Commercial Corp. v. Trim-Lean Meat Prods., Inc. (*In re* Trim-Lean Meat Prods., Inc.), 5 Bankr. 190, 191 (Bankr. D. Del. 1980), *aff'd*, 10 Bankr. 333 (D. Del. 1981) ("A secured party has the primary responsibility for seeing to perfection of its security interest."). Therefore, if a creditor fails to adhere to the perfection requirements of Article Nine the security interest will be deemed unperfected. *E.g.*, *In re* Sterling Wood Prods., Inc., 34 Bankr. 183 (Bankr. E.D.N.Y. 1983); *In re* Leymore Indus., Inc., 2 Bankr. 229 (Bankr. S.D.N.Y. 1980).

295 For example, U.C.C. section 9-103(1)(d) places a duty on the creditor to monitor its collateral. If the collateral is transported into another jurisdiction then a creditor has four months to perfect its security interest. U.C.C. § 9-103(1)(d) (1987). If a creditor fails to perfect its security interest within the four month period then it loses its secured status. *E.g.*, Zimmerman v. Continental Bank (*In re* Foland & Co.), 55 Bankr. 593 (Bankr. E.D. Pa. 1985); Williams v. Weems (*In re* Ken Gardner Ford Sales, Inc.), 41 Bankr. 105 (Bankr. E.D. Tenn. 1984); Borg-Warner Acceptance Corp. v. Twelves (*In re* Utah Agricorp, Inc.), 12 Bankr. 573 (Bankr. D. Utah 1981).

296 *Trim-Lean Meat Products, Inc.*, 5 Bankr. at 191-92; *In re* Flynn, 6 U.C.C. Rptr. 1119, 1121-22 (E.D. Mich. 1969).

297 National Bank of Texas v. West Texas Wholesale Supply Co., (*In re* McBee), 714 F.2d 1316, 1321 (5th Cir. 1983); Brushwood v. Citizens Bank of Perry, (*In re* Glasco, Inc.), 642 F.2d 793, 795 (5th Cir. 1981); Connecticut Bank & Trust Co. v. Schindelman (*In re* Bosson), 432 F. Supp. 1013, 1017 (D. Conn. 1977). *See also supra* note 127-29 and accompanying text.

298 Article Nine places the onus on the creditor to file an accurate financing statement with the correct filing officer. *See* U.C.C. §§ 9-401, 9-402 (1987). A creditor searching the records is relying upon the validity of the filing statement.

failed to comply with Article Nine.[299]

Strict enforcement of Article Nine insures not only that state law will be enforced, but also the policy of combatting ostensible ownership underlying Article Nine and Code section 544(a) will be effectuated. The imposition of a constructive trust for the breach of a security agreement is in essence giving effect to a secret lien.[300] Deviation from strict enforcement of Article Nine would mean that creditors will not be able to rely upon the filing systems; therefore, the U.C.C. policy of attempting to bring predictability to commercial transactions would be undermined.[301]

f. *Under State Law a Trustee Using Banckruptcy Code Section 544(a)(1) Prevails over a Creditor Seeking to Impose a Constructive Trust*

Section 544(a)(1) grants a trustee the status of a hypothetical lien creditor without notice.[302] Under section 544(a)(1), none of the debtor's prepetition malfeasance or knowledge may be imputed to the trustee.[303] U.C.C. section 9-103(1)(b) provides that a lien creditor has priority over an entity with an unperfected security interest.[304] Consequently, under state law, a trustee prevails over a creditor with an unperfected security interest.[305]

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299 *See* Selby v. England (*In re* California Pump & Mfg. Co.), 588 F.2d 717 (9th Cir. 1978); Uniroyal, Inc. v. Universal Tire & Auto Supply Co., 557 F.2d 22 (1st Cir. 1977).

300 A constructive trust is an inchoate remedy which does not come into existence until a court has impressed a constructive trust on the debtor's property. Chbat v. Tleel (*In re* Tleel), 876 F.2d 769, 771 (9th Cir. 1989). Thus, a constructive trust acts as a secret lien on the debtor's property.

301 Strict adherence to the Article Nine filing requirements allows creditors to rely on the filing system because strict adherence compels creditors to file. Departure from the strict filing requirements would defeat the purpose of the Article Nine filing system. *Uniroyal, Inc.*, 557 F.2d at 23; Koehring Co. v. Nolden (*In re* Pacific Trencher & Equip., Inc.), 27 Bankr. 167, 170-17 (Bankr. 9th Cir. 1983), *aff'd*, 735 F.2d 362 (9th Cir. 1984).

302 11 U.S.C. § 544(a)(1). *See, e.g.* Advanced Aviation, Inc. v. Vann (*In re* Advanced Aviation, Inc.), 101 Bankr. 310, 312 (Bankr. M.D. Fla. 1989); Faircloth v. Paul (*In re* International Gold Bullion Exch., Inc.), 60 Bankr. 256, 260 (Bankr. S.D. Fla. 1986);D. COWANS, *supra* note 189, at § 10.4. *See supra* note 148.

303 Pirsig Farms, Inc. v. John Deere (*In re* Pirsig Farms, Inc.), 46 Bankr. 237, 242 (D. Minn. 1985); Boatmen's Bank of Benton v. Wiggs (*In re* Wiggs), 87 Bankr. 57, 58 (Bankr. S.D. Ill. 1988); I.A. Durbin, Inc. v. Jefferson Nat'l Bank (*In re* I.A. Durbin, Inc.), 46 Bankr. 595, 602 (Bankr. S.D. Fla. 1985); Kaye v. Williams (*In re* Munzenreider Corp., 34 Bankr. 82, 84-85 (Bankr. M.D. Fla. 1983). *See supra* note 150.

304 *See* Rock Hill Nat'l Bank v. York Chem. Indus., Inc. (*In re* York Chem. Indus., Inc.), 30 Bankr. 583, 586 (Bankr. D.S.C. 1983); R. ANDERSON, *supra*, note 255, at § 9-301:30.

305 *See* Underwood v. Kensington Mortgage & Fin. Co. (*In re* Tuders), 77 Bankr.

The recognition of a trustee's status as a hypothetical lien creditor is essential to the successful operation of a bankruptcy case.[306] One of the purposes of a bankruptcy case is to enforce the claims against the debtor's assets in a single proceeding.[307] A trustee has the duty to marshall and examine the debtor's assets.[308] A trustee's status as a hypothetical lien creditor allows a trustee to avoid unperfected security interests in personal property.[309] A trustee is a representative and fiduciary of the unsecured creditors.[310] Under state law any pre-petition misconduct committed by the debtor is not imputed to the unsecured creditors.[311] A trustee's status as a hypothetical lien creditor assures unsecured creditors that unperfected liens will be treated consistently under nonbankruptcy and bankruptcy law.[312] Therefore, creditors will not be adverse to participating in bankruptcy cases because they know that the results under

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904, 907 (Bankr. N.D. Ala. 1987); Howison v. Rockport Nat'l Bank (*In re* Crowley), 42 Bankr. 603, 605 (Bankr. D. Me. 1984); Brent Explorations, Inc. v. Karst Enters., Inc. (*In re* Brent Explorations, Inc.), 31 Bankr. 745, 747-49 (Bankr. D. Colo. 1983).

306 One commentator stated:

> The general approach of [s]ection 544 is the same as [s]ections 70c and 70e of the Bankruptcy Act. The intent of Congress to substitute a single creditor representative, the trustee, for multiple creditor efforts would not be particularly satisfactory if in so doing, creditors have less remedies available than they would have outside of bankruptcy. The policy of equal treatment of creditors is thwarted if pre-filing transfers are left intact. The bankruptcy law does a certain amount of reversing of prefiling transfers. The non-bankruptcy law has a fair amount of complexity as to what transfers may be set aside including procedural prerequisites. Section 544 gives the trustee the non-bankruptcy creditor rights and deems certain procedural prerequisites to invalidation to have been taken.

D. COWANS, *supra* note 188, at § 10.4, 104-105.

307 *See In re* American Reserve Corp., 840 F.2d 487, 489 (7th Cir. 1988); T. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7-25 (1986).

308 11 U.S.C. §§ 704(1), 1106(a)(3) (1988).

309 11 U.S.C. § 544(a)(1) (1988). *See* Agritrade Corp. v. General Coffee Corp. (*In re* General Coffee Corp.), 32 Bankr. 23, 24-25 (Bankr. S.D. Fla. 1983) (citations omitted); ; R. ROSENBERG & M. LUREY, COLLIER LENDING INSTITUTIONS AND THE BANKRUPTCY CODE ¶ 3.07[1][a] (1986).

310 Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 356 (1985); Ford Motor Credit Co. v. Weaver, 680 F.2d 451, 462 n.8 (6th Cir. 1982), *reh'd denied, reh'g en banc denied* (Aug. 18, 1982); M BIENENSTOCK, *supra*, note 3, at 72-73.

311 Usually creditors and debtors are deemed separate entities, and the debtor's knowledge and malfeasance will not be imputed to the unsecured creditors. In the absence of a creditor having knowledge of a improperly filed financing statement, an improperly filed financing statement is ineffective. U.C.C. § 9-401(2) (1987).

312 If the unsecured creditor obtains a judgment, then he has priority over a creditor with an unperfected security interest. *See* U.C.C. § 9-301(1)(b) (1987). Section 544(a)(1) insures that a creditor with an unperfected security interest will be

state commercial law and federal bankruptcy law systems will be consistent.[313]

2. Under the State Recording Statutes a Trustee Employing Bankruptcy Code Section 544(a)(3) Should Prevail over a Creditor Who Has Failed to Record Its Interest and Is Claiming a Constructive Trust

a. *Introduction*

The object of the state recording statutes is to notify third parties of outstanding interests in real property.[314] In order for a party to be protected by a recording statute it must record its interest.[315] A party's failure to comply with a recording statute renders the party's interest susceptible to defeat by a bona fide purchaser.[316]

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treated uniformly because a trustee as a hypothetical lien creditor will be able to avoid unperfected security interests.

313 *See* Butner v. United States, 440 U.S. 48, 54-55 (1979); Lewis v. Manufacturers Nat'l Bank of Detroit, 364 U.S. 603, 609 (1961). Creditors will not be adverse to participating in bankruptcy cases because a trustee will be able to avoid unperfected security interests, preferences and fraudulent conveyances in creating an estate. The ability to avoid unperfected security interests is also important in terms of preference analysis because an important element of a preference problem is demonstrating that the creditor received more than other unsecured creditors would receive in a chapter 7 case. *See* 11 U.S.C. § 547(b)(5)(A) (1988).

314 Hardine v. Pioneer Nat'l Title Ins., 145 Ariz. 83, 85, 699 P.2d 1314, 1316 (Ct. App. Ariz. 1985); Farm Bureau Fin. Co. v. Carney, 100 Idaho 745, 749, 605 P.2d 509, 513 (1980); Blakely v. Kelstrup, 708 P.2d 253, 254 (Mont. 1985), *reh'g denied* (Nov. 19, 1985); Security Pacific Fin. Corp. v. Taylor, 193 N.J. Super. 434, 442, 474 A.2d 1096, 1100 (Ch. Div. 1984); Jeffers v. Doel, 99 N.M. 351, 353, 658 P.2d 426, 428 (1982) (citation omitted).

There are three types of recording statutes: race, notice, and race-notice. A. AXELROD, C. BERGER & Q. JOHNSTONE, LAND TRANSFER AND FINANCE 641 (3d ed. 1986). Under a race statute a purchaser who records its interest first has priority over all other unrecorded interests whether or not it had notice of the other unrecorded interests. 6A R. POWELL, THE LAW OF REAL PROPERTY ¶ 905[1] (P. Rohan rev. ed. 1990)[hereinafter R. Powell]. Under a notice statute a purchaser takes priority over all unrecorded interests of which it had no notice when it acquired its interest in the property. R. CUNNINGHAM, W. STOEBUCK & D. WHITMAN, THE LAW OF PROPERTY ¶ 11.9 (1984). Under a race-notice statute a purchaser prevails if it has no notice of a prior unrecorded interest and it records its interest before the prior unrecorded interest records its interest. *Id.* Only Louisiana and North Carolina have enacted race statutes. A. AXELROD, C. BERGER & Q. JOHNSTONE, *supra* at 641.

315 *See* COLO. REV. STAT. ANN. § 38-35-109 (West 1990); CONN. GEN. STAT. ANN. §§ 47-10, 33a (West 1986); FLA. STAT. ANN. § 695.01 (West 1969); MINN. STAT. ANN. § 507.34 (West 1947); N.Y. REAL PROPERTY LAW § 291 (McKinney 1989).

316 *See* Bandell Invs. Ltd. v. Capitol Fed. Savs. and Loan of Denver (*In re* Bandell Invs. Ltd.), 80 Bankr. 210 (D. Colo. 1987); D & F Petroleum v. Official Creditor's

b. *Under State Law a Trustee Utilizing Bankruptcy Code Section 544(a)(3) Defeats the Interest of a Party Holding an Unrecorded Equitable Interest in Real Property*

Section 544(a)(3) grants a trustee the status of a bona fide purchaser without notice.[317] trustee uses section 544(a)(3), he or she is not chargeable with the actual knowledge of the debtor.[318] A trustee using section 544(a)(3) defeats an entity holding an unrecorded equitable interest in real property.[319] Therefore, a correct interpretation of state law requires that a trustee prevail over an entity holding an unrecorded equitable interest in real property over which the imposition of a constructive trust is sought.[320]

Committee (*In re* Cascade Oil Co., Inc.), 65 Bankr. 35 (Bankr. D. Kan. 1986); Clark v. Kahn (*In re* Dlott), 43 Bankr. 789 (Bankr. D. Mass. 1983); CAL. CIV. CODE § 1214 (West 1982); ILL. ANN. STAT. ch. 30, ¶ 29 (Smith-Hurd 1990); OHIO REV. CODE ANN. § 5301.25(A) (Page 1989); PA. STAT ANN. tit. 21, § 351 (Purdon 1955).

317 11 U.S.C. § 544(a)(3) (1988). Putney v. Dalton (*In re* Dalton), 90 Bankr. 519, 521 (Bankr. M.D. Fla. 1988); Stone v. Decatur Fed. Savs. and Loan Ass'n, 81 Bankr. 160, 162 (Bankr. M.D. Ga. 1987); R. D'AGOSTINO, *supra* note 77, at ¶ 544.02. Under state law, a bona fide purchaser is an entity who has given consideration and does not have actual, constructive, or implied notice of rights, equities, or claims of others against the property. Howard, McRoberts & Murray v. Starry, 382 N.W.2d 293, 296 (Ct. App. Minn. 1986); Home Owners' Loan Corp. v. Tognoli, 127 N.J. Eq. 390, 392, 13 A.2d 571, 572-73 (Ch. 1940); Grand Inv. Co. v. Savage, 49 Wash. App. 364, 368, 742 P.2d 1262, 1264-65 (Ct. App. Wash. 1987). *See supra* notes 171-74 and accompanying text.

318 Sandy Ridge Oil Co. v. Centerre Bank Nat'l Ass'n (*In re* Sandy Ridge Oil Co.), 807 F.2d 1332, 1334-36 (7th Cir. 1986); McCannon v. Marston, 679 F.2d 13, 16-17 (3d Cir. 1982); Teofan v. Cools (*In re* Spring Creek Invs. of Dallas, N.V., Inc.), 71 Bankr. 157, 159 (Bankr. N.D. Tex. 1987). *But see* Maine Nat'l Bank v. Morse (*In re* Morse), 30 Bankr. 52, 54 (Bankr. 1st Cir. 1983) ("That phrase in § 544(a) means without regard to any *personal* knowledge the trustee may have.") (emphasis in original).

319 *See, e.g.*, *In re* Vermont Fiberglass, Inc., 45 Bankr. 603, 605 (Bankr. D. Vt. 1984); First Nat'l Bank of Poplar Bluff v. R & J Const. Co. (*In re* R & J Constr. Co.), 43 Bankr. 29, 31 (Bankr. E.D. Mo. 1984); Berge v. Value Enters. Ltd. (*In re* Berge), 39 Bankr. 960, 962-63 (Bankr. W.D. Wis. 1984); Hardway Restaurant, Inc. v. Once Upon a Stove (*In re* Hardway Restaurant, Inc.), 31 Bankr. 322, 331 (Bankr. S.D.N.Y. 1983).

320 A bona fide purchaser is an entity without any actual, constructive or implied knowledge of a prior unrecorded interest in real property. Angle v. Slayton, 102 N.M. 521, 523, 697 P.2d 940, 942 (1985); Grand Inv. Co. v. Savage, 49 Wash. App. 364, 368, 742 P.2d 1262, 1264-65 (Ct. App. Wash. 1987). The vesting of a trustee with the powers of a bona fide purchaser means that a trustee does not have knowledge of any of the malfeasance that the debtor may have committed prior to the commencement of the bankruptcy case. Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899, 905-07 (Bankr. C.D. Cal. 1984). Therefore, under state law a trustee employing section 544(a)(3) prevails over a party claiming an unrecorded equitable interest in real property. *See* Chbat v. Tleel

c. *The Policy Underlying the Recording Statutes Dictates that a Trustee Employing Bankruptcy Code Section 544(a)(3) Should Defeat a Party Holding an Unrecorded Equitable Interest in Real Property*

The policy underlying the recording statutes dictates that a trustee prevail over an entity that has failed to record its interest. The objective of the recording statutes is to provide notice of alleged interests in real property.[321] Strict adherence to section 544(a)(3) insures that parties seeking to enforce equitable interests will need to record their claims.[322] Thus, stringent enforcement of section 544(a)(3) is necessary to fulfill the goal of the recording statutes.[323]

C. Priciples of Statutory Construction Require that a Trustee Using Bankruptcy Code Section 544(a) to Avoid an Unperfected Security Interest be Immune to the Equitable Affirmative Defense of a Constructive Trust

1. The Express Language of Bankruptcy Code Section 544(a)(1) and (a)(3) Preclude the Imposition of a Constructive Trust

a. *Introduction*

The starting point in statutory construction is to consider the language of the statute.[324] A statute should ordinarily be read to effectuate rather than to frustrate the purposes of the legislation.[325] The language of the statute will prevail if it is unambiguous and there is no clearly expressed legislative intent to the

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(*In re* Tleel), 876 F.2d 769, 771-72 (9th Cir. 1989); *Great Plains*, 38 Bankr. at 905-07 (Bankr. C.D. Cal. 1984).

321 *See* Echo Ranch, Inc. v. State *ex. rel* Evans, 107 Idaho 808, 815, 693 P.2d 454, 457-58 (Idaho 1984); Condry v. Laurie, 184 Md. 317, 320, 41 A.2d 66, 68 (1945); Andy Assocs., Inc. v. Bankers Trust Co., 49 N.Y.2d 13, 20, 424 N.Y.S.2d 139, 143, 399 N.E.2d 1160, 1164 (1979); Security State Bank v. Luebke, 303 Or. 418, 421, 737 P.2d 586, 588 (1987) (en banc).

322 *Tleel*, 876 F.2d at 773; National Bank of Alaska, N.A. v. Seaway Express Corp. (*In re* Seaway Express Corp.), 105 Bankr. 28, 31-32 (Bankr. 9th Cir. 1989), *aff'd*, 912 F.2d 1125 (9th Cir. 1990); Billings v. Cinnamon Ridge, Ltd. (*In re* Granada, Inc.), 92 Bankr. 501, 509-10 (Bankr. D. Utah 1988).

323 Strict enforcement is also consistent with combatting the problem of ostensible ownership, which is also a goal of the strong arm powers. Hence, strict enforcement of section 544(a)(3) is consistent with state and local law.

324 Mansell v. Mansell, 109 S. Ct. 2023, 2028 (1989); Blum v. Stenson, 465 U.S. 886, 896 (1984); Consumer Product Safety Comm'n v. GTE Sylvania, Inc., 447 U.S. 102, 108 (1980); Hudgins v. City of Ashburn, Ga., 890 F.2d 396, 405 (11th Cir. 1989).

325 Motor Vehicle Mfrs. v. Ruckelshaus, 719 F.2d 1159, 1165 (D.C. Cir. 1983);

contrary.[326] A primary rule of statutory construction is to ascertain the intent of the legislature from the language used and to give effect to the plain and ordinary meaning of the words used in the statute.[327] Statutory language is to be construed strictly to effect legislative intent.[328]

b. *Recent Supreme Court Decisions Interpreting the Bankruptcy Code Support the Conclusion that Under Strict Statutory Construction a Trustee Using Bankruptcy Code Section 544(a) Prevails Over a Defrauded Creditor Claiming a Constructive Trust*

United States v. Ron Pair Enterprises, Inc.[329] is a Supreme Court opinion which employed strict statutory construction to interpret the Code. In *Ron Pair*, the issue before the Supreme Court was whether under Code section 506(b) an oversecured creditor with a nonconsensual lien was entitled to post-petition interest. The Court held that under section 506(b) an oversecured creditor with a nonconsensual lien was entitled to post-petition interest.[330] The express language of section 506(b) stated that post-petition interest be available to oversecured creditors.[331] The Court observed that the language of section 506(b) made no distinction between consensual and nonconsensual liens.[332] The Court further asserted that the plain language of the statute was conclusive, because a literal application would not produce a result that was contrary to the intention of the drafters.[333] The Court rejected attaching any significance to the pre-Code practice of distinguishing between consensual and nonconsensual liens for the purpose of determining whether a creditor was entitled to post-petition interest, in light of the express language of

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Motor and Equip. Mfrs. Ass'n, Inc. v. Envtl. Protection Agency, 627 F.2d 1095, 1108 (D.C. Cir. 1979), *cert. denied*, 446 U.S. 952 (1980).

326 Laracuente v. Chase Manhattan Bank, 891 F.2d 17, 23 (1st Cir. 1989); Malloy v. Eichler, 860 F.2d 1179, 1183 (3d Cir. 1988); Bradley v. Austin, 841 F.2d 1288, 1293 (6th Cir. 1988); White v. Pierce, 834 F.2d 725, 728 (9th Cir. 1987); Oliver v. U.S. Postal Service, 696 F.2d 1129, 1131 (5th Cir. 1983).

327 United Scenic Artists, Local 829, Bhd. of Painters and Allied Trades, AFL-CIO v. NLRB, 762 F.2d 1027, 1032 n.15 (D.C. Cir. 1985).

328 Consumer Product Safety Comm'n v. GTE Sylvania, Inc., 447 U.S. 102, 108 (1980); *In re* Petro Mktg. Group, Inc., 680 F.2d 566, 570 (9th Cir. 1982); Atchison, Topeka & Santa Fe Ry. Co., v. Arizona, 559 F. Supp. 1237, 1246 (D. Ariz. 1983).

329 109 S. Ct. 1026 (1989).

330 *Id.* at 1034 (citing 11 U.S.C. § 506(b) (1988)).

331 *Id.* at 1030.

332 *Id.*

333 *Id.* at 1031.

section 506(b) authorizing the payment of post-petition interest on all oversecured claims.[334]

c. *Strict Statutory Construction of Bankruptcy Code Section 544(a)(1) Precludes the Imposition of a Constructive Trust*

The express language of Bankruptcy Code Section 544(a)(1) and (a)(3) prohibits the imposition of a constructive trust. Bankruptcy Code Section 544(a)(1) grants a trustee the status of a hypothetical lien creditor.[335] The express language of Bankruptcy Code Section 544(a)(1) acts to cleanse the trustee of any malfeasance that the debtor may have committed prior to the commencement of the case.[336] A debtor's prepetition misconduct cannot operate as an estoppel against a trustee.[337] One of the purposes for providing the ideal creditor status is to prevent the use of equitable defenses being raised against a trustee when he is using the Bankruptcy Code Section 544(a)(1).[338] Therefore, a strict interpretation of Bankruptcy Code Section 544(a)(1) precludes the imposition of a constructive trust against a trustee.[339]

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334 *Id.* at 1031-33.

335 *In re Pirsig Farms,Inc.*, 46 Bankr. 237, 242 (D. Minn. 1985); *In re York Chemical Industries, Inc.*, 30 Bankr. 583, 585 (Bankr. D.S.C. 1983); 11 U.S.C. § 544(a)(1) (1988); *Collier on Bankruptcy* ¶ 544.02 (L. King ed. 1989).

336 One court has stated:

> It is clear, from the foregoing, that a trustee in bankruptcy is a hypothetical lien creditor, without notice, as to all legal and equitable interest the Debtor had as of the date of the Debtor's filing of the Petition. Moreover, a trustee in bankruptcy takes the foregoing interests on behalf of the general unsecured creditors without imputation of knowledge of the debtors activities or practices which may have been or were in actualor constructive fraud of a particular creditor of the debtor.

In re International Gold Bullion Exchange, Inc., 60 Bankr. 256, 260 (Bankr. S.D. Fla. 1986).

337 *In re Wiggs*, 87 Bankr. 57, 58-59 (Bankr. S.D. Ill. 1988); *In re I.A. Durbin*, 46 Bankr. 595, 602 (Bankr. S.D. Fla. 1985); *In re Minzenreider Corp.*, 34 Bankr. 82, 84 (Bankr. M.D. Fla. 1983).

338 *In re Great Plains Western Ranch Co., Inc.*, 38 Bnakr. 899, 903-04 (Bankr. C.D. Cal. 1984); *In re Brent Explorations, Inc.*, 31 Bankr. 745, 749 (Bankr. D. Colo. 1983).

339 Under strict statutory construction, a trustee is required to prevail over a defrauded creditor because the phrase "without regard to any knowledge" makes a trustee immune from any affirmative equitable defenses. *In re Pirsig Farms, Inc.*, 46 Bankr. 237, 242 (D. Minn. 1985). To establish a constructive trust a person usually has to establish some type of malfeasance. A court ignores the specific language of Bankruptcy Code Section 544(a)(1) when it imposes a constructive trust to circumvent the trustee's strong arm powers because the court is ascribing the debtor's wrongdoing to the estate.

In essence, when a court imposes a constructive trust on personal property in

d. *Strict Statutory Construction Precludes the Imposition of a Constructive Trust When a Trustee Uses Bankruptcy Code Section 544(a)(3) to Avoid an Unrecorded Interest in Real Property*

The express language of Bankruptcy Code Section 544(a)(3) grants a trustee the status of a bona fide purchaser without notice.[340] The trustee's status as a bona fide purchaser is defined by state law.[341] A bona fide purchaser is usually a purchaser who pays valuable consideration without actual, implied or constructive notice of an inconsistent prior equity.[342] Further, under Bankruptcy Code Section 544(a)(3) none of the debtor's or creditors' knowledge may be imputed to the trustee.[343] Under a strict interpretation of Bankruptcy Code Section 544(a)(3) the trustee should triumph because the phrase "without knowledge" provides a trustee with an irreproachable status which is invul-

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which a creditor has an unperfected security interest, the court is invoking U.C.C. Section 9-401(C)(2), U.C.C. Section 9-401(c)(2) holds that a good faith filing note made in all the required places or an improper place is nevertheless effective against any person who has knowledge of the filing. U.C.C. § 9-401(c)(2). The court imposing a constructive trust is enforcing an unperfected security interest, and it is holding that the debtor's knowledge preclude's the estate from denying the validity of the security interest. The express language of the Bankruptcy Code Section 544(a)(1) prevents a creditor from using U.C.C. § 9-401(C)(2). *In re Measure COntrol Devices, Inc.*, 48 Bankr. 613, 615 (Bankr. E.D.N.Y. 1985) ("UCC § 9-401[c](2) is inapplicable to this case since the Bankruptcy Code explicitly gives the trustee the status of a lien creditor without notice.").

340 *In re Keenan*, 9 Bankr. 197, 199 (Bankr. D. Minn. 1989); *In re Turner*, 78 Bankr. 166, 170 (Bankr. E.D. Tenn. 1987); 11 U.S.C. § 544(a)(3) (1988). One court stated:

> It is undisputed that section 544(a)(3) confers upon the Trustee, as of the date the bankruptcy petition is filed, all of the rights and powers that a bona fide purchaser would have under state law, including the right and power to avoid a prior, unrecorded convayance which is avoidable by an actual bona fide purchaser from the debtor. Whether such a bona fide purchaser actually exists, however, is irrelevant. Moreover, this status is conferred upon the Trustee under section 544(a)(3) regardless of his own personal knowledge of any relevant facts.

In re Investment Sales Diversified, Inc., 49 Bankr. 837, 843 (Bankr. D. Minn. 1985).

341 *In re Bandell Investments, Ltd.*, 80 Bankr. 210, 212 (D. Colo. 1987); *in re Dlott*, 43 Bankr. 789, 793 (Bankr. D. Mass. 1983); *In re Taylor*, 43 Bankr. 524, 527-28 (Bankr. N.D. Ala. 1984); *In re Investment Diversified, Inc.*, 38 Bankr. 446, 453 (Bankr. D. Minn. 1984); B. Weintraub & A.N. Resnick, *Bankruptcy Law Manual* ¶ 7.03 (rev. ed. 1986).

342 *Howard, McRoberts & Murray v. Starry*, 382 N.W.2d 293, 296 (Ct. App. Minn. 1986); *McVean v. Coe*, 12 Wash. App. 738, 532 P.2d 629, 631 (Ct. App. Wash. 1975); *Fane Development Co. v. Townsend*, 381 P.2d 1012, 1014 (Okla. 1963).

343 *In re Sandy Ridge Oil Co., Inc.*, 807 F.2d 1332, 1335-36 (7th Cir. 1986); *McCannon v. Marston*, 679 F.2d 13, 16-17 (3d Cir. 1982).

nerable.[344] When a court imposes a constructive trust it is disregarding the trustee's status as a bona fide purchaser without notice, and the court is imputing the debtor's knowledge to the trustee.[345]

Application of the rules of strict statutory construction set forth in *Ron Pair* leads to the conclusion that a trustee using section 544(a)(1) or section 544(a)(3) should prevail over a defrauded creditor holding an unperfected security interest or unrecorded interest in real property. The express language of section 544(a)(1) grants a trustee the status of a hypothetical lien creditor without notice, and the express language of section 544(a)(3) grants a trustee the status of a bona fide purchaser without notice.[346] This language reflects Congress' intent that the pre-petition fraudulent conduct of the debtor should not hinder a trustee's attempt to avoid unrecorded or unperfected interests in real or personal property. Furthermore, the history and development of the trustee's strong arm powers indicate this interpretation of section 544(a) is consistent with legislative intent. Therefore, when construing the Code as the Supreme Court did in *Ron Pair*, it becomes clear that a trustee employing section 544(a) should prevail over a defrauded creditor.

Another recent Supreme Court decision which employed strict statutory construction is *Pennsylvania Department of Public Welfare v. Davenport*.[347] In *Davenport*, the issue before the Court was whether a criminal restitution obligation could be discharged in a chapter 13 case. The Supreme Court answered that question affirmatively.[348] The Court reasoned that a restitution obligation

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344 Under Bankruptcy Code Section 544(a)(3) a trustee acquires the status of a bona fide purchaser without knowledge. The status of a bona fide purchaser without knowledge was intended to prevent any malfeasance from being imputed to the debtor. Therefore, the status of a bona fide purchaser without knowledge grants a trustee a powerful tool to avoid unrecorded interests in real property. *See In re Sandy Ridge Oil Co., Inc.*, 807 F.2d 1332, 1334-36 (7th Cir. 1986); *In re Granada, Inc.*, 92 Bankr. 501, 505 (Bankr. D. Utah 1988).

345 Under notice and race-notice recording statutes a defrauded creditor would prevail against a debtor because the debtor has knowledge of the creditor's unrecorded interest. The imposition of a constructive trust is the recognition that the debtor's interest is inferior to the creditor's interest because under the recording statute the debtor's knowledge precludes it from becomming a bona fide purchaser. The language of Bankruptcy Code Section 544(a)(3) expressly provides that the debtor's knowledge may not be imputed to the trustee. Therefore, when a court impresses a constructive trust to protect an unrecorded equitable interest in real property it disregards the express language of Bankruptcy Code Section 544(a)(3).

346 11 U.S.C. §§ 544(a)(1), 544(a)(3) (1988).

347 110 S. Ct. 2126 (1990).

348 *Id.* at 2130-31.

was a debt[349] and stressed that the discharge provisions in chapter 13 were greater than in chapter 7.[350] In enacting these provisions, Congress made a conscious policy decision that section 523(a)(7), which provides an exception to discharge for debts arising from fines, penalties, and forfeitures, would be inapplicable in chapter 13 cases, the Court declared.[351] Thus, strict statutory construction compelled the conclusion that restitution obligations were dischargeable in chapter 13.[352]

When a court imposes a constructive trust to avoid the application of section 544(a), it is attempting to punish a debtor for committing malfeasance.[353] The court will refuse to apply section 544(a) because the debtor is attempting to use equity as a sword.[354] This result, however, is incompatible with the history, language, and policy of section 544(a). Unlike section 1112(b),[355] which grants a court discretion in determining

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349 *Id.*

350 *Id.* at 2133.

351 *Id.*

352 *Id.* Specifically, the Court declared:

> Among those exceptions that Congress chose *not* to extend to chapter 13 proceedings is § 523(a)(7)'s exception for debts arising from a "fine, penalty, or forfeiture." Thus, to construe "debt" narrowly in this context would be to override the balance Congress struck in crafting the appropriate discharge exceptions for chapter 7 and chapter 13 debtors.

Id.(emphasis in original).

353 *See* Sanyo Elec., Inc. v. Howard's Appliance Corp. (*In re* Howard's Appliance Corp.), 874 F.2d 88, 94 (2d Cir. 1989).

354 *Cf.*, Shell Oil Co. v. Waldron (*In re* Waldron), 785 F.2d 936 (11th Cir. 1986) (per curiam) *cert. denied*, 478 U.S. 1028 (1986). In *Waldron*, the debtors were solvent, and the sole purpose for filing for chapter 13 was to reject an executory contract. The Eleventh Circuit held that the chapter 13 petition should be dismissed because the debtors were attempting to misuse chapter 13. Because the debtors were solvent, the court reasoned, rejection of the executory contract would not benefit the estate. The case did not belong in the bankruptcy court, the court declared. The Eleventh Circuit asserted:

> "The bankruptcy laws are intended as a shield, not as a sword." Congress could not have intended that the debt-free, financially secure Waldrons be permitted to engage the bankruptcy machinery solely to avoid an enforceable option contract. From all that appears, the contract was negotiated at arms length; if the Waldrons now feel that it is less attractive than it should be, the difference is attributable to changes in the economic climate not to the Waldrons' financial situation. The bankruptcy laws were simply not intended to be used as a sword by the rapacious.

Id. at 940 (citation omitted).

355 11 U.S.C. § 1112(b) (1988). Some courts have used the discretion drafted into section 1112(b) to hold that chapter 11 petitions must be filed in good faith. *E.g.*, Carolin Corp. v. Miller, 886 F.2d 693, 698-99 (4th Cir. 1989); *In re* Winshall Settlor's Trust, 758 F.2d 1136, 1137 (6th Cir. 1985); Albany Partners, Ltd. v. West-

whether a chapter 11 case should be converted or dismissed, the language of section 544(a) does not grant a court discretion to take into consideration a debtor's wrongdoing.[356] If Congress had desired to make debtor malfeasance an exception to the application of section 544(a), it could have drafted that section in such a manner as to prohibit the use of the statute if the debtor had committed fraud.[357] Congress has made a conscious policy decision to do otherwise, and this is reflected in the language of section 544(a). Therefore, *Davenport* supports the contention that the imposition of a constructive trust to avoid the debtor's malfeasance would be incorrect. Congress has made a policy determination which is evidenced by the clear language of section 544(a).

2. In Order to Effectuate the Policy and Goals of Bankruptcy Code Section 544(a) A Trustee Employing Bankruptcy Code Section 544 (a) Should Defeat a Defrauded Creditor Alleging a Constructive Trust

a. *Introduction*

In determining the meaning of a statute, a court looks not only to the language of a particular section, but also to the design of the entire statute including its underlying objectives and policies.[358] The principal purpose of intent behind a statute controls, and all of its parts should be interpreted as subsidiary to

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brook (*In re* Albany Pateners, Ltd.), 749 F.2d 670, 674 (11th Cir. 1984); Furness v. Lilienfield, 35 Bankr. 1006, 1010 (D. Md. 1983); *In re* Mill Place Ltd. Partnership, 94 Bankr. 139, 141-42 (Bankr. D. Minn. 1988); *In re* HBA East, Inc., 87 Bankr. 248, 258 (Bankr. E.D.N.Y. 1988); *In re* McDermott, 78 Bankr. 646, 651 (Bankr. N.D.N.Y. 1985); *see also* Cohn, *Good Faith and The Single-Asset Debtor*, 62 AM. BANKR. L.J. 131 (1988); Ordin, *The Good Faith Principle in the Bankruptcy Code: A Case Study*, 38 BUS. LAW. 1795 (1983). Therefore, courts have used their discretion and have dismissed chapter 11 petitions that were filed in bad faith. *See In re* Castleton Assocs. Ltd. Partnership, 109 Bankr. 347 (Bankr. S.D. Ind. 1989); *In re* U.S. Loan Co., 105 Bankr. 676 (Bankr. M.D. Fla. 1989); *In re* Harvey, 101 Bankr. 250 (Bankr. D. Nev. 1989); *In re* Mill Place Ltd. Partnership, 94 Bankr. 139 (Bankr. D. Minn. 1988).

356 Belisle v. Plunkett, 877 F.2d 512, 513-14 (7th Cir. 1989), *cert. denied*, 110 S. Ct. 241 (1989); Chbat v. Tleel (*In re* Tleel), 876 F.2d 769, 772 (9th Cir. 1989).

357 Pennsylvania Dep't of Pub. Welfare v. Davenport, 110 S. Ct. 2126, 2133 (1990) ("We will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.").

358 *See e.g.*, Crandon v. United States, 110 U.S. 997, 1001 (1990); Comm'r of Internal Revenue v. Engle, 464 U.S. 206, 217 (1984); United States Army Eng'r Center v. Fed. Labor Relations Auth., 762 F.2d 409, 416 (4th Cir. 1985); United States v. Matteo, 718 F.2d 340, 341 (2d Cir. 1983).

and harmonious with that intent.[359] When construing a statute, therefore, a court must interpret the language of one section so that it is consistent with the language of other sections and with the objectives of the entire statute.[360] A statute must be construed so that no provision will be inoperative or superfluous.[361] A court should preserve the entire statute and accord each clause and word due effect.[362] Legislative enactments should be construed in a manner designed to give effect to all parts of the statute while avoiding a result contrary to the apparent intent of the legislature.[363]

b. *The Imposition of a Constructive Trust to Defeat the Use of the Trustee's Strong Arm Powers is Inconsistent with Bankruptcy Code Sections 541(a)(3) and (a)(4), 544(a), 550(a), and 551*

The express language and the policies underlying the Code dictate that a trustee should prevail when he uses section 544(a) to avoid an unperfected security interest or an unrecorded interest in real property. Section 544(a) allows a trustee to avoid an unperfected interest in personal property and an unrecorded interest in real property.[364] Section 550(a) authorizes a trustee to recover the avoided property or the value of the avoided property.[365] Section 551 provides for automatic preservation of any transfer avoided under section 551.[366] Section 541(a)(3) declares

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359 *See* Rickard v. Auto Publisher, Inc., 735 F.2d 450, 457 (11th Cir. 1984); Adams v. Howerton, 673 F.2d 1036, 1040 (9th Cir. 1982), *cert. denied*, 458 U.S. 1111 (1982); Duke v. University of Texas at El Paso, 663 F.2d 522, 525 (5th Cir. 1981).

360 Nupulse, Inc. v. Schlueter Co., 853 F.2d 545, 549 (7th Cir. 1988); Sierra Club v. Clark, 755 F.2d 608, 613 (8th Cir. 1985); Brach v. Amoco Oil Co., 677 F.2d 1213, 1220 (7th Cir. 1982).

361 Central Montana Elec. Power Coop., Inc. v. Administrator of the Bonneville Power Admin., 840 F.2d 1472, 1478 (9th Cir. 1988); Quarles v. St. Clair, 711 F.2d 691, 701 n.32 (5th Cir. 1983); Motor and Equip. Mfrs. Ass'n, Inc. v. E.P.A., 627 F.2d 1095, 1108 (D.C. Cir. 1979), *cert. denied*, 446 U.S. 952 (1980).

362 *See* Director, Office of Workers' Compensation Programs, United States Dep't of Labor v. Goudy, 777 F.2d 1122, 1127 (6th Cir. 1985); Meade Township v. Andrus, 695 F.2d 1006, 1009 (6th Cir. 1982).

363 Certified Color Mfrs. Ass'n v. Mathews, 543 F.2d 284, 296 (D.C. Cir. 1976); *see* United States Army Eng'r Center v. Federal Labor Relations Auth., 762 F.2d 409, 416 (4th Cir. 1985).

364 11 U.S.C. § 544(a) (1988).

365 *Id.* at § 550(a).

366 Section 551 provides:

> Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.

that any property recovered under section 550 becomes property of the estate.[367] In addition, section 541(a)(4) provides that any interest in property preserved for the benefit of the estate under section 551 is property of the estate.[368] Sections 541(a)(3), 541(a)(4), 544(a), 550(a), and 551 permit a trustee to bring into the estate all property in which the debtor may have had a bare legal interest.[369] This argument is buttressed by the principle that the concept of property of the estate is to be construed broadly.[370]

Section 541(d) governs property in which the debtor has bare legal title and lacks an equitable interest.[371] Section 541(d) was intended to protect purchasers in the secondary mortgage market.[372] Neither the express language of section 541(d) nor its legislative history appear to circumscribe the scope of section

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Id. at § 551.

367 *Id.* at § 541(a)(3).

368 *Id.* at § 541(a)(4).

369 One court has stated:

> The fallacy of plaintiff's position lies in a misreading of § 541. Three sections of the Act must be read together—§ 541, § 551 and § 544. Granted that the bare language of these sections may appear to be elliptical, the meaning which emerges is that assets recoverable by a trustee pursuant to § 544 become property of the estate notwithstanding the provisions of § 541(d). In other words, if a person other than the debtor holds an equitable interest in assets subject to recovery under § 544, the provisions of § 541(d) upon which plaintiff relies do not prevent the trustee from recovering those assets.
>
> Section 541(a)(4) provides that an estate is comprised of "[a]ny interest in property preserved for the benefit of or ordered transferred to the estate under section . . . 551". [sic] § 551 provides that "[a]ny transfer avoided under section . . . 544 . . . is preserved for the benefit of the estate but only with respect to property of the estate". [sic] Thus, § 541, and § 551 which is incorporated therein by reference, bring within the debtor's estate property recoverable pursuant to § 544.

Elin v. Busche (*In re* Elin), 20 Bankr. 1012, 1016 (D.N.J. 1982), *aff'd without opinion*, 707 F.2d 1400 (3d Cir. 1983).

370 *See* Miller v. Jones (*In re* Jones), 43 Bankr. 1002, 1005 (N.D. Ind. 1984); Scott W. Putney, Trustee, Inc. v. May (*In re* May), 83 Bankr. 812, 813-14 (Bankr. M.D. Fla. 1988); Coben v. Lebrun (*In re* Golden Plan of Cal., Inc.), 37 Bankr. 167, 169 (Bankr. E.D. Cal. 1984).

371 11 U.S.C. § 541(d) (1988).

372 *In re* Cambridge Mortgage Corp., 92 Bankr. 145 150 (Bankr. D.S.C. 1988); *In re* Columbia Pacific Mortgage, Inc., 20 Bankr. 259, 261-62 (Bankr. W.D. Wash. 1981). The *Cambridge* court stated:

> It is indisputable that the major motivating force behind the enactment of § 541(d) was the protection of the national secondary mortgage market and certain participants in that market, such as Federal Home Loan Mortgage Corporation, the Government National Mortgage Association, and Federal National Mortgage Association.

544(a).[373] It is doubtful that Congress intended that section 541(d) override section 544(a).[374] A harmonious reading of the Code reflects that section 541(d) was not intended to limit the trustee's avoiding powers.[375]

In re Cambridge Mortgage Corp., 92 Bankr. at 150. *See supra* notes 114-26 and accompanying text.

[373] *See* 11 U.S.C. § 541(d) (1988). The legislative history of section 541(d) contains no mention that the provision was intended to limit the scope of the trustee's avoiding powers. One court has remarked:

> Section 541(d) poses no barrier to the trustee's complaint seeking to avoid these liens since the debtor did not possess legal title to these properties at the commencement of his bankruptcy petition. Section 541(d) by its very terms restricts its applicability solely to property in which the debtor holds legal title as of the commencement of the bankruptcy case. When the debtor in this case filed his chapter 7 petition, he possessed no interest whatsoever in the real property at issue. The debtor had transferred the properties by deed prior to the filing of the petition and, as between him and his transferees or their successors, the deeds were valid and binding. The problem for the defendants in this case is that these deeds were not properly recorded under Tennessee's registration laws and are therefore vulnerable to attack by creditors of the debtor and by the trustee in bankruptcy who stands in the shoes of these creditors pursuant to § 544(a)(1) and (a)(2).

McAllester v. Aldridge (*In re* Anderson), 30 Bankr. 995, 1009 (M.D. Tenn. 1983) (citation omitted).

[374] Chbat v. Tleel (*In re* Tleel), 876 F.2d 769, 773 (9th Cir. 1989); D & F Petroleum v. Cascade Oil Co. (*In re* Cascade Oil Co.), 65 Bankr. 35, 40 (Bankr. D. Kan. 1986). The Ninth Circuit has stated:

> [debtor]'s contention that under section 541(d) *all* beneficial or equitable owners of property may exempt their property from the debtor's estate in *all* circumstances, notwithstanding the debtor's legal title and the avoidance powers of section 544, goes too far. This interpretation would open the door to allegations of secret deals resulting in constructive trusts and thereby shelter some unsecured claims from avoidance. This result was not intended by the Bankruptcy Code and is contrary to the policy goal of ratable distribution among creditors.

In re Tleel, 876 F.2d at 773 (emphasis in original). As the Ninth Circuit's comments reflect, if section 541(d) shielded unrecorded real property interests and unperfected security interests in personal property then the historic policies underlying the strong arm powers would be undermined. There is no evidence that Congress intended to circumscribe the application and the policies underlying section 544(a). Indeed, courts will not interpret the Bankruptcy Code to erode past practice absent a clear indication that Congress has intended such a departure. Pennsylvania Dep't of Pub. Welfare v. Davenport, 110 S. Ct. 2126, 2133 (1990).

[375] If section 541(d) overruled section 544(a), then both sections 541(a)(3), 541(a)(4), 544(a), 550(a), and 551 would become superfluous. An interpretation of a statute that renders a portion superfluous is to be avoided. Mountain States Tel. and Tel. Co. v. Pueblo of Santa Ana, 472 U.S. 237, 249 (1985); Colautti v. Franklin, 439 U.S. 379, 392 (1979); Beisler v. C.I.R., 814 F.2d 1304, 1307 (9th Cir. 1987) (en banc); EEOC v. Continental Oil Co., 548 F.2d 884, 889 (10th Cir. 1977).

There is no evidence that indicates that section 541(d) overrides section 544(a). The courts that have imposed constructive trusts to circumvent the applica-

c. *The Supreme Court's Decision in United Savings Association of* Texas v. Timbers of Inwood Forest Associates, Ltd. *Supports the Argument that the Rules of Statutory Construction are Applied to the Bankruptcy Code, a Constructive Trust Should Not be Imposed to Thwart the Use of the Trustee's Strong Arm Powers*

The Supreme Court's decision in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*,[376] supports the argument that when the rules of statutory construction are applied to the Bankruptcy Code, a holder of an unperfected security interest in personal property or unrecorded interest in real property may not utilize a constructive trust to defeat the trustee's strong arm powers. In *Timbers*, the issue before the Court was whether an undersecured creditor could receive compensation pursuant to section 362(d)(1) for the delay caused by an automatic stay in foreclosing on its collateral. A unanimous Court held that the creditor was not entitled to such recovery for lost opportunity costs.[377] One of the grounds on which the Court rested this holding was its construction of the Code.[378] The Court decided that granting an undersecured creditor lost opportunity costs under section 362(d)(1) would be inconsistent with other provisions of the Code.[379]

The Court began its analysis by noting that section 362(d)(1), which governs termination of the automatic stay for lack of adequate protection, does not clarify the meaning of the phrase "interest in property."[380] Emphasizing that construing a statute is a holistic endeavor, the court observed that while the

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tion of the trustee's strong arm powers have heavily relied on United States v. Whiting Pools, Inc., 462 U.S. 198, 204 n.8 (1983), which states that an estate does not succeed to property in which a debtor holds bare legal title. *See* Sanyo Elec. Inc. v. Howard's Appliance Corp. (*In re* Howard's Appliance Corp.), 874 F.2d 88, 93 (2d Cir. 1989); Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1013 (5th Cir. 1985). In *Whiting Pools* the Court did not discuss sections 541(a)(3), 541(a)(4), 544(a), 550(a), and 551. Further, *Whiting Pools* reflects that the concept of property of the estate is to be construed broadly. R. D'AGOSTINO, *supra* note 77, at ¶ 541.08[10]. Therefore, the courts relying on *Whiting Pools* in this manner have misconstrued the holding of the case. Moreover, it is unlikely that the Supreme Court intended that footnote eight should be the basis for restricting the purview of section 544(a) and disregarding the complex interrelationship among sections 541(a)(3) and 541(a)(4), 544(a), 550(a), and 551. *See Tleel*, 876 F.2d at 773; *Anderson*, 30 Bankr. at 1008-09; *Cascade Oil Co.*, 65 Bankr. at 38-41.

376 108 S. Ct. 626 (1988).

377 *Id.* at 635 (citing 11 U.S.C. § 362(d)(1) (1988)).

378 *Id.* at 629-33.

379 *Id.*

380 *Id.* at 630.

phrase "interest in property" might plausibly mean the right to immediately foreclose, other provisions of the Code suggest that this is not so.[381] For instance, the Court cited the example of section 506(b) which denies an unsecured creditor postpetition interest.[382] If Congress had intended to grant an undersecured creditor interest on the value of its collateral, the Court reasoned, it would have drafted section 506 differently to clearly set this forth.[383] The Court declared that awarding an undersecured creditor lost opportunity costs would also be inconsistent with section 552.[384] Section 552(a), the Court noted, states that a prepetition security interest does not extend to property of the estate acquired postpetition.[385] The Court stated, however, that section 552(b) provides an exception permitting a perfected security interest to extend to proceeds, product, offspring, profits, or rents of collateral in which a creditor has a prepetition perfected security interest.[386] Thus, granting an undersecured creditor compensation for lost opportunity costs, the Court explained, would give an undersecured creditor a security interest in assets that were acquired postpetition and would thus be con-

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381 Justice Scalia wrote:

> A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme—because the same terminology is used elsewhere in a context that makes its meaning clear, or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law. That is the case here. Section 362(d)(1) is only one of a series of provisions in the Bankruptcy Code dealing with the rights of secured creditors. The language in those other provisions, and the substantive dispositions that they effect, persuade us that the "interest in property" protected by § 362(d)(1) does not include a secured party's right to immediate foreclosure.

Id. (citing 11 U.S.C. § 362(d)(1) (1980)) (citations omitted).

382 *Id.* at 630-31.

383 *Id.* at 631. The Court stated:

> If the Code had meant to give the undersecured creditor, who is thus denied interest on his *claim*, interest on the value of his *collateral*, surely [section 506] is where that disposition would have been set forth, and not obscured within the "adequate protection" provision of § 362(d)(1). Instead, the intricate phraseology set forth above, § 506(b) would simply have said that the secured creditor is entitled to interest "on his allowed claim, or on the value of the property securing his allowed claim, whichever is lesser." Petitioner's interpretation of § 362(d)(1) must be regarded as contradicting the carefully drawn disposition of § 506(b).

Id. (emphasis in original).

384 *Id.* at 631.

385 *Id.*

386 *Id.*

trary to section 552.[387]

Finally, the granting of lost opportunity costs to an undersecured creditor would make section 362(d)(2) a nullity, the Court asserted.[388] By applying section 362(d)(1) to an alleged interest in property, an undersecured creditor would be entitled to relief from the automatic stay if (1), it is undersecured, or (2), it is undersecured and its collateral is unnecessary for an effective reorganization.[389] According to the Court, this interpretation would render section 362(d)(2) ineffective.[390]

Timbers reflects that a Code section should not be read in isolation.[391] When there is a purported conflict between two bankruptcy sections, the conflict should be resolved by examining the entire Code and reaching a solution which is consistent with the express language and goals of the Code.[392] In addition, it is important to examine how similar sections were construed under the Act and to determine whether Congress indicated that the interpretation under the Act should be discontinued under the Code.[393]

If one were to read section 541(d) in isolation, the argument for imposing a constructive trust to defeat the use of the trustee's strong arm powers would then be plausible. When one examines sections 541(a)(3) and (a)(4), 544(a), 550(a), and 551, however, the argument that a constructive trust can quell the trustee's strong arm powers becomes tenuous.[394] If Code section 541(d) is sufficient to exclude property from the estate that is subject to the trustee's strong arm powers, then sections 541(a)(3) and 550(a) would then become superfluous. Moreover, there is nothing in either the Code or the legislative history which indicates that Congress intended section 541(d) to restrict the trustee's

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387 *Id.* at 631-32.

388 *Id.* at 632.

389 *Id.*

390 *Id.*

391 *Id.* at 630-33.

392 *See id.*

393 *See id.*

394 The argument that section 541(d) can decimate the trustee's strong arm powers also disregards that property of the estate is to be construed broadly. Sections 541(a)(3), 541(a)(4), 544(a), 550(a) and 551 further the policy of construing property of the estate broadly to include all of the debtor's equitable and legal interest in property. 11 U.S.C. §§ 541(a)(3), 541(a)(4), 544(a), 550(a), 551 (1988). The trustee's strong arm powers enable the trustee to claim property that an unsecured creditor with a judgment lien would be able to obtain. Thus, property of the estate is construed broadly to maximize the distribution to unsecured creditors.

strong arm powers.[395] Therefore, under holistic statutory construction, a trustee using section 544(a) should prevail over a creditor alleging a constructive trust.

D. *A Court Should Not Use Its Equitable Powers to Impose a Constructive Trust to Circumvent the Application of Section 544(a)*

1. Introduction

A bankruptcy court is a court of equity.[396] Nevertheless, a bankruptcy court must use its equitable powers in a manner consistent with the Code.[397] A bankruptcy court may not use its equitable powers to create substantive rights which are otherwise unavailable under the Code.[398] Further, a bankruptcy court may not use its equitable powers to construe a statute so as to circumvent the express language and intent of the statute.[399]

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395 The malfeasance exception would create a major exception that would weaken the trustee's strong arm powers. There is nothing in the history or language of the Bankruptcy Code, however, that Congress intended to create such a major exception. *See* 11 U.S.C. §§ 101-1330 (1988); S. REP. No. 989, 95th Cong., 2d Sess. 82-83, *reprinted in* 1978 U.S. CODE & ADMIN. NEWS 5787, 5868-69.

396 *In re* Mansuy, 94 Bankr. 443, 446 (Bankr. N.D. Ohio 1988); *In re* Unknown Group of Cases Seeking to be Filed, 79 Bankr. 651, 652 (Bankr. E.D. Va. 1987); Stair v. Shumate (*In re* Shumate), 39 Bankr. 809, 814 (Bankr. M.D. Tenn. 1984); *In re* Petur U.S.A. Instrument Co., 35 Bankr. 561, 563 (Bankr. W.D. Wash. 1983); Devon Energy Corp. v. Utica Nat'l Bank and Trust Co. (*In re* Project 5 Drilling Program-1980), 30 Bankr. 670, 674 (Bankr. W.D. Okla. 1983).

397 Equitable Life Assurance Society v. Sublett (*In re* Sublett), 895 F.2d 1381, 1385 (11th Cir. 1990); Appeal of Landahl, Brown & Weed Assocs., Inc. (*In re* Longardner & Assocs. Inc.), 855 F.2d 455, 462 (7th Cir. 1988); Medical Plaza, Ltd. v. Medical Plaza Assocs., Ltd. (*In re* Medical Plaza Associates, Ltd.), 67 Bankr. 879, 882 (W.D. Mo. 1986); *In re* Boyer, 108 Bankr. 19, 24 (Bankr. N.D.N.Y. 1988); Hood v. Williams (*In re* Hood), 92 Bankr. 648, 651 (Bankr. E.D. Va. 1988), *aff'd*, 92 Bankr. 656 (E.D. Va. 1988).

398 *See* Appeal of Morristown & Erie R.R. (*In re* Morristown & Erie R.R.), 885 F.2d 98, 100 (3d Cir. 1989); United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986); Francis v. Riso (*In re* Riso), 57 Bankr. 789, 793 (D.N.H. 1986); *In re* Charles & Lillian Brown's Hotel, Inc., 93 Bankr. 49, 54 (Bankr. S.D.N.Y. 1988). As Circuit Judge Posner has stated, "[t]he fact that a proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be." Appeals of Chicago, Milwaukee, St. Paul and Pacific R.R. (*In re* Chicago, Milwaukee, St. Paul and Pacific R.R.), 791 F.2d 524, 528 (7th Cir. 1986).

399 *See* Johnson v. First Nat'l Bank of Montevideo, Minn., 719 F.2d 270, 273 (8th Cir. 1983), *cert. denied*, 465 U.S. 1012 (1984); *In re* Rashid, 97 Bankr. 610, 615 (W.D. Okla. 1989); Rudd v. Laughlin, 95 Bankr. 705, 706 (D. Neb. 1988), *aff'd*, 866 F.2d 1040 (8th Cir. 1989); Boatmen's Bank of Benton v. Wiggs (*In re* Wiggs), 87 Bankr. 57, 59 (Bankr. S.D. Ill. 1988).

1. The Use of Equity to Avoid the Employment of the Trustee's Strong Arm Powers is Contrary to the Express Language of Bankruptcy Code Section 544(a)

The application of equity to avoid the use of the trustee's strong arm powers is contrary to the express language of section 544(a).[400] When a court imposes a constructive trust to protect a creditor who has an unperfected security interest or unrecorded interest in real property, the court is using its equitable powers in a manner that is inconsistent with section 544(a). More importantly, the employment of equity to impose a constructive trust is inimical to the policies underlying section 544(a).[401]

Section 544(a) is an anti-equity statute.[402] The historical development of the trustee's strong arm powers indicates that the trustee was granted the status of a hypothetical lien creditor to prevent creditors from asserting equitable affirmative defenses when the trustee was attempting to avoid an unperfected security interest.[403] The explicit language of sections 544(a)(1) and section 544(a)(3) grants a trustee the status of a hypothetical lien creditor without knowledge and the status of a bona fide purchaser without knowledge, respectively.[404] A trustee is granted

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400 When a court imposes a constructive trust it is in essence holding that a trustee is estopped from contesting the validity of the unperfected security interest or unrecorded interest in real property. The debtor's prepetition malfeasance prevents the estate from using section 544(a). The language of section 544(a) was intended to preclude the use of equitable affirmative defenses against the estate. 11 U.S.C. § 544(a) (1988); *see* I.A. Durbin, Inc. v. Jefferson Nat'l Bank (*In re* I.A. Durbin, Inc.), 46 Bankr. 595, 602 (Bankr. S.D. Fla. 1985); Brent Explorations, Inc. v. Karst Enters., Inc. (*In re* Brent Explorations, Inc.), 31 Bankr. 745, 748-49 (Bankr. D. Colo. 1983).

401 Section 544(a) is intended to battle the problem of ostensible ownership by compelling creditors to file or record their interests. *See* Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899, 903-04 (Bankr. C.D. Cal. 1984). The employment of a constructive trust to defeat a trustee using section 544(a) is contrary to the policy of combatting ostensible ownership because one of the purposes of section 544(a) is to defeat secret liens. *See In re* Keenan, 96 Bankr. 197, 220 (Bankr. D. Minn. 1989). Section 544(a) is also intended to foster equality among creditors by treating similarly situated creditors in the same manner. R. D'AGOSTINO, *supra* note 77, at ¶ 544.01. When a constructive trust is imposed the policy of creditor equality is thwarted because an unsecured creditor is elevated to the position of a secured creditor. Thus, the creditor receives a preference.

402 *See Wiggs*, 87 Bankr. at 57-59; Kaye v. Williams (*In re* Munzenreider Corp.), 34 Bankr. 82, 84-85 (Bankr. M.D. Fla. 1983); *Brent Explorations*, 31 Bankr. at 748-49.

403 *See Great Plains*, 38 Bankr. at 903-04. P. MURPHY, *supra* note 128, at § 12.01; J. MOORE, *supra* note 133, at ¶ 70.45.

404 *See supra* notes 148-53, 171-74 and accompanying text.

the status of either hypothetical lien creditor or a bona fide purchaser without knowledge so that none of the debtor's prepetition knowledge or malfeasance will be imputed to the estate.[405] A trustee's status as an innocent third party under section 544(a) is necessary because he is acting for the unsecured creditors and not for the debtor.[406] Thus, the express language of section 544(a) precludes use of equity to salvage unperfected security interests and unrecorded interests in real estate.[407]

A case which supports the position that equity should not be used to disregard the dictates of a Code section is *Norwest Bank Worthington v. Ahlers*.[408] In *Ahlers*, the issue before the Supreme Court was whether the respondents' promise of future expertise, experience, and labor permitted the confirmation of their reorganization plan, even though the reorganization plan violated the absolute priority rule.[409] The Supreme Court held that the respondents' reorganization plan violated the absolute priority rule. The respondents advanced various equitable arguments which the Court rejected.[410] The significance of *Ahlers* is that the Supreme Court made it clear that in a bankruptcy matter a court is not at liberty to indiscriminately use its equity powers. A court may use its equity powers only in a manner that is consistent with the Code.

Another case that supports the contention that a court may

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405 *See, e.g.* Bandell Invs., Ltd. v. Capitol Fed. Sav. and Loan Ass'n of Denver, (*In re* Bandell Invs., Ltd.), 80 Bankr. 210, 212 (D. Colo. 1987); Pirsig Farms, Inc. v. John Deere Co. (*In re* Pirsig Farms, Inc.), 46 Bankr. 237, 242 (D. Minn. 1985); Billings v. Cinnamon Ridge Ltd. (*In re* Granada, Inc.), 92 Bankr. 501, 505 (Bankr. D. Utah 1988).

406 Faircloth v. Bouchard (*In re* International Gold Bullion Exch. Inc.), 53 Bankr. 660, 665 (Bankr. S.D. Fla. 1985); *Great Plains*, 38 Bankr. at 903.

407 *See* Chbat v. Tleel (*In re* Tleel), 876 F.2d 769 (9th Cir. 1989); *Pirsig Farms*, 46 Bankr. at 240-42 (D. Minn. 1985); Boatmen's Bank of Benton v. Wiggs (*In re* Wiggs), 87 Bankr. 57 (Bankr. S.D. Ill. 1988); Clark v. Kahn (*In re* Dlott), 43 Bankr. 789 (Bankr. D. Mass. 1983).

408 485 U.S. 197 (1988).

409 *Id.* at 199 (citing 11 U.S.C. § 1129(b)(2)(B)(ii) (1988)).

410 *Id.* at 206-07. The Court stated:

> The short answer to these arguments is that whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code. The Code provides that undersecured creditors can vote in the class of unsecured creditors, the Code provides that a "fair and equitable" reorganization plan is one which complies with the absolute priority rule, and the Code provides that it is up to the creditors—and not the courts—to accept or reject a reorganization plan which fails to honor the absolute priority rule.

Id. (citations omitted).

not use equity to circumvent the express application of a Code provision is *Official Committee of Equity Security Holders v. Mabey*.[411] In *Official Committee*, the issue before the Fourth Circuit was whether the establishment of an emergency treatment fund for Dalkon Shield claimants prior to the allowance of claims of women who would benefit from the emergency fund and prior to the confirmation of the debtor's reorganization plan violated the Bankruptcy Code. The Fourth Circuit held that the emergency treatment fund violated the confirmation sections of the Code and was an improper use of the court's equitable powers.[412] The Court of Appeals reasoned that a court may not use its equitable powers in clear disregard of the Code.[413] The creation of the emergency treatment program violated Code sections 1121-1129.[414]

Official Committee demonstrates that the use of equity to avoid the express language of a bankruptcy statute is incorrect. The major transgression in *Official Committee* is that the emergency treatment fund violated the policy underlying the confirmation provisions of the Code. The employment of equity not only disregarded the clear language of the applicable bankruptcy statutes, but also the policy supporting those provisions.

The use of equitable principles, however, in *Midlantic National Bank v. New Jersey Department of Environmental Protection*[415] is

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411 832 F.2d 299 (4th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988).

412 *Id.* at 302-03.

413 *Id.* at 302. The court stated:

> We have searched *Midlantic* without finding any reference to the equitable powers under § 105(a), and we find such decision has no relevance to the issues presently before us. While the equitable powers emanating from § 105(a) are quite important in the general bankruptcy scheme, and while such powers may encourage courts to be innovative, and even original, these equitable powers are not a license for a court to disregard the clear language and meaning of the bankruptcy statutes and rules.

Id. (citing Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection, 474 U.S. 494 (1986)) (citations omitted).

414 *Id.* (citing 11 U.S.C. §§ 1121-1129 (1984)). The Fourth Circuit declared:

> The clear language of these statutes, as well as the Bankruptcy Rules applicable thereto, does not authorize the payment in part or in full, or the advance of monies to or for the benefit of unsecured claimants prior to the approval of the plan of reorganization. The creation of the Emergency Treatment Program has no authority to support it in the Bankruptcy Code and violates the clear policy of chapter 11 reorganizations by allowing piecemeal, pre-confirmation payments to certain unsecured creditors.

Id.

415 474 U.S. 494 (1986).

reconcilable with *Ahlers* and *Official Committee*. In *Midlantic*, the Court held that a trustee could not use Code section 554 to abandon an industrial waste site.[416] Although the express language of section 554 authorized abandonment, courts had developed a policy under the Act that abandonment could not be used to thwart the public interest.[417] Further, Judicial Code section 959(b) required that a trustee comply with local health and safety laws.[418] In *Midlantic*, the use of equity was consistent with bankruptcy policy and it did not impede the intended purpose of the statute.[419] In *Ahlers* and *Official Committee*, however, the use of equity would have produced results that were not only contrary to the express language of the bankruptcy statutes but also to the policy underlying those bankruptcy statutes.

Using equity to evade the express language of section 544(a) would be inappropriate.[420] As shown in *Ahlers* and *Official Committee*, the use of equity to avoid the application of section 544(a) would be contrary to the express language and policies underlying that section.[421] Unlike the provision at issue in *Midlantic*, there are no historical policies that have created a recognized exception to express application of section 544(a).[422] Therefore,

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416 *Id.* at 507.

417 *Id.* at 500-01.

418 *Id.* at 505 (citing 28 U.S.C. § 959(b) (1984)).

419 *Id.* There is no indication in the legislative history that Congress intended to abolish the exception that abandonment could not be used to obstruct legitimate state and federal interest. *See id.* If Congress had intended to abrogate the judicial exception to the abandonment rule it would have clearly stated its intent. *See id.*

Judicial Code section 959(b) requires that a trustee comply with state and local health and safety laws. 28 U.S.C. § 959(b) (1988). Thus, bankruptcy policy does not permit a trustee to evade state and local regulatory laws. The use of equity in *Midlantic* did not constitute a departure from precedent. Further, the use of equity did not thwart the policy underlying section 554.

420 Certain sections invite a court to use equity. *See, e.g.*, 11 U.S.C. §§ 362(d)(1), 707(b), 1112(b) (1988). But, the express language of section 544(a) does not authorize a court to use its discretion or equitable powers. 11 U.S.C. § 544(a). Thus, the use of equity is inappropriate to circumvent the application of the trustee's strong arm powers.

421 In *Ahlers* and *Official Committee* the proposed interpretations of the bankruptcy statutes disregarded the express language of those statutes, the policies underlying those statutes, and the historical interpretations of those statutes. Although the courts may have produced equitable results for some parties, the results would have been inequitable to the individuals those statutes were intended to protect. For example, the absolute priority rule was intended to protect unsecured creditors. In *Ahlers* the respondents' proposed interpretation of section 1129(b)(2)(B)(ii) would have eviscerated the absolute priority rule because it is difficult to value future labor and it is impossible to compel someone to work for the pendency of a reorganization plan.

422 In *Midlantic*, there were historical policies developed under the Bankruptcy

the use of equity to circumvent section 544(a) would be incorrect because the application of equity is contrary to the express language and the policies underlying the statute.[423]

3. The Application of Equity to Avoid the Use of the Trustee's Strong Arm Powers is Contrary to the Purpose Underlying Bankruptcy Code Section 544(a)

The trustee's status as a hypothetical lien creditor and a bona fide purchaser without knowledge was intended to allow the trustee to avoid secret liens.[424] Historically it has been a policy of the Act and the Code to combat secret liens, because it was thought that secret liens defrauded creditors.[425] Although the employment of the trustee's strong arm powers could lead to harsh results, Congress reached the conclusion that it was more

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Act which prohibited a trustee from using abandonment to frustrate state and local regulatory laws. Under the Bankruptcy Act the scope of the trustee's strong arm powers were enlarged by the Congress as a response to the Supreme Court's decision in York Mfg. Co. v. Cassell, 201 U.S. 344 (1906). Thereafter, the courts granted the trustee the status of a hypothetical lien creditor. P. MURPHY, *supra*, note 128, at § 12.01. There is nothing in the legislative history or the express language of the Code that indicates that the scope of the trustee's strong arm powers were intended to be reduced. R. D'AGOSTINO, *supra* note 77, at ¶ 544.02.

423 Courts have applied equity to disregard the express language of a statute when an individual was attempting to exploit the bankruptcy process and reach a result that was contrary to bankruptcy policy. *E.g.*, Shell Oil Co. v. Waldron (*In re* Waldron), 785 F.2d 936 (11th Cir. 1986), *cert. denied*, 478 U.S. 1028 (1986); *see* Chinichian v. Campolongo (*In re* Chinichian), 784 F.2d 1440 (9th Cir. 1986). In *Waldron*, the debtors attempted to reject an executory contract. The Eleventh Circuit held that the debtors could not use section 1325(a). to evade a legitimate contract. 11 U.S.C. § 1325(a) (1984). Rejection of a contract in bankruptcy is intended to enable a debtor to rehabilitate itself, the court declared. Because the debtors were solvent, the court reasoned, the rejection of the executory contract would not have furthered the debtors rehabilitation.

The use of equity runs counter to the policy and language of section 544(a). The historic policy of the strong arm powers was to avoid secret liens. *See, e.g.*, *In re* Horton, 31 F.2d 795, 799 (W.D. La. 1928); Millikin v. Second Nat'l Bank of Baltimore, 206 F. 14, 16 (4th Cir. 1913). What a constructive trust does is to give effect to a secret lien. *See* Sanyo Elec., Inc. v. Howard's Appliance Corp. (*In re* Howard's Appliance Corp.), 874 F.2d 88 (2d Cir. 1989) (constructive trust used to protect party that had an unperfected interest in some of the debtor's inventory).

424 R. JORDAN & W. WARREN, BANKRUPTCY 584 (2d ed. 1989); B. WEINTRAUB & A. RESNICK, BANKRUPTCY LAW MANUAL ¶ 7.01 (Rev. ed. 1986); D. BAIRD & T. JACKSON, BANKRUPTCY, 219-22 (1985).

425 *See* Benedict v. Ratner, 268 U.S. 353 (1925); Finance Co. of Am. v. Hans Mueller Corp. (*In re* Automated Bookbinding Servs., Inc.), 471 F.2d 546, 552 (4th Cir. 1972); United States v. Truitt (*In re* Ivy), 37 Bankr. 285, 288 (Bankr. E.D. Ky. 1983); D. WHALEY, PROBLEMS AND MATERIALS ON COMMERCIAL LAW 636 (1986).

important to address the problem of ostensible ownership.[426] Dealing with the problem of ostensible ownership is important because failure to do so could impair the effectiveness of our economy.[427] When creditors extend credit they must be able to rely on the accuracy of the filing and recording systems for personal and real property.[428] If a creditor does not have to record to perfect its security interest, then creditors are at risk when they extend credit because a creditor with an unperfected security interest will prevail over other creditors.[429] The purpose of Article Nine and the recording statutes is to provide certainty to business transactions.[430] The use of equity to recognize unperfected security interests in personal property and unrecorded interests in real property could lead to fraud and weaken the dependability of the filing and recording statutes.[431]

3. The Imposition of a Constructive Trust to Defeat the Use of Bankruptcy Code Section 544(a) is Tantamount to the Creation of Substantive Rights Which is Contrary to Bankruptcy Policy

Bankruptcy is intended to enforce entitlements created by nonbankruptcy law.[432] A bankruptcy court may not use its equi-

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426 *See supra* note 127-29 and accompanying text.

427 Creditors need to rely on the accuracy of filing and recording records when they extend financing. If there is a major exception to the perfection of security interests or recordation of interests in real property then Article Nine and the recordation systems will become ineffective and creditors will be unable to rely on their accuracy. The costs of secured credit will increase because of the risk that an unperfected lien will be recognized in a bankruptcy case. *See* Uniroyal, Inc. v. Universal Tire & Auto Supply Co., 557 F.2d 22, 23 (1st Cir. 1977); *Granada, Inc.*, 92 Bankr. at 510.

428 *See* National Bank of Alaska, N.A. v. Seaway Express Corp. (*In re* Seaway Express Corp.), 105 Bankr. 28, 31-32 (Bankr. 9th Cir. 1989), *aff'd*, 912 F.2d 1125 (9th Cir. 1990); J. WHITE & R. SUMMERS, *supra* note 129, at § 22-13.

429 *See* Sanyo Elec., Inc. v. Howard's Appliance Corp. (*In re* Howard's Appliance Corp.), 874 F.2d 88 (2d Cir. 1989); Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009 (5th Cir. 1985).

430 *See* Security State Bank v. Luebke, 303 Or. 418, 422, 737 P.2d 586, 588 (1987) (en banc); Andy Assocs., Inc. v. Bankers Trust Co., 49 N.Y.2d 13, 20, 424 N.Y.S.2d 139, 143, 399 N.E.2d 1160, 1164 (1979); T. QUINN, *supra* note 268, at ¶ 9-101[A][2].

431 *See* D & F Petroleum v. Cascade Oil Co. (*In re* Cascade Oil Co.), 65 Bankr. 35, 38-39 (Bankr. D. Kan. 1986); Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899, 904 (Bankr. D.C. Cal. 1984).

432 *See* T. JACKSON, *supra*, note 299, at 20-27. State law usually determines property interests in bankruptcy. *See* Mutual Benefit Life Ins. Co. v. Netree, Ltd.,(*In re* Pinetree, Ltd.), 876 F.2d 34, 36 (5th Cir. 1989), *reh'g denied*, July 25, 1989; Esselen Assocs. v. Crysen/Montenay Energy Co., 102 Bankr. 25, 28 (S.D.N.Y. 1989); Green v. Lowes, Inc. (*In re* Southwest Freight Lines, Inc.), 100 Bankr. 551, 554 (D. Kan.

table powers to create substantive rights that neither nonbankruptcy nor bankruptcy law has provided for in determining the extent of substantive rights.[433] In *Gillis v. California*,[434] the district court authorized a receiver to operate a business without obtaining a license from the state regulatory agency. Judicial Code section 65, the predecessor of Judicial Code section 959(b), required a receiver to comply with all applicable state and local regulatory laws.[435] The Supreme Court held that district court incorrectly authorized the receiver to operate the business without obtaining a license. The Court said that Congress had the authority to require that receivers adhere to local law.[436] The Court stated that "if the receiver cannot continue to carry on the [c]ompany's business according to the plain direction of Congress, he must pursue some other course permitted by law."[437]

The use of equity to impose a constructive trust to escape the application of section 544(a) is tantamount to the creation of a substantive legal right.[438] When a court impresses a construc-

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1989); *In re* Skelly, 38 Bankr. 1000, 1001 (D. Del. 1984); *In re* Baquet, 61 Bankr. 495, 498 (Bankr. D. Mont. 1986); 1 R. GINSBERG, BANKRUPTCY: STATUTES, RULES § 5.01[b][1] (2d ed. 1989).

433 United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986); Southern Railway Co. v. Johnson Bronze Co., 758 F.2d 137, 141 (3d Cir. 1985); Scott v. Almiro Fur Fashion (*In re* Fisher), 100 Bankr. 351, 357 (Bankr. S.D. Ohio 1989); *In re* Charles & Lillian Brown's Hotel, Inc., 93 Bankr. 49, 54 (Bankr. S.D.N.Y. 1988).

434 293 U.S. 62 (1934).

435 *Id.* at 63-64 (citing 11 U.S.C. § 24 (1888)). Judicial Code section 959(b) is codified at 28 U.S.C. 959(b) (1988).

436 *Id.* at 66.

437 *Id.*

438 The imposition of a constructive trust to cure a defective security interest is in essence the creation of substantive rights. A case in which a court refused to use its equitable powers in contravention of a bankruptcy statute and state law to create substantive rights is Johnson v. First Nat'l Bank of Montevideo, Minn., 719 F.2d 270 (8th Cir. 1983), *cert. denied*, 465 U.S. 1012 (1984). In *Johnson* the Eighth Circuit held that a bankruptcy court may not use its equitable powers under section 105(a) to toll the expiration of the statutory redemption period created under state law in connection with real estate mortgages. *Id.* at 278-79 (citing 11 U.S.C. § 105(a) (1980)). The court noted that section 105(a) vested a bankruptcy court with broad equitable powers. *Id.* at 273. The court further asserted that a bankruptcy court's equitable powers are not unlimited, especially where property rights created and defined by state law are concerned. *Id.* Unless there is conflict between state and federal law, the court explained, state law governs the issue of property rights. *Id.*

The *Johnson* opinion noted that the Supreme Court stressed in Butner v. United States that in a bankruptcy case property rights are created and defined by state law. *Id.* at 273-74 (citing Butner v. United States, 440 U.S. 48 (1979)). Therefore, under *Butner* and the language of section 105(a), the court reasoned, absent a specific grant of power from Congress or extraordinary circumstances, a bankruptcy court may not exercise its equitable powers to create substantive rights which do not exist under state law. *Id.* at 274. The court concluded that a bank-

tive trust to protect an unperfected security interest or unrecorded interest in real property from the trustee's strong arm powers, it is, in effect, transforming the creditor's status from unsecured to secured. Although the creditor has failed to comply with the applicable filing or recording statute, the court is granting the creditor the protection of the filing or recording statute. Equity should not assist a creditor that has failed to comply with a filing or recording statute.[439] In essence, the imposition of a constructive trust is granting a creditor postpetition perfection which is contrary to section 362(a)(4).[440] Thus, the imposition of a constructive trust is inimical to bankruptcy policy.

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ruptcy court may not employ section 105(a) to toll the running of the statutory redemption period. *Id.* The court held that the case lacked the exceptional circumstances necessary to invoke the equitable authority of the court. *Id.* Moreover, the debtors failed to identify any federal interest which would justify interfering with state law. *Id.* at 275. The court held that the bankruptcy court erred in using section 105(a) to suspend the running of the statutory redemption period. *Id.*

Johnson reflects the policy that bankruptcy is based on enforcing rights and entitlements that are created under state law. T. JACKSON, *supra*, note 299, at 21-22. Unless there is a conflict between bankruptcy and state law concerning property rights, it is the duty of the bankruptcy court to apply state law. *Johnson*, 719 F.2d at 274-75.

439 Uniroyal, Inc. v. Universal Tire & Auto Supply Co., 557 F.2d 22, 23 (1st Cir. 1977); *see* Pirsig Farms, Inc. v. John Deere Co. (*In re* Pirsig Farms, Inc.), 46 Bankr. 237, 242 (D. Minn. 1985); Boatmen's Bank of Benton v. Wiggs, (*In re* Wiggs), 87 Bankr. 57, 59 (Bankr. S.D. Ill. 1988).

440 Section 362(a)(4) prohibits any act to perfect a pre-petition security interest or record a pre-petition interest in real property. 11 U.S.C. § 362(a)(4) (1988). *See In re* Lenz, 90 Bankr. 458, 460 (Bankr. D. Colo. 1988); Bond Enters. Inc. v. Western Bank of Farmington (*In re* Bond Enters., Inc.), 54 Bankr. 366, 368-69 (Bankr. D.N.M. 1985); *In re* Carlisle Court, Inc., 36 Bankr. 209, 219 (Bankr. D.D.C. 1983); Emerson Quiet Kool Corp. v. Marta Group, Inc. (*In re* Marta Group, Inc.), 33 Bankr. 634, 639 (Bankr. E.D. Pa. 1983). Some courts and scholars have stated that a constructive trust arises only after it has been impressed by a court. *See* McAllester v. Aldridge (*In re* Anderson), 30 Bankr. 995, 1014 (M.D. Tenn. 1983); Edmondson v. Bradford-White Corp. (*In re* Tinnell Traffic Servs., Inc.), 41 Bankr. 1018, 1021 (Bankr. M.D. Tenn. 1984); G. BOGERT, *supra*, note 69, at § 472; *contra* Capital Investors Co. v. Morrison, 800 F.2d 424, 427 n.5 (4th Cir. 1986); Stansbury v. United States, 543 F. Supp. 154, 157 (N.D. Ill. 1982), *aff'd*, 735 F.2d 1367 (7th Cir. 1984); United States v. Fontana, 528 F. Supp. 137, 146 (S.D.N.Y. 1981); 5 A. SCOTT & W. FRATCHER, THE LAW OF TRUSTS § 462.4 (4th ed. 1989).

E. The Imposition of a Constructive Trust to Circumvent the Application of Bankruptcy Code Section 544(a) is Contrary to the Policy of Creditor Equality and Interferes with the Operation and Distributional Provisions of the Bankruptcy Code.

1. The Imposition of a Constructive Trust is Contrary to the Policy of Creditor Equality Which is Central to the Bankruptcy Process and Bankruptcy Code Section 544(a)

One of the fundamental policies of the Code is to foster creditor equality.[441] Equal treatment of similarly situated creditors is essential to the operation of the bankruptcy process.[442] The Code has various sections that are designed to insure creditor equality.[443] Section 544(a) is intended to promote creditor equality by avoiding unperfected liens and enhancing the distri-

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441 *See* England v. Industrial Comm'n of Utah (*In re* Visiting Home Servs., Inc.), 643 F.2d 1356, 1360 (9th Cir. 1981); Dotson v. Bradford (*In re* Bradford), 6 Bankr. 741, 744 (D. Nev. 1980); *In re* Co, 83 Bankr. 456, 458 (Bankr. N.D. Ohio 1988); *In re* Epstein, 39 Bankr. 938, 941 (Bankr. D.N.M. 1984); Johnson v. First Nat'l Bank of Montevideo, Minn. (*In re* Oak Farms, Inc.), 37 Bankr. 178, 179 (Bankr. D. Minn. 1984); *In re* South Atl. Packers Assoc., Inc., 28 Bankr. 80, 81 (Bankr. D.S.C. 1983).

442 *See* National Bank of Alaska, N.A. v. Seaway Express Corp. (*In re* Seaway Express Corp.), 912 F.2d 1125 (9th Cir. 1990); Elliott v. Frontier Properties, LP (*In re* Shurtleff, Inc.), 778 F.2d 1416, 1419 (9th Cir. 1985). The Seventh Circuit has made the following comments concerning the policy of creditor equality:

> And it might be more accurate to say not that there is a principle (however qualified) of equal treatment among creditors but that bankruptcy provides a mechanism for enforcing pre-bankruptcy entitlements given by state or federal law, with some exceptions. But the idea of equal treatment is a useful as well as persistent one. An important purpose of bankruptcy law is to prevent individual creditors from starting a "run" on the debtor by assuring them that they will be treated equally if the debtor is precipitated into bankruptcy, rather than being given either preferential treatment for having jumped the gun or disadvantageous treatment for having hung back.

In re Elcona Homes Corp., 863 F.2d 483, 484 (7th Cir. 1988)

443 Lane Bryant, Inc. v. Vichele Tops, Inc. (*In re* Vichele Tops, Inc.), 62 Bankr. 788, 792 n.4 (Bankr. E.D.N.Y. 1986); *see* 11 U.S.C. §§ 547, 1122(a), 1322(b)(1) (1988). One of the principal sections that assures creditor equality is section 547. DeRosa v. Buildex Inc. (*In re* F & S Cent. Mfg. Corp.), 53 Bankr. 842, 846 (Bankr. E.D.N.Y. 1985); *In re* Bennet, 35 Bankr. 357, 360 (Bankr. N.D. Ill. 1984); Gaver v. Ford Motor Credit Co. (*In re* Davis), 22 Bankr. 644, 646 (Bankr. M.D. Ga. 1982). Section 547(b) prohibits a creditor from receiving payments outside the ordinary course of business within the ninety-day period prior to the commencement of the case, and that allows it to receive a greater distribution than the creditor would receive in a chapter 7 case. Marathon Oil Co. v. Flatau (*In re* Craig Oil Co.), 785 F.2d 1563, 1564 n.1 (11th Cir. 1986); Barash v. Public Fin. Corp., 658 F.2d 504, 507 (7th Cir. 1981); 11 U.S.C. § 547(b) (1988); R. ROSENBERG, M. LUREY & M. FLICS, COLLIER, LENDING INSTITUTIONS AND THE BANKRUPTCY CODE ¶ 3.05 (1987).

bution of the estate for unsecured creditors.[444]

The imposition of a constructive trust is inimical to the policy of creditor equality, because it has the effect of favoring one creditor to the detriment of all the other unsecured creditors.[445] A constructive trust is an inchoate remedy which is used by a creditor when it has failed to perfect its security interest or record its interest in real property.[446] A constructive trust elevates an unsecured creditor to the status of a secured creditor.[447]

Historically, bankruptcy courts have been reluctant to impose constructive trusts because constructive trusts undermine creditor equality.[448] There was little precedent under the Bankruptcy Act for using a constructive trust to thwart the use of the trustee's strong arm powers.[449] Under the Code, the trustee's strong arm powers have been expanded.[450] The legislative history of section 544(a) does not state that a constructive trust may defeat the trustee's strong arm powers.[451]

2. Creditor Equality Is Necessary to Induce Creditors to Correctly Use Involuntary Bankruptcy

Traditionally the courts have fostered equality among creditors because equality is the most assured method to induce credi-

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444 R. D'AGOSTINO, *supra* note 77, at ¶ 544.01; *see* Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899, 903-04 (Bankr. C.D. Cal. 1984).

445 Chbat v. Tleel (*In re* Tleel), 876 F.2d 769, 773-74 (9th Cir. 1989); Elliott v. Frontier Properties, LP (*In re* Shurtleff, Inc., 778 F.2d 1416, 1420 (9th Cir. 1985); National Bank of Alaska, N.A. v. Seaway Express Co. (*In re* Seaway Express Corp.), 105 Bankr. 28, 31 (Bankr. 9th Cir. 1989), *aff'd*, 912 F.2d 1125 (9th Cir. 1990); Lane Bryant v. Vichele Tops, Inc. (*In re* Vichele Tops, Inc.), 62 Bankr. 788, 792 (Bankr. E.D.N.Y. 1986).

446 *See* Torres v. Eastlick (*In re* North American Coin & Currency, Ltd.), 767 F.2d 1573, 1575 (9th Cir. 1985), *cert. denied*, 475 U.S. 1083 (1986); Edmondson v. Bradford-White Corp. (*In re* Tinnel Traffic Servs., Inc.), 41 Bankr. 1018, 1021 (Bankr. M.D. Tenn. 1984).

447 The imposition of a constructive trust has the effect of granting an unsecured creditor with an unperfected security interest the status of a secured creditor because the imposition of a constructive trust grants the creditor an interest in the property superior to that of the debtor or other creditors. *See In re* Howard's Appliance Corp., 874 F.2d 88 (2d Cir. 1989).

448 *See* United States v. Randall, 401 U.S. 513, 517 (1971); Wisconsin v. Reese (*In re* Kennedy & Cohen, Inc.), 612 F.2d 963, 966 (5th Cir. 1980), *cert. denied*, 449 U.S. 833 (1980); *In re* Faber's Inc., 360 F. Supp. 946, 949-50 (D. Conn. 1973).

449 J. MOORE, *supra* note 133, at ¶ 70.47.

450 Schlossberg v. I.R.S (*In re* Barnett), 62 Bankr. 638, 640 (Bankr. D. Md. 1986); R. D'AGOSTINO, *supra* note 77, at ¶ 544.02.

451 *See* S. REP. No. 989, 95th Cong., 2d Sess. 85 *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5871.

tors to use and participate in the bankruptcy process. Bankruptcy is intended to protect creditors, and one of the major means of protecting creditors is the involuntary bankruptcy case.[452] Creditors file involuntary petitions to prevent the estate from being dissipated.[453] If the order for relief is entered in an involuntary case, the debtor remains in control or a trustee is appointed to operate the estate.[454] The trustee or debtor-in-possession may use section 544(a) to avoid unperfected security interests or unrecorded interests in real property. If a trustee or debtor-in-possession is subject to the imposition of a constructive trust when using the strong arm powers, creditors may be reluctant to commence an involuntary case. Under these conditions, an individual unsecured creditor may think that it will be better to pursue its nonbankruptcy remedies. The unsecured creditor may order a title search or U.C.C. report regarding a debtor. The report may indicate that a substantial amount of the debtor's assets are unencumbered. The creditor, realizing that there are assets against which it may recover on a judgment, will vigorously pursue its nonbankruptcy remedies and enforce its judgment. The creditor will not seek to file an involuntary petition because another creditor could seek to impose a constructive trust on the unencumbered assets. Creditors know that under state law, the judgment creditor will defeat another creditor with an unperfected security interest or unrecorded interest in real property. The major risk to the creditor is that another creditor will obtain a judgment and enforce it before it is able to enforce its judgment. The resultant race to the courthouse is precisely the conduct sought to be avoided by the Code.

It is important that creditors start an involuntary bankruptcy case before the estate is depleted.[455] Creditors commence involuntary cases to preserve the estate in an attempt to maximize the

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452 R. JORDAN & W. WARREN, *supra*, note 405, at 254-57; B. WEINTRAUB & A. RESNICK, *supra* note 405, at ¶ 2.03.

453 T. EISENBERG, BANKRUPTCY AND DEBTOR-CREDITOR LAW 461 (2d ed. 1988); E. WARREN & J. WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 374 (1986).

454 11 U.S.C. §§ 303(f), 303(g) (1988).

455 *See* 11 U.S.C. § 362(a) (1988); S. REP. No. 989, 95th Cong., 2d Sess. *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5835. If the business is viable as a going concern it is important to file the involuntary petition as soon as possible. The filing of the petition will serve to preserve the enterprise under the supervision of the bankruptcy court. The trustee will be able to pursue preferences and sell the enterprise as a going concern.

return for the unsecured creditors.[456] If creditors wait too long, the debtor's funds might be exhausted and the only option remaining will be to liquidate the company. In addition, at a late stage the company assets may have been expended and the unsecured creditors may receive nothing. An involuntary case may help to stabilize a failing business and provide it with the breathing spell that it needs to resuscitate itself.[457] The threat of the imposition of a constructive trust may defeat the use of involuntary bankruptcy cases, because creditors may think that they will be better off pursuing their individual state law remedies. Therefore, the policies underlying the commencement of involuntary bankruptcy cases will be frustrated if the policy of creditor equality is defeated through the imposition of constructive trusts.

3. The Imposition of a Constructive Trust Interferes with the Distributional Provisions of the Bankruptcy Code

Bankruptcy is a collective proceeding where nonbankruptcy entitlements are enforced according to the distributional scheme developed by Congress.[458] Nonbankruptcy law usually determines property interests in bankruptcy cases.[459] Under Bankruptcy law creditors of equal rank should receive the same proportionate distribution from the bankruptcy estate.[460] The imposition of a constructive trust has the effect of granting a creditor a greater entitlement because the creditor will usually receive a greater distribution than general unsecured creditors.[461] The imposition of a constructive trust creates rights in

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456 *See* D. BAIRD & T. JACKSON, BANKRUPTCY 71 (1985); D. ROME, BUSINESS WORKOUTS MANUAL ¶ 6.01[1] (1985).

457 The filing of an involuntary petition activates the automatic stay which prohibits creditor collection activity. *See* 11 U.S.C. § 362(a) (1988). Further, a chapter 11 debtor is granted a 120 day exclusive period to proffer a reorganization plan. 11 U.S.C. § 1121(b) (1988). Thus, chapter 11 may provide an ailing corporation the protection is needs to revitalize itself.

458 *In re* American Reserve Corp., 840 F.2d 487, 489 (7th Cir. 1988); Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 859-60 (1982).

459 *See* Geddes v. Livingston (*In re* Livingston), 804 F.2d 1219, 1221 (11th Cir. 1986); Tradax v. First Nat'l Bank in Stuttgart (*In re* Howell Enters., Inc.), 105 Bankr. 494, 497 (Bankr. E.D. Ark. 1989); Lupper v. Banner Indus., Inc. (*In re* Lee Way Holding Co.), 105 Bankr. 404, 410 (Bankr. S.D. Ohio 1989).

460 Barnes v. Whelan, 689 F.2d 193, 202 (D.C. Cir. 1982); 11 U.S.C. §§ 1122(a), 1322(b)(1) (1988).

461 The creditor who is the beneficiary of a constructive trust will retain the property to assure payment on a portion of its claim. An unsecured creditor is relegated

property, which is contrary to bankruptcy policy.[462] One of the consequences of imposing a constructive trust is that a creditor is granted a special priority that it would not be entitled to under state law.[463] The creation of a special priority means that strict application of the distributional provisions of the Code will be circumvented, and the creditor will receive a windfall.[464]

F. The Concept of Unjust Enrichment, a Central Issue in Finding Constructive Trust, is Difficult to Establish in a Bankruptcy Case Where a Trustee Uses Bankruptcy Code Section 544(a) to Avoid an Unperfected Security Interest

1. Introduction

One of the requirements for establishing a constructive trust is that a court must find that, were the debtor to retain the property, the debtor would be unjustly enriched.[465] The concept of unjust enrichment is difficult to establish in a bankruptcy case. First, Section 544(a) is intended to insure that state recording statutes concerning personal and real property are enforced in bankruptcy cases.[466] If a creditor has failed to perfect its interest according to state law then it is not entitled to the property because the creditor is a mere unsecured creditor. Secondly, the best interest test and absolute priority rule, which will be discussed later in this article, insure that any property recovered under section 544(a) will benefit the unsecured creditors rather than the debtor.[467]

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to waiting until the secured and priority creditors have been paid. A creditor with a constructive trust is in a better position than a general unsecured creditor.

462 *See* Butner v. United States, 440 U.S. 48, 55 (1979).

463 Under state law an unperfected security interest would only be enforceable against the debtor and not a judgment creditor. Vintero Corp. v. Corporation Venezolana de Fomento (*In re* Vintero Corp.), 735 F.2d 740, 742 (2d Cir. 1984), *cert. denied*, 469 U.S. 1087 (1984); U.C.C. § 9-301(1)(b) (1987).

464 Strict enforcement of section 544(a) would have relegated the creditor to the status of a general unsecured creditor. The imposition of a constructive trust means that the creditor will retain a property interest in the property subject to the constructive trust thereby receiving a windfall.

465 *See* American Nat'l Bank and Trust Co. of Rockford, Ill. v. United States, 832 F.2d 1032, 1035 (7th Cir. 1987); Republic Bank, Lubbock v. Daves (*In re* Daves), 770 F.2d 1363, 1366 (5th Cir. 1985); American Nat'l Bank of Jacksonville v. Fed. Deposit Ins. Co., 710 F.2d 1528, 1541 (11th Cir. 1983).

466 *In re* Keenan, 96 Bankr. 197, 200 (Bankr. D. Minn. 1989); Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899, 903-04 (Bankr. C.D. Cal. 1984).

467 The best interest test and the absolute priority rule insure that the unsecured creditors will receive the benefit of any interest in property avoided under section 544(a).

2. Policy Underlying Section 544(a) Prevents Unjust Enrichment to the Debtor and Insures that the Unsecured Creditors Will Receive Their Nonbankruptcy Entitlements

One of the policies underlying section 544(a) is to insure the enforcement of state recording statutes in bankruptcy cases.[468] If a creditor fails to perfect its interest in personal property then the creditor is a mere unsecured creditor.[469] An unperfected security interest may be valid against the debtor; however, it is subordinate to that of a lien creditor.[470] Section 544(a) enforces the state recording system, because it makes unperfected security interests and unrecorded interests in real property unenforceable in bankruptcy cases.[471] Section 544(a) insures that the policy of creditor equality will be effectuated in bankruptcy cases.[472] For example, in a chapter 11 case the estate is being operated for the benefit of creditors.[473] When a trustee uses section 544(a) to avoid an unperfected security interest, the trustee may either recover the property or the value of the property for the estate.[474] The recovered property becomes property of the estate.[475] The beneficiaries of the trustee's strong arm powers are the unsecured creditors because the property is brought into the estate and distributed according to the provisions of the Code.[476] If an individual creditor had pursued its state law remedies, then it

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468 *See supra* notes 405-12 and accompanying text. *In re* Keenan, 96 Bankr. 197, 200 (Bankr. D. Minn. 1989); Billings v. Cinnamon Ridge, Ltd. (*In re* Granada, Inc.), 92 Bankr. 501, 509-10 (Bankr. D. Utah 1988); J. WHITE, BANKRUPTCY AND CREDITORS' RIGHTS 222-25 (1985).

469 Budd Leasing Corp. v. Mid-Missouri Energy Corp. (*In re* Mid-Missouri Energy Corp.), 34 Bankr. 58, 60 (Bankr. W.D. Mo. 1983); Equilease Corp. v. AAA Mach. Co. (*In re* AAA Mach. Co.), 30 Bankr. 323, 326 (Bankr. S.D. Fla. 1983); Wil-Win Farms v. Ford Motor Credit Co. (*In re* Will-Win Farms), 21 Bankr. 299, 301 (Bankr. M.D. Fla. 1982).

470 Howison v. Rockport Nat'l Bank (*In re* Crowley), 42 Bankr. 603, 605 (Bankr. D. Me. 1984); *In re* Kaneohe Custom Design, Ltd., 41 Bankr. 298, 300-01 (Bankr. D. Haw. 1984) (citation omitted); U.C.C. § 9-301(1)(b) (1987); J. WHITE & R. SUMMERS, *supra*, note 129, at § 23-3.

471 National Bank of Alaska, N.A. v. Seaway Express Corp. (*In re* Seaway Express Corp.), 912 F.2d 1125 (9th Cir. 1990); *In re* Keenan, 96 Bankr. 197, 200 (Bankr. D. Minn. 1989); Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38 Bankr. 899, 903-04 (Bankr. C.D. Cal. 1984).

472 *See* Advanced Aviation, Inc. v. Vann (*In re* Advanced Aviation, Inc.), 101 Bankr. 310, 312 (Bankr. M.D. Fla. 1989); D. COWANS, *supra* note 188, at § 10.4.

473 *See* Boatmen's Bank of Wenton v. Wiggs (*In re* Wiggs), 87 Bankr. 57, 58 (Bankr. S.D. Ill. 1988); R. JORDAN & W. WARREN, *supra*, note 405 at 727-28.

474 11 U.S.C. § 550(a) (1988).

475 11 U.S.C. §§ 541(a)(3), 541(a)(4), 551 (1988).

476 Loup v. Great Plains W. Ranch Co. (*In re* Great Plains W. Ranch Co.), 38

would have been able to enforce its judgment against any of the debtor's property that was unencumbered.[477] The effect of section 544(a) is to vest the trustee with all of the remedies of the individual creditors so that the trustee may act on behalf of all of the individual creditors.[478] When the trustee acts to avoid an unperfected security interest he or she is enforcing the entitlements of the unsecured creditors. There is no unjust enrichment when a trustee uses section 544(a) to avoid an unperfected security interest because, under nonbankrutpcy law, the unsecured creditors would have pursued their state law remedies and would have prevailed against the creditor with the unperfected security interest.[479]

3. Unjust Enrichment and Chapter 7

In a chapter 7 case the debtor turns over its property to a trustee.[480] A trustee is responsible for liquidating the estate and distributing the proceeds to the creditors.[481] When a trustee uses section 544(a) to avoid an unperfected security interest it is difficult to establish unjust enrichment. The trustee was not a party to the transaction that gave rise to the granting of the security interest.[482] Further, the trustee is acting on behalf of the unsecured creditors who were not parties to the transaction which created the security interest. In a chapter 7 case it is incorrect to impute any of the debtor's malfeasance to the estate.[483] If the trustee is successful in avoiding an unperfected security interest it is doubtful that the debtor will derive any direct benefit because in a chapter 7 case the debtor is the last entity to be paid.[484]

Bankr. 899, 903-04 (Bankr. C.D. Cal. 1984); M. BIENENSTOCK, *supra*, note 3, at 345-47.

477 *See* U.C.C. § 9-301(1)(b) (1987).

478 R. AARON, BANKRUPTCY LAW FUNDAMENTALS § 10.01[1] (1990); D. COWANS, *supra* note 188, at § 10.4.

479 T. JACKSON, *supra*, note 299, at 71; T. CRANDALL, R. HAGEDORN & F. SMITH, DEBTOR-CREDITOR LAW MANUAL ¶ 16.02 (1985).

480 11 U.S.C. § 704(1) (1988).

481 11 U.S.C. §§ 702, 704(1) (1988).

482 An interim trustee is appointed by the United States Trustee promptly after the entry of the order for relief. 11 U.S.C. § 701(a)(1) (1988). Thereafter, a permanent trustee is elected at the first section 341 meeting. *Id.* at § 702(b) (1988).

483 In a chapter 7 case a debtor is a nominal entity because it does not operate the estate. The debtor does not control how the assets are to be distributed. Thus, the debtor is insignificant in the management of a chapter 7 case.

484 Under section 726(a) all administrative expenses and unsecured claims have to be paid prior to the debtor's receipt of any distribution. 11 U.S.C. §§ 726(a)(1), (2) (1988). Therefore, if the trustee is able to avoid an unperfected security inter-

4. Unjust Enrichment and Chapter 11

a. *The Best Interest Test Prevents Unjust Enrichment*

With certain exceptions, the distributional provisions of chapter 11 provide that creditors must be paid prior to the equity holders receiving any distributions.[485] The best interest of creditors test requires that an impaired unsecured creditor who has rejected the plan of reorganization receive under the chapter 11 plan at least what he would receive in a chapter 7 case.[486] If a plan of reorganization fails to comply with the best interest test, then a bankruptcy court will deny confirmation.[487] Under the best interest test, creditors receive the benefit of any property that is brought into the estate as a result of the trustee's strong arm powers.[488] In a chapter 11 case if the trustee is able to avoid an unperfected security interest the unsecured creditors and not the debtor will reap the benefits; consequently, there is no unjust enrichment.

b. *Unjust Enrichment and the Absolute Priority Rule*

The classic example of how chapter 11 prevents unjust enrichment is the absolute priority rule set forth in section 1129(b)(2)(B)(ii). In *Norwest Bank Worthington v. Ahlers*,[489] the Court was confronted with the issue of whether the debtors' promises of future experience, labor and expertise permitted the confirmation of their plan of reorganization even though the plan violated the absolute priority rule.[490] The Court declared that the reorganization plan should not have been confirmed.[491] The

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est, the debtor will not benefit until all of the creditors are paid. *See* 11 U.S.C. § 726(a) (1988); R. D'AGOSTINO, *supra* note 77, at ¶ 726.02[6].

485 Section 1129(b)(2)(B)(i) provides that a class of dissenting unsecured creditors must be paid in full prior to equity security holders receiving any distributions. Norwest Bank Washington v. Ahlers, 485 U.S. 197, 202 (1988); 11 U.S.C. § 1129(b)(2)(i)(B) (1988).

486 *Id.* at § 1129(a)(7)(A)(ii).

487 *Id.* at § 1129(b)(2)(B); *In re* Edgewater Motel, Inc., 85 Bankr. 989, 992-96 (Bankr. E.D. Tenn. 1988); *In re* Future Energy Corp., 83 Bankr. 470, 489-90 (Bankr. S.D. Ohio 1988); *In re* Brusseau, 57 Bankr. 457, 459 (Bankr. D.N.D. 1985).

488 Section 1129(a)(7)(A)(ii) insures that unsecured creditors have to receive the amount they would have received in a chapter 7 case. In a chapter 7 case unsecured creditors have priority over equity security holders. 11 U.S.C. § 726(a) (1988). Therefore, any property that is recovered under Section 544(a) has to be used to pay the unsecured creditors prior to the equity security holders receiving any distribution.

489 485 U.S. 197 (1988).

490 *Id.* at 199.

491 *Id.*

Supreme Court reasoned that the absolute priority rule was embodied in section 1129(b)(2)(B).[492] The plan of reorganization violated the absolute priority rule because it permitted the debtors to retain their equity interests.[493] The Court held that the debtors failed to satisfy the substantial contribution exception to the absolute priority rule.[494]

Since *Ahlers*, lower federal courts have vigorously enforced the absolute priority rule, and they have refused to confirm plans of reorganization that have failed to satisfy the rule.[495] An example of how stringently the absolute priority rule has been enforced after *Ahlers* is *In re Stegall*.[496] In *Stegall*, the debtors proposed to pay their unsecured creditors ten percent of the debt during the next ten years without any interest. This amount consisted of twenty-four thousand dollars plus their labor. Twenty-two thousand dollars of this amount represented the value of crops planted after the commencement of the case.

The Seventh Circuit affirmed the denial of the confirmation of the plan of reorganization, because the plan failed to satisfy the absolute priority rule.[497] The court doubted that the fresh capital doctrine, under which a debtor may "retain an interest in the bankrupt estate ahead of his creditors to the extent that he puts new capital into the estate," was viable after *Ahlers*.[498] In

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492 *Id.* at 202.

493 *Id.*

494 The Supreme Court declared:

> Viewed from the time of approval of the plan, respondents' promise of future services is intangible, inalienable, and in all likelihood, unenforceable. It "has no place in the asset column of the balance sheet of the new [entity]." Unlike "money or money's worth," a promise of future services cannot be exchanged in any market for something of value to the creditors *today*. In fact, no decision of this Court or any Court of Appeals, other than the decision below, has ever found a promise to contribute future labor, management, or expertise sufficient to qualify for the *Los Angeles Lumber* exception to the absolute priority rule.

Id. at 204 (citation omitted) (emphasis in original).

495 *See, e.g.*, *In re* Stegall, 865 F.2d 140 (7th Cir. 1989); Carson Nugett, Inc. v. Green (*In re* Green), 98 Bankr. 981 (Bankr. 9th Cir. 1989); *In re* Ashton, 107 Bankr. 670 (Bankr. D.N.D. 1989); *In re* Snyder, 105 Bankr. 898 (Bankr. C.D. Ill. 1989); *In re* Johnson, 101 Bankr. 307 (Bankr. M.D. Fla. 1989); *In re* Perdido Motel Group, Inc., 101 Bankr. 289 (Bankr. N.D. Ala. 1989); Pennbank v. Winters (*In re* Winters), 99 Bankr. 658 (Bankr. W.D. Pa. 1989).

496 865 F.2d 140 (7th Cir. 1989).

497 *Id.* at 141-44.

498 *Id.* at 142. Judge Posner wrote:

> The Solicitor General's amicus curiae brief in *Norwest Bank v. Worthington v. Ahlers*, . . . argued that [the fresh capital exception] is wrong,

addition, the Seventh Circuit said that the debtors' proposed contribution was insufficient to warrant confirmation of the plan of reorganization.[499] Under *Ahlers*, property of the estate has to be distributed to pay the claims of the unsecured creditors; therefore, the debtor will not be unjustly enriched if a trustee is allowed to avoid an unperfected security interest.[500]

5. Unjust Enrichment and Chapter 13: The Best Interest Test

If an unperfected security interest is avoided in a chapter 13 case, the property or its value becomes property of the estate.[501] In order to have a chapter 13 plan confirmed, a debtor must comply with section 1325.[502] Section 1325(a)(4) provides that an unsecured creditor must receive at least what it would in a chapter 7 case.[503] If a debtor fails to comply with section 1325(a), confirmation of the chapter 13 plan will be denied.[504] Any property recovered under section 544(a) would have to be used to pay the claims of the unsecured creditors and could not be directly dis-

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> pointing out that the Code codifies the exceptions to the absolute-priority rule and that the fresh-capital exception is not in the list. The Solicitor General noted that creditors are better judges of what is in their self-interest than bankruptcy judges, so if most or at least a substantial minority of creditors (weighted by debt) are not impressed by the debtor's proposal to infuse new capital into the sinking enterprise, that ought to be the end of it.

Id. (citations omitted).

499 *Id. Stegall* reflects the position that the absolute priority rule demands that dissatisfied creditors be compensated if the debtor is to retain an interest in the enterprise.

500 When a business is incorporated it is assumed that the corporation will be operated for the benefit of its shareholders. H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS §§ 71 & 72 (3d ed. 1983). The shareholders are supposed to receive the profits of the corporation in the form of dividends and shareholder equity. R. CLARK, CORPORATE LAW § 1.2 (1986). But, when a corporation files for chapter 11 the corporation is operated not only for the shareholders, but also for the creditors. M. BIENENSTOCK, *supra*, note 3, at 71-72. If the debtor fails to act in the best interests of the unsecured creditors then the unsecured creditors may seek the appointment of a trustee. *See In re* Ionosphere Clubs, Inc., 113 Bankr. 164, 167-69 (Bankr. S.D.N.Y. 1990); 11 U.S.C. § 1102(a)(2) (1988). The creditors are to be paid first and if there is a surplus then the equity security holders will receive a distribution. *Id.* at § 726(a). The best interest test and the absolute priority rule insure that the creditors will be paid prior to the equity security holders receiving a distribution. Therefore, the policy justifying the imposition of a constructive trust against a debtor is inapplicable in a chapter 11 case.

501 *Id.* at §§ 103(a), 550(a).

502 *Id.* at § 1325.

503 *Id.* at § 1325(a)(4).

504 *See In re* Rhein, 73 Bankr. 285 (Bankr. E.D. Mich. 1987).

tributed to the debtor.[505] Consequently, there is no unjust enrichment if an unperfected security interest is avoided in a chapter 13 case.

G. *The Breach of a Security Agreement Should Not Be the Basis for Imposing a Constructive Trust*

1. Introduction

Article Nine of the Uniform Commercial Code provides that a security agreement must be entered into between a lender and a borrower before a security interest will attach.[506] A security agreement is a contract that governs the obligations between a lender and borrower.[507] A security agreement may provide for the place where the collateral is to be located.[508] As noted earlier, in *In re Howard's Appliance Corp.*[509] the Second Circuit held that the debtor's breach of a security agreement with Sanyo Electric Co., Inc. (Sanyo) was a sufficient basis for the imposition of a constructive trust over goods stored in New Jersey.[510] The court emphasized that, until six months prior to the chapter 11 filing, the debtor had stored its inventory in New York in accordance with the security agreement.[511] The court was persuaded that the debtor began warehousing the Sanyo collateral in New Jersey with the expectation that Sanyo would not perfect its interest in the collateral located in New Jersey.[512] Although the debtor had notified Sanyo's shipping department regarding the shipment of goods to New Jersey, the court ruled that it was incumbent upon the debtor to notify one of Sanyo's principals that the Sanyo merchandise would be stored in New Jersey.[513]

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505 Section 726(a) mandates that the claims of the unsecured creditors be paid in full before the debtor receives any distribution. 11 U.S.C. § 726(a) (1988).

506 U.C.C. § 9-203(1)(a) (1987); *see* J. WHITE & R. SUMMERS, *supra*, note 129, at § 22-3. A written security agreement is unnecessary if the creditor has possession of the collateral. U.C.C. § 9-203(1)(a) (1987).

507 U.C.C. Section 9-105(1)(l) defines security agreement as "an agreement which creates or provides for a security interest." U.C.C. § 9-105(1) (1987). The security agreement functions as a contract to evidence the terms of the transactions and the events of default. *See* R. HENSON, *supra*, note 265, at § 3-10; *see also* T. QUINN, *supra* note 268, at ¶ 9-203[A][1][a].

508 *See* Sanyo Elec., Inc. v. Howard's Appliance Corp. (*In re* Howard's Appliance Corp.), 874 F.2d 88, 90 (2d Cir. 1989).

509 874 F.2d 88 (2d Cir. 1989).

510 *Id.* at 94.

511 *Id.*

512 *Id. See supra* note 64.

513 *Id.* at 95.

2. Breach of a Security Agreement is an Insufficient Basis to Warrant the Imposition of a Constructive Trust

The breach of a security agreement should not result in the imposition of a constructive trust. First, a breach of a security agreement is a mere breach of contract, which is an insufficient basis for the imposition of a constructive trust.[514] A constructive trust has traditionally been employed to rectify breaches of fiduciary duty and fraud.[515] A conventional borrower and lender relationship is not a fiduciary relationship.[516] Therefore, the theories underlying the imposition of a constructive trust are inappropriate in the context of a lender and borrower who enter into a security agreement.

3. The Language and Policies Underlying Article Nine Do Not Warrant the Imposition of a Constructive Trust for the Breach of a Security Agreement

Article Nine of the U.C.C. does not lend support to the imposition of a constructive trust for the transfer of goods in contravention of a security agreement. It is the duty of the lender to monitor the location of the goods.[517] Indeed, Article Nine envisions that the location of the collateral will change during the repayment period of the loan.[518] U.C.C. section 9-103(1)(d)(i)

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514 *See supra* notes 198-204 and accompanying text.

515 *See supra* note 196 and accompanying text. *See also* United States v. Holzer, 840 F. 2d 1343, 1347 (7th Cir. 1988); United States v. Brimberry, 779 F.2d 1339, 1348 (8th Cir. 1985); MDO Dev. Corp. v. Kelly, 726 F. Supp. 79, 85 (S.D.N.Y. 1989); Kopelman v. Kopelman, 710 F. Supp. 99, 102-03 (S.D.N.Y. 1989); Brinkman v. White Farm Equip. Co. (*In re* White Farm Equip. Co.), 63 Bankr. 800, 807 (Bankr. N.D. Ill. 1986).

516 *See* Cosoff v. Rodman (*In re* W.T. Grant Co.), 699 F.2d 599, 609 (2d Cir. 1983), *cert. denied*, 464 U.S. 822 (1983); Weinberger v. Kendrick, 698 F.2d 61, 78 (2d Cir. 1982), *cert. denied*, 464 U.S. 818 (1983); Anaconda-Ericsson, Inc. v. Hessen (*In re* Teletronics Servs., Inc., 29 Bankr. 139, 169 (Bankr. E.D.N.Y. 1983). Indeed, lenders vehemently attempt to escape a fiduciary relationship with their borrowers so that they will not be subject to equitable subordination or lender liability. *See In re* Century Inns, Inc., 59 Bankr. 507, 522-26 (Bankr. S.D. Miss. 1986); Toledo Trust Co. v. Peoples Banking Co. (*In re* Hartley), 52 Bankr. 679, 691 (Bankr. N.D. Ohio 1985); Zimmerman v. Central Penn Nat'l Bank (*In re* Ludwig Honold Mfg. Co.), 46 Bankr. 125, 128-29 (Bankr. E.D. Pa. 1985). It is only when there is overreaching or fraud that equitable subordination of a lender's claim is appropriate. Unsecured Creditors' Comms. of Pacific Express, Inc. v. Pioneer Commercial Funding Corp. (*In re* Pacific Express, Inc.), 69 Bankr. 112, 116 (Bankr. 9th Cir. 1986).

517 Aoki v. Shepherd Mach. Co. (*In re* J.A. Thompson & Son), 665 P.2d 941, 950 (9th Cir. 1982); Associates Commercial Corp. v. Trim-Lean Meat Prods., Inc. (*In re* Trim-Lean Meat Prods., Inc.), 5 Bankr. 190, 191 (Bankr. D. Del. 1980), *aff'd*, 10 Bankr. 333 (D. Del. 1981).

518 Article Nine has an entire section devoted to multi-state transactions. *See*

grants a secured party four months to perfect its security interest in the new jurisdiction when collateral subject to a perfected security interest has been removed to another jurisdiction.[519]

Therefore, suppose that in *In re Howard's Appliance Corp.*, the Sanyo collateral had been originally shipped to Nassau County, New York on January 2, 1986. Thereafter, on April 1, 1986, the debtor began warehousing the Sanyo merchandise in New Jersey. Furthermore, Sanyo filed its financing statements with New York Secretary of State and the Nassau County Clerk. Then, on August 6, 1986, the debtor filed for chapter 11. Under these facts, Sanyo has an unperfected security interest, because it failed to file a financing statement within the four month period prescribed by U.C.C. section 9-103(1)(d)(i).[520] Sanyo's failure to file a financing statement precluded prospective creditors from receiving notice concerning Sanyo's interest in the collateral.[521] Some creditors may have been mislead as to the status of the collateral.[522]

In *In re Howard's Appliance Corp.*,[523] the Second Circuit im-

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U.C.C. § 9-103 (1987); J. WHITE & R. SUMMERS, *supra*, note 129, at §§ 22-20 - 22-25; R. BRAUCHER & R. RIEGERT, INTRODUCTION TO COMMERCIAL TRANSACTIONS 472-78 (1977).

519 U.C.C. § 9-103(1)(d)(i) (1987); *see* 8 W. HAWKLAND, R. LORD & C. LEWIS, UNIFORM COMMERCIAL CODE SERIES § 9-103:05 (1986).

520 *See* Zimmerman v. Continental Bank (*In re* Foland & Co.), 55 Bankr. 593 (Bankr. E.D. Pa. 1985); Borg-Warner Acceptance Corp. v. Twelves (*In re* Utah AgriCorp., Inc.), 12 Bankr. 573 (Bankr. D. Utah 1981); U.C.C. § 9-103(1)(d)(i) (1987); R. HENSON, *supra*, note 265, at § 9-6.

521 The Third Circuit has stated that "[t]he purpose of the four-month filing requirement is to protect subsequent creditors and/or purchasers of the collateral who otherwise cannot determine whether the collateral is subject to the interests of a third party. General Electric Credit Corp. v. Nardulli & Sons, 836 F.2d 184, 191 (3d Cir. 1988).

522 The purpose of the filing requirements of Article Nine of the U.C.C. is to require a creditor to inform other creditors about its interest in the collateral. *Nardulli & Sons.*, 836 F.2d at 191; Frank v. Norbel Credit Union (*In re* Murray), 109 Bankr. 245, 247 (Bankr. E.D. Mich. 1989). The burden is on the creditor to monitor its collateral and to make sure that its security interest is perfected. Any creditor reviewing the filing records would not have been placed on notice of Sanyo's interest. *Howard's Appliance* suggests, however, that the debtor may be required to inform the creditor that the collateral is being transferred to another jurisdiction. Furthermore, *Howard's Appliance* could be construed as imposing a fiduciary duty on the borrower to do everything possible to insure that a lender perfects its security interest. This is contrary to the language and policy of multi-state provisions. Furthermore, it is contrary to the language and policy of Article Nine of the U.C.C. to employ equitable remedies to protect a creditor who has failed to perfect its security interest. Uniroyal, Inc. v. Universal Tire & Auto Supply Co., 557 F.2d 22, 23 (1st Cir. 1977). Thus, the imposition of a constructive trust in the context of a multi-state transaction governed by the Article Nine of the U.C.C. is inappropriate.

523 874 F.2d 88 (2d Cir. 1989).

posed a constructive trust on the Sanyo collateral because the court found that the debtor had a duty to inform Sanyo's principals regarding the location of the collateral.[524] The language of U.C.C. section 9-103(1)(d)(i) does not impose a duty upon a borrower to inform the lender as to the location of the collateral; rather, it is incumbent upon the lender to make sure that it has perfected its security interest.[525] Consequently, it is incorrect to impose a constructive trust to protect a secured creditor who has failed to follow the filing requirements of Article Nine.

V. WHEN AN ESTATE IS SOLVENT A TRUSTEE SHOULD NOT BE PERMITTED TO USE BANKRUPTCY CODE SECTION 544(a) TO AVOID AN UNPERFECTED SECURITY INTEREST OR UNRECORDED INTEREST IN REAL PROPERTY

A. The Policy Underlying Bankruptcy Code Section 544(a) Mandates That a Solvent Debtor Should Not Be permitted to Use the Trustee's Strong Arm Powers

The policy underlying section 544(a) mandates that a solvent debtor should not be permitted to use the trustee's strong arm powers. The issue of whether a constructive trust should be imposed to avoid the trustee's strong arm powers involves the issue of equity. Congress thought secret liens were inequitable, and it enacted section 544(a) as a means of combatting them. When Congress enacted section 544(a), it made a conscious policy decision to protect unsecured creditors at the expense of creditors who might have been defrauded by an unscrupulous debtor.[526] Nevertheless, there may be circumstances where it would be inequitable and imprudent to permit a trustee to use section 544(a). For example, suppose a debtor is solvent and there are sufficient assets to pay all the claims of the general unsecured creditors. Under these circumstances, a bankruptcy court should prevent a trustee from using section 544(a). All of the claims of the general unsecured creditors are being paid; the creditor who receives a constructive trust does not receive a preference.[527]

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524 *Id.* at 94-95.

525 *See* J. WHITE & R. SUMMERS, *supra*, note 129, at § 22-21.

526 *See* Boatmen's Bank of Benton v. Wiggs (*In re* Wiggs), 87 Bankr. 57 (Bankr. S.D. Ill. 1988); *Great Plains*, 38 Bankr. at 899; Brent Explorations, Inc. v. Karst Enters., Inc. (*In re* Brent Explorations, Inc.), 31 Bankr. 745 (Bankr. D. Colo. 1983).

527 One of the major arguments against the imposition of a constructive trust to defeat the trustee's strong arm powers is that a constructive trust violates the policy of creditor equality. Chbat v. Tleel (*In re* Tleel), 876 F.2d 769, 774 (9th Cir. 1989);

The policy of creditor equality is honored. In addition, the policy of ostensible ownership is not impaired because the estate has sufficient assets to pay all the claims and the creditors are not injured because of secret liens.

Section 544(a) was intended to benefit unsecured creditors.[528] When a solvent debtor uses section 544(a) to avoid an unperfected security interest, the debtor will receive the benefits of the trustee's strong arm powers instead of the unsecured creditors, which is contrary to bankruptcy policy. Unsecured creditors do not benefit when a solvent debtor uses section 544(a), because the estate has sufficient assets to pay their claims. In *In re Chapman*[529] one of the issues before the court was whether the debtor should be permitted to avoid an unrecorded third mortgage. The court held that the debtor should not be permitted to use section 544(a)(3) to avoid an unrecorded third mortgage.[530] The court reasoned that the strong arm powers were intended to benefit unsecured creditors and that lien avoidance would produce an insignificant benefit to one unsecured creditor.[531] The holding in *Chapman* is correct because the debtor rather than the creditor would benefit from lien avoidance.

An analogous situation to when a solvent debtor attempts to use section 544(a) is when a solvent debtor attempts to reject an executory contract. The rejection of an executory contract is intended to permit debtor rehabilitation by purging the estate of burdensome executory contracts.[532] Some courts have held that a solvent debtor may not use section 365(a) to reject an unexpired executory contract or an unexpired lease.[533] The decisions regarding solvent debtors attempting to use section

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Elliott v. Frontier Properties, LP (*In re* Shurtleff, Inc.), 778 F.2d 1416, 1420 (9th Cir. 1986).

528 *See Tleel*, 876 F.2d at 769; R. D'AGOSTINO, *supra* note 77, at ¶ 544.01; M. BIENENSTOCK, *supra*, note 3, at 345.

529 51 Bankr. 663 (Bankr. D.C. 1985).

530 *Id.* at 666.

531 *Id.*

532 L. KING & M. COOK, CREDITORS' RIGHTS, DEBTORS' PROTECTION AND BANKRUPTCY § 17.01 (2d ed. 1989); Cuevas, *Necessary Modifications and Section 1113 of the Bankruptcy Code: A Search for the Substantive Standard for Modification of a Collective Bargaining Agreement in a Corporate Reorganization*, 64 AM. BANKR. L.J. 133, 143-44 (1990).

533 *See, e.g.*, Shell Oil Co. v. Waldron (*In re* Waldron), 785 F.2d 936 (11th Cir. 1986), *cert. denied*, 478 U.S. 1028 (1986); Bregman v. Meehan (*In re* Meehan), 59 Bankr. 380 (E.D.N.Y. 1986). In *In re Meehan*, the district court affirmed a bankruptcy court order denying the debtor's motion to reject an executory contract. The court reasoned that rejection of an executory contract should benefit the unsecured creditors. *Id.* at 385. The debtor was solvent; therefore, rejection of the

365(a) to reject executory contracts provide insights concerning whether a solvent debtor should be allowed to use section 544(a) to avoid unperfected liens and unrecorded interests in real property. One of the policies underling sections 365(a) and 544(a) is to enhance the distribution of the estate for unsecured creditors.[534] As in the rejection of an executory contract by a solvent debtor, the use of section 544(a) by a solvent debtor will not benefit the unsecured creditors. Further, the decisions involving solvent debtors and executory contracts involve whether it is consistent with the policy underlying section 365(a) to permit rejection. When courts deny solvent debtors the authority to reject executory contracts the courts are not ignoring the express language of section 365(a) to do equity; rather, the courts are looking to the policy of section 365(a) to resolve the issue. When a court prohibits a solvent debtor from using section 544(a), the court would not be disregarding the express language of the statute. Rather, the court would be using the policy underlying section 544(a) to determine whether it is correct to allow lien avoidance.[535]

B. The Filing of a Chapter 11 Petition by a Solvent Debtor for the Sole Purpose of Avoiding an Unperfected Security Interest or Unrecorded Interest in Real Property Should Be Deemed in Bad Faith

The use of section 544(a) by a solvent debtor to avoid an

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executory contract would not benefit the unsecured creditors. *Id.* The Ninth Circuit Bankruptcy Appellate Panel has stated:

> If without regard to rejection of the contract, the estate is solvent and the unsecured creditors would receive 100 percent of their claims, rejection would then accomplish nothing for the general unsecured creditors. We do not doubt that if in the judgment of the bankruptcy court, an estate is solvent in the sense that a 100 percent payout will occur in the event of liquidation, that it is within the discretion of the court to decline to authorize rejection of a contract on the grounds that no benefit would accrue to the creditors from rejection.

In re Chi-Feng Huang, 23 Bankr. 798, 803 (Bankr. 9th Cir. 1982).

534 T. EISENBERG, *supra*, note 434, at 687-89; B. WEINTRAUB & A. RESNICK, *supra*, note 405, at 7-3.

535 One of the major problems with cases imposing constructive trusts to evade the application of section 544(a) is that they attempt to do equity; however, in the process they ignore the policy underlying the statute. *See* Sanyo Elec. Inc. v. Howard's Appliance Corp. (*In re* Howard's Appliance Corp.), 874 F.2d 88 (2d Cir. 1989). By prohibiting a solvent debtor from using section 544(a), the policy underlying the statute is enforced because the unsecured creditors would not benefit from lien avoidance. Further, the problem of ostensible ownership is not involved because the estate has sufficient assets to satisfy the creditors' claims.

unperfected security interest or unrecorded interest in real property may be deemed bad faith.[536] The bankruptcy court is a court of equity, and the bankruptcy laws are not intended to be used as a sword.[537] The bad faith doctrine is intended to insure that debtors do not misuse the bankruptcy process.[538] One of the goals of the bankruptcy laws is to foster debtor rehabilitation.[539] If a solvent debtor has filed a chapter 11 case for the purpose of avoiding an unperfected security interest or unrecorded interest in real property then a creditor may make a motion to dismiss the case.[540] The solvent debtor's case does not belong in the bankruptcy court because there is no need for rehabilitation and the unsecured creditors will not benefit from lien avoidance. Under these circumstances the court should dismiss the solvent debtor's case.[541]

VI. CONCLUSION

Imposing a constructive trust to thwart the use of the

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536 The bankruptcy laws are intended to assist individuals who need financial rehabilitation. *See* R. JORDAN & W. WARREN, *supra*, note 405, at 23-25. Solvent individuals are generally not permitted to use the bankruptcy laws because they do not need financial rehabilitation. *In re* Davis, 93 Bankr. 501, 504 (Bankr. S.D. Tex. 1987); *In re* Smith, 58 Bankr. 448, 450 (Bankr. W.D. Ky. 1986); *see also, In re* Karum Group, Inc., 66 Bankr. 436 (Bankr. W.D. Wash. 1986). In *In re Davis*, the bankruptcy court dismissed a chapter 11 petition because it was filed in bad faith. The debtor filed the chapter 11 case to avoid posting a supersedeas bond. The debtor was solvent. The court found that the debtor filed the chapter 11 petition as a litigation tactic—not with an honest intention to reorganize. If a debtor is solvent then it has the ability to pay its debts, and it is unnecessary to use section 544(a) to enhance the size of the estate to insure a one hundred percent distribution. Thus, the use of section 544(a) by a solvent debtor may be deemed bad faith.

537 *Waldron*, 785 F.2d at 940; *In re* Penn Cent. Transp. Co., 458 F. Supp. 1346, 1356 (E.D. Pa. 1978).

538 *In re* Walter, 108 Bankr. 244, 247-48 (Bankr. C.D. Cal. 1989); *In re* Ravick Corp., 106 Bankr. 834, 842-43 (Bankr. D.N.J. 1989); *In re* Berkshire Manor Apartments, Ltd., 104 Bankr. 417, 418-19 (Bankr. N.D. Fla. 1989).

539 *See* Fitzsimmons v. Walsh (*In re* Fitzsimmons), 725 F.2d 1208, 1210 (9th Cir. 1984); *In re* Ionosphere Clubs, Inc., 98 Bankr. 174, 176-77 (Bankr. S.D.N.Y. 1989); Cuevas, *Judicial Code Section 158: The Final Order Doctrine*, 18 SW. U.L. REV. 1, 3-4 n.6 (1988).

540 Section 1112(b) permits a bankruptcy court to dismiss a case for cause. 11 U.S.C. § 1112(b) (1988). The concept of "cause" in section 1112(b) was intended to be construed flexibly. *In re* Roy Dawson Radio Corp., 70 Bankr. 588, 590-91 (Bankr. M.D. Fla. 1987).

541 Dismissal is appropriate because the debtor is attempting to exploit the bankruptcy process. *See* Natural Land Corp. v. Baker Farms, Inc. (*In re* Natural Land Corp.), 825 F.2d 296 (11th Cir. 1987); *In re* U.S. Loan Co., 105 Bankr. 676 (Bankr. M.D. Fla. 1989). Section 1112(b), 11 U.S.C. § 1112(b) (1988), provides a court with sufficient discretion to dismiss a case for bad faith, and therefore, the constructive trust exception is unnecessary.

trustee's strong arm powers is contrary to bankruptcy policies of combatting ostensible ownership and ratable distribution. The imposition of a constructive trust to defeat the use of the strong arm powers is contrary to the historic development of section 544(a). In addition, the express language of section 544(a) was intended to prevent the imposition of a constructive trust. There is no indication that section 541(d) was intended to overrule section 544(a). The imposition of a constructive trust is also contrary to the policies underlying the U.C.C. and the real property recording statutes. Another danger with the imposition of a constructive trust is that it leads to uncertainty. If courts are at liberty to ignore the express language of bankruptcy and commercial law statutes, then a major policy of bankruptcy and commercial law will be defeated. When all these factors are considered, the imposition of a constructive trust to defeat the use of the trustee's strong arm powers is unjustifiable.