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Constructive Trusts and Fraudulent Transfers: When Worlds Collide

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CONSTRUCTIVE TRUSTS AND FRAUDULENT TRANSFERS: WHEN WORLDS COLLIDE

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When Ponzi schemes collapse and enter into bankruptcy liquidation, bankruptcy trustees assume that conveyances made by the debtor for no consideration are fraudulent conveyances. This Article argues that they are not. Virtually all the assets held by a Ponzi scheme are held in constructive trust for the victims of the fraud. If victims of the fraud can trace the proceeds of their investments into property transferred to a third party, the third party holds the asset transferred in trust for the relevant victim. When a bankruptcy trustee characterizes the asset as a fraudulently conveyed asset, the trustee expropriates the asset from the victim on behalf of the unsecured creditors of the Ponzi scheme. There are only two justifications for this expropriation. First, tracing is impossible or too costly. This claim reduces to the theory that a thief should not restore the loot to the victim when it is costly to do so. Second, when the third party points out that the victims (not the bankruptcy trustee) own the cause of action for restoration of the loot, the third party is making an impermissible ius tertii defense. Being estopped from this defense, the third party must surrender the transferred asset to the bankruptcy trustee. This essentially completes the expropriation of victim property for the benefit of the unsecured creditors, who are scarcely entitled to enjoy this stolen property.

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I. INTRODUCTION

In Ponzi schemes, an evil mastermind controls constructive trust property that belongs to the victims of fraud. The Supreme Court has implied (and the Sixth Circuit has directly ruled) that bankruptcy trustees have no standing to collect trust property on behalf of the victims (who properly are not even creditors). Yet bankruptcy courts assume that transfers by the mastermind to third parties are fraudulent transfers, in which case bankruptcy trustees *do* have standing. But they are *not* fraudulent transfers. This Article describes why not and discusses whether a bankruptcy trustee nevertheless can enjoy standing to supervise the liquidation of a Ponzi scheme.

Fraudsters often end up in jail, and their larceny-riven estates in bankruptcy. Very frequently, just before either event, the fraudster usually tries to unload the loot—by giving it away to accomplices or by paying creditors, who may or may not know they are getting stolen money.

Are these fraudulent transfers? I insist they are not. In a fraudulent transfer, a debtor (*D*) owns the legal and equitable title to some property, real or personal. *D* then conveys the property to some third party (*X*). If, at the time, *D* is insolvent and if *X* has given no value in return, *X* has a voidable title to the thing transferred. The creditors of *D* (or *D*'s bankruptcy trustee) are invited to place a judicial lien on *X*'s thing. If *X* has given value in return, the creditors of *D* might still claim that *X* has received a fraudulent transfer. If *D*, by the transfer, intended to hinder, delay, or defraud his creditors, then *X* has but a voidable title to the thing transferred—though *X* is accorded a good faith transferee defense where *X* has given value in return.[1]

If, however, *X* is receiving a property looted from some victim (*V*), *X* is not receiving *D*'s property. *X* is receiving *V*'s property. *D*'s creditors have no cause of action against *X*. Rather, *V* does. And yet, to an extensive degree, litigants, courts, and law reviews simply assume that fraudulent transfer law has jurisdiction over the case.[2]

This Article explores cases in which *D* unloads pirated booty before descending into the black pit of bankruptcy. In such cases, we may assume that we are dealing with a constructive trust. Prior to the transfer, *D* had legal title to a thing, say a gold brick, and *V* had equitable title. When *X* can prove this, *X* has not received a fraudulent transfer, and the creditors of *D* have no access to *X*'s legal or equitable title in the brick. On the other hand, if *X* is denied the right to prove this, *X* will be stuck with the conclusion that *X* has received *D*'s property, not *V*'s property. Under that assumption, *X* has received a fraudulent transfer, and the creditors have access to *X*'s gold brick and *V* has lost her equitable title to the brick. In such a case, the creditors complete the pillaging of *V* that *D* was unable to complete.

So far, *V* is a property owner with a right to possess the gold brick. Confusing matters is the fact that (at *V*'s option) *V* has a claim against *D* sounding in tortious conversion of *V*'s property.[3] It is usually thought (erroneously) that *V* is thus one of *D*'s creditors and must share *X*'s gold brick with the other creditors of *D*. This is a loss for *V*. If *V* has a constructive trust claim, *V* could have *X*'s gold brick entirely to herself. As a creditor with a conversion claim, *V* must share. Yet *V* is no creditor where *V* does not exercise this option to seek a money judgment for conversion.

Constructive trusts and fraudulent transfers occupy entirely different worlds. Courts need to discover which of these worlds they occupy. The dilemma becomes acute in the case of Ponzi schemes. In such cases, nearly everyone is *V*. *D* has an equitable interest in no (or comparatively little) property but legal title to the whole. If *X* has received a distribution from a

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1. David Gray Carlson, *Mere Conduit*, 93 AM. BANKR. L.J. 475, 483–85 (2019) [hereinafter Carlson, *Conduit*].

2. *See* Andrew Kull, *Common-Law Restitution and the Madoff Liquidation*, 92 B.U. L. REV. 939, 944 (2012) [hereinafter Kull, *Madoff*] ("Trustees and courts settled on 'fraudulent transfer' as the least-bad fit . . . .").

3. RESTATEMENT (SECOND) TORTS § 222A(1) (AM. LAW INST. 1965) ("Conversion is an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel.").

Ponzi artist and if *X* is permitted to point out that *X* received *V*'s property (not *D*'s property), then *D*'s creditors (and their representative, the bankruptcy trustee) have no fraudulent transfer theory against *X*. *X* walks away scot-free from bankruptcy litigation. *X* is still liable to *V* for converting *V*'s property. But *V* may not be sufficiently organized to pursue *X*. In that case, *X* (*D*'s bad faith coconspirator) enjoys the avails of *D*'s fraudulent scheme. Neither *V* nor *C* get anything. *X* walks away with the gold brick.

Cannot the bankruptcy trustee declare herself to be a representative of *V*, empowering the trustee to recover for the benefit of *V* from *X*? The Supreme Court and the Sixth Circuit have implied that the answer is no.[4] Therefore, if bankruptcy courts are to keep jurisdiction over Ponzi liquidations, some account must be given as to how *X* has received a fraudulent transfer when *D* was never the equitable owner of the property conveyed.

Two doctrines come to the rescue of bankruptcy trustees seeking to recover Ponzi distributions. First, if *V* cannot trace the property *V* conveyed to *D* into the hands of *X*, *V*'s constructive trust theory fails. Then we must admit that *D* *did* have equitable title to the property conveyed to *X*. Failure of tracing suggests *D* has successfully stolen *V*'s equitable interest by commingling it with *D*'s other things. In that case, (if *X* is not a good faith transferee for value) *D*'s bankruptcy trustee has a fraudulent conveyance theory against *X*. But there is something ethically wrong with the easy claim by *D*'s bankruptcy trustee that tracing is impossible, in this age where computers can generate "waterfall" analyses in seconds.[5] When a trustee pleads that tracing is impossible or too costly, the trustee asks the court to complete the theft from *V* that *D* only commenced. The direct beneficiaries of tracing inconvenience are the clients of the bankruptcy trustee—the unsecured creditors of *D*.

Alternatively, suppose tracing is conceptually possible. Then perhaps the trustee can invoke the ancient doctrine of *ius tertii*—the idea that estops *X* from claiming that a third party not before the court has better title to the thing transferred than do the creditors of *D*. If *ius tertii* silences *X*, then the trustee can proceed *as if D* had both legal and equitable title to the thing transferred.

But if we apply the *ius tertii* rule in this way, the bankruptcy, in effect, completes the theft from *V* that *D* failed to consummate.[6] The claim of *ius tertii* has a dicey ethical component to it, which this Article shall explore. *Ius tertii*

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4. Caplin v. Marine Midland Grace Trust Co. of New York, 406 U.S. 416, 417 (1972); Stevenson v. J.C. Bradford & Co. (*In re* Cannon), 277 F.3d 838, 855–56 (6th Cir. 2002).

5. *See In re* Adelphia Commc'ns Corp., 368 B.R. 140, 219–22 (Bankr. S.D.N.Y. 2007).

6. Andrew Kull, *Restitution in Bankruptcy: Reclamation and Constructive Trust*, 72 AM. BANKR. L.J. 265, 276 (1998) [hereinafter Kull, *Bankruptcy*] (explaining that the refusal to recognize constructive trusts "makes bankruptcy an instrument of confiscation").

is also obviously in tension with the principle that the trustee has no standing to assert the equitable property interests of third party property owners in litigation against *X*.

Before we can proceed, we need a very precise definition of *constructive trust* and how the concept of constructive trust relates to the rawer, cruder notion of stolen or embezzled funds. Part I provides this definitional work.

Courts suspect (wrongly) that constructive trust law violates the federal bankruptcy policy of equality between creditors. Accordingly, the law of constructive trust in bankruptcy turns out to be problematic. In three federal circuits, there are danger signs that the state law of constructive trust will be preempted by contrary bankruptcy notions of creditor equality. If constructive trusts violate federal bankruptcy policy, then the worlds of constructive trust and fraudulent transfer do not collide for the simple reason that there is only one world—the world of fraudulent transfer. Therefore, this Article surveys the authority for the proposition that constructive trusts are not permitted in bankruptcy cases.

A short Part II defines precisely what a fraudulent transfer is, with an eye toward distinguishing a fraudulent transfer from *D*'s conveyance of constructive trust property. The distinction will be: Does *D* own the equitable interest in the transferred thing? If so, we are in the world of fraudulent transfer. Does *V* own the equitable interest in the thing transferred? If so, we inhabit the world of constructive trust.

Part III attends the boisterous ruin when the world of fraudulent transfer collides with the world of constructive trust. In a great many cases, especially Ponzi cases, the bankruptcy trustee pleads fraudulent transfer when in fact *D* never owned equitable title to the property conveyed to *X*. Courts are often flummoxed when worlds collide. In the end, the trustee's fraudulent transfer theory depends on the dubious ethics of denying *V* access to tracing fictions or silencing *X* on *ius tertii* grounds. In both cases, the trustee is shown to be a more effective thief than *D* ever was.

II. WHAT IS A CONSTRUCTIVE TRUST?

Andrew Kull, reporter for the elegant Restatement (Third) of Restitution & Unjust Enrichment (*R3RUE*)[7], laments the sad state of restitutionary knowledge in the modern age:

> Issues of restitution thus pervade the commercial law without being the focus of any imaginable law practice. Most law schools gave up teaching restitution a generation ago, and

7. *See* Andrew Kull, *Three Restatements of Restitution*, 68 WASH & LEE L. REV. 867, 867 (2011).

> many judges and practitioners are not familiar with its general principles. Lack of familiarity with the restitutionary elements of the background rules results in a predictable distortion of commercial law.[8]

In light of this sad estimate, I begin with a thorough review of the constructive trust as a concept, and how it fares in the bankruptcy courts. It has been twenty years since such a review was conducted, and much water has flowed under the bridge of sighs since then, especially in the Sixth Circuit, which twenty-five years ago purported to abolish constructive trusts in bankruptcy proceedings. Once this review is completed, a comparison may be made between constructive trust and fraudulent transfer theory.

A. *Delivery of Title is Required*

A constructive trust arises from unjust enrichment as a result of a transfer from *V* to *F* (for "fraudster"), where there is something wrong with the capacity of the transferor *V*. For example, the transferor is an infant or is mentally incompetent.[9] Or, most familiarly, the transferor was induced by fraud to part with title.[10] The defects attendant to the transfer imply that *F* has enjoyed unjust enrichment.[11]

It is paramount that, for a constructive trust to arise, a property owner must perform the incidents of transfer to a transferee. In a constructive trust, one

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8. Kull, *Bankruptcy*, *supra* note 6, at 267. Elsewhere, Professor Kull blames the Federal Rules of Civil Procedure:

> The reformers cannot have foreseen . . . the gradual process by which the elimination of a separate equity jurisdiction would lead first to the disappearance of equity from the law school curriculum, then to an ebb tide in professional awareness, as lawyers who had never learned these rules gradually took over from those who had.

Kull, *Madoff*, *supra* note 2, at 966; *see also* Andrew Kull, *Rationalizing Restitution*, 83 CALIF. L. REV. 1191, 1195 (1995) [hereinafter Kull, *Rationalizing*] ("To put it bluntly, American lawyers today (judges and law professors included) do not know what restitution is. The subject is no longer taught in law schools . . . .").

9. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 16 cmt. a, b (AM. LAW INST. 2011). "Persons of abnormal status in our law were, originally, lunatics, infants and married women." 1 GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 103b (rev. ed. 1940).

10. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 13.

11. Emily L. Sherwin, *Constructive Trusts In Bankruptcy*, 1989 U. ILL. L. REV. 297, 299 [hereinafter Sherwin, *Constructive Trusts*] ("Unjust enrichment is a broad concept: it refers to any case in which the defendant received a benefit that, for reason of fairness, he should not retain.").

expects to find that *V* has surrendered title[12] to property to *F*. Thus, the *R3RUE* states:

> If a defendant is unjustly enriched *by the acquisition of title* to identifiable property at the expense of the claimant or in violation of the claimant's rights, the defendant may be declared a constructive trustee, for the benefit of the claimant, of the property in question and its traceable product.[13]

In a real estate case, a transfer of title would require the signing and delivery of a deed. In the case of tangible personal property, delivery of the thing is the usual formality.[14]

In spite of the defect in transferor consent,[15] the transferee still gets title. That title has transferred is just another way of saying that *V* has delivered a deed in favor of the transferee *F*, or that delivery of personal property has been accomplished with the idea, however flawed, that the transferee *F* is to have title.

To give a counter-example, a bailor may permit the bailee to have possession of a thing, but the bailee has no title. We would therefore never say

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12. Koreag, Controle et Revision S.A., v. Refco F/X Assocs., Inc., 961 F.2d 341, 352 (2d Cir. 1992) ("Under New York law, a party claiming entitlement to a constructive trust must ordinarily establish four elements: (1) a confidential or fiduciary relationship; (2) a promise, express or implied; (3) a transfer made in reliance on that promise; and (4) unjust enrichment."). It is *V* that must surrender title. In the classic case of Vineyard v. McKenzie (*In re* Quality Holstein Leasing), *F* owned an airplane as to which a lender (*SP*) had an unperfected security interest. 752 F.2d 1009, 1010 (5th Cir. 1985). The security interest was unperfected because of a fraudulently filed release of a perfected security interest. *Id.* at 1011. *F* gave the plane to *D Corp*., a wholly owned subsidiary, and *D Corp*. filed for bankruptcy. *Id. SP* claimed that, since *F* was dishonest, *F* (who was not bankrupt) retained equitable title; *D Corp*. should be compelled (*SP* claimed) to give the plane back to *F*, where *SP* might enforce its security interest, free of *D Corp*.'s bankruptcy trustee. *Id.* at 1011–12. The constructive trust was properly rejected. *Id.* at 1015. *SP* was a *transferee* of a security interest on *F*'s legal and equitable title; *SP* was no *transferor* to *D Corp*. *Id.*

13. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 55(1) (emphasis added). Some authorities hold that "although, under applicable state law, a debtor may not be able to obtain *title* to property which it obtains by fraud, a debtor may nonetheless have an *interest* in that property sufficient under the language of § 548." Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 162 (1998) (citing Jobin v. Lalan (*In re* M&L Bus. Mach. Co.), 160 B.R. 851, 857 (Bankr. D. Colo. 1993), *aff'd*, 167 B.R. 219 (D. Colo. 1994). In fact, *legal* title follows the deed. Thus, in a constructive trust, *F* has a voidable *title* to the *res* of the trust. Whether this suffices as sufficient under Bankruptcy Code § 548(a) will be considered in due course.

14. Robert Stevens, *When and Why Does Unjustified Enrichment Justify the Recognition of Proprietary Rights?*, 92 B.U. L. REV. 919, 926 (2012).

15. *See* Daniel Friedmann, *Does the Dead Contract Rule Restitution From Its Grave?*, 92 B.U. L. REV. 811, 811 (2012) ("defect in the will").

that the bailee holds the thing in constructive trust. The bailor never, even defectively, intended to convey title.[16]

In a constructive trust, the title that *F* has is *voidable*.[17] That means that the transferor *V* may rescind the deed and compel the transferee to re-convey title.[18] Or, alternatively, if the transferee *F* is not of a mood to obey court orders, *V* may have a court declare that the transferor is the owner of title.[19]

Alternatively, *V* may recover a money judgment for conversion.[20] But by taking that route, *V* debases herself and becomes a mere general creditor of *F*. If *V* opts for conversion, *V* affirms that *F* is the title owner of the item stolen and that *F* must pay the price. Thus, conversion depends upon *V*'s admission that *V* has no property interest in the disputed chattel.[21] Conversion puts an end to constructive trust theory.

B. *Voidable, Not Void*

A constructive trust arises from a transfer under conditions of unjust enrichment. But *V* is not required to rescind.[22] Title is *voidable*, not *void*. For example, suppose an infant conveys Blackacre to *D,* and *D* pays for title. The guardian in charge of the infant's estate may conclude that the infant shrewdly obtained a good price and that rescission is not prudent.[23] In contrast to the guardian (who chooses not to rescind), *D* (the transferee) has no right to rescind.[24] *D* had capacity to receive title even though the infant lacked capacity to give it (in anything but a voidable way). Title then stays with *D* (so long as

16. Stevens, *supra* note 14, at 926. If bailment is coupled with authority to sell, and if the sale occurs, it has been said that the seller holds the proceeds in constructive trust. *See In re* Mississippi Valley Livestock, 745 F.3d 299, 307 (7th Cir. 2014). This is more appropriately called a resulting trust, as "constructive trust" connotes wrongdoing. On resulting trusts, see *infra* text accompanying note100.

17. *See infra* text accompanying notes 22–25.

18. Roscoe Pound, *The Progress of the Law, 1918–1919 Equity*, 33 HARV. L. REV. 420, 421 (1918) ("As the chancellor acted in personam, one of the most effective remedial expedients at his command was to treat a defendant as if he were a trustee and put pressure upon his person to compel him to act accordingly.").

19. FED. R. CIV. P. 70(a) provides for this, in the case of federal litigation.

20. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 60(3) (AM. LAW INST. 2011).

21. Pierpoint v. Hoyt, 182 N.E. 235, 236 (1932); Cooper v. Shepherd (1846) 136 Eng. Rep. 107, 109; 3 C.B. 265, 269.

22. United States v. Miller, 997 F.2d 1010, 1020 (2d Cir. 1993) (stating that constructive trusts are "imposed, at the election of an aggrieved party").

23. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 16 cmt. e; RESTATEMENT (SECOND) CONTRACTS § 14 (AM. LAW INST. 1981).

24. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 16 cmt. d.

the guardian chooses not to rescind). The relation between the guardian and *D* is an asymmetric one.

That the transfer is merely voidable, not void, has its effect when a third party *X* wants to claim that *X* has not received a fraudulent conveyance from *D* because *D* had only legal title and because *V* is the equitable owner of the conveyed property.[25] Voidability (as opposed to voidness) gives rise to the *ius tertii* principle that usually will be decisive in Ponzi scheme cases.

C. *Stolen Property Compared*

A different situation exists with regard to stolen property. A thief is said to have "no title" to the property stolen. Suppose the thief sells to a good faith purchaser, *B*. Since the thief has no title to give, *B* obtains no title.[26] On the other hand, suppose *B* pays cash to the thief. Through the magic of *ratification*, *V* has the option to change the thief into a faithful agent.[27] As faithful agent in possession of *V*'s funds, the erstwhile thief buys a thing on behalf of *V*.[28] The thief then takes possession of the purchased thing in constructive trust for *V*. This is how *proceeds theory* works. Via ratification, the thief's wrongful act becomes a rightful act. Ratification (not theft) is the moment when legal and equitable title split themselves in twain.[29] Thus, stolen goods are not held in constructive trust, but the *consequences* of the theft (at the option of the victim) might become trust property.

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25. *See infra* text accompanying notes 396–421.

26. U.C.C. § 2-403(1) (AM. LAW INST. & UNIF. LAW COMM'N 2012).

27. Ratification, so far as I know, is my own contribution to the law of restitution. In an otherwise astute article, Professor James Steven Rogers writes of Scalawag, who steals a car from Fred. Scalawag then swaps the car for a tractor.

> The tractor never belonged to Fred, so Fred has no special rights to the tractor as a matter of simple property law. Under the law of restitution, however, Fred can obtain a declaration that Scalawag holds the tractor in constructive trust for Fred . . . . The Restatement states this principle without qualification: "A claimant entitled to restitution from property may obtain restitution from any traceable product of that property, without regard to subsequent changes of form." Although this may seem like a simple proposition, it is, in fact, virtually impossible to come up with a coherent explanation for the result that Fred gets the tractor.

James Steven Rogers, *Indeterminacy and the Law of Restitution*, 68 WASH. & LEE L. REV. 1377, 1399 (2011) (quoting RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58(1)). In fact, ratification does the trick. The theft was actually (after the fact) made into a consensual transfer to a trustee who faithfully swapped the car for the tractor.

28. Fur & Wool Trading Co. v. George I. Fox, Inc., 156 N.E. 670, 671 (N.Y. 1927).

29. Am. Sugar-Ref. Co. v. Fancher, 40 N.E. 206, 207–08 (N.Y. 1895).

D. *Constructive Trusts Pre-exist Their Judicial Declaration*

Courts repeat the adage that constructive trust is just a remedy. Such a claim is misleading.[30] It yields the misimpression that, until a constructive trust is declared, it does not exist. Such an assumption guarantees that, in most cases, constructive trusts are void in bankruptcy.

As Professor Stevens has put it:

> Unfortunately, describing the constructive trust as remedial can also lead to confusion. It can make it appear that there is no trust at all before the court order and that the judge is creating property rights out of thin air where none existed before. Where the defendant is in bankruptcy proceedings, for example, allowing the judge to create rights that will afford the plaintiff priority when the plaintiff had no such entitlement beforehand is profoundly wrong. . . . Claims for remedial constructive trusts *in this sense* profoundly offend bankruptcy policy and are rightfully struck down both in England and the United States. . . . [H]owever, the *Restatement (Third)* does not employ "remedy" in this strong sense. The rights to rescind . . . do not offend bankruptcy policy because they are not remedial in this strong sense. They simply reflect the rights that existed before the court order. It is the law that creates the trust, not any choice of the judge.[31]

In fact, a constructive trust has two elements to it. As the *R3RUE* emphasizes, one element is implication of a remedy.[32] A constructive trust is not itself, strictly speaking, a remedy.[33] The constructive trust invokes remedies supplied from other sources.[34] In real estate cases, the remedy is ejectment or declaratory relief or perhaps an injunction to deliver legal title to *V*. In the case of personal property, the remedy is replevin.

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30. Kull, *Rationalizing*, *supra* note 8, at 1222–23.

31. Stevens, *supra* note 14, at 934–35 (footnotes omitted).

32. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 55 cmt. b.

33. *But see* XL/Datacomp, Inc. v. Wilson (*In re* Omegas Grp.), 16 F.3d 1443, 1449 (6th Cir. 1994) ("A constructive trust is a legal fiction, a common-law remedy in equity that may only exist by the grace of judicial action.").

34. Kull, *Rationalizing*, *supra* note 8, at 1194 ("The restoration remedies (replevin, ejectment, and so forth) operate without regard to the defendant's enrichment.").

The second element is pre-existing reality.[35] Constructive trust reports a pre-existing state of affairs.[36] The pre-existing state of affairs goes by the name of unjust enrichment. The remedy *follows* from the state of the world where the transferor *V* is already entitled to repossess from *F*. This is an example (pervasive in law) of the future anterior tense[37]—the property will have belonged to *V*, once the court is induced to ponder the matter.

Ignoring this second aspect gives rise to the accusation that a constructive trust does not exist until a court declares it so. On this view, *V* has no interest in Blackacre upon executing the deed, but she has a right to rescind. If the court acts to vindicate this right, she is (for the first time) the equitable owner of Blackacre and becomes the legal owner when the transferee, under constraint of specific performance, actually executes the deed back.

But this is a false view. To illustrate why, let us consider the ancient case of *Taylor v. Plumer*,[38] where *V* entrusted funds to *F*. *F* embezzled the funds and bought some stock certificates and gold. *V*'s agent violently grabbed the stock and gold just before *F* was about to flee the country. *F* was later forced into bankruptcy. The bankruptcy "assignees" sued *V* in trover (i.e. the tort of conversion). *V* prevailed. Therefore, *V*'s equitable interest in the stock and coins must have pre-existed a judicial declaration of the constructive trust.[39]

This result had nothing to do with *F*'s bankruptcy proceeding. Suppose *F* was not bankrupt and brought a trover action against *V*. *F* must show a right to possess that is good against *V*. But this is precisely what *F* cannot show. *F* had a duty to tender possession of the stock and coins to *V*.[40] No court would order

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35. City Nat'l Bank of Miami v. Gen. Coffee Corp. (*In re* Gen. Coffee Corp.), 828 F.2d 699, 702 (11th Cir. 1987) ("[A] constructive trust arises when the facts giving rise to the fraud occur.").

36. Sherwin, *Constructive Trusts*, *supra* note 11, at 312 ("In the [First] *Restatement's* view, the plaintiff is the equitable owner of the property from the time of the unjust enrichment. Therefore, when the court grants a constructive trust decree, it is merely enforcing a preexisting property right, rather than establishing priority between the claimant and other creditors.").

37. David Gray Carlson, *The Traumatic Dimension in Law*, 24 CARDOZO L. REV. 2287, 2287 (2003).

38. (1815) 105 Eng. Rep. 721; 3 M & S 562.

39. In the film noir PITFALL (Regal Films 1948), Byron Barr embezzles funds from his employer and buys gifts for his fiancée Lizabeth Scott. He is arrested and imprisoned. Dick Powell, in a great looking fedora, pays off an insurance bond and (being subrogated to the employer's rights against Barr) simply takes Scott's gifts. No court had declared that Scott held the gifts in constructive trust. Thus, Hollywood believes a constructive trust justifies self-help.

40. Suttles v. Vogel, 533 N.E.2d 901, 904 (Ill. 1988) ("The sole duty of the constructive trustee is to transfer title and possession of the wrongfully acquired property to the beneficiary."); RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 55(2) (AM. LAW INST. 2011) ("The obligation of a constructive trustee is to surrender the constructive trust property to the claimant, on such conditions as the court may direct.").

V to pay *F* where *V*'s right of possession is better than that of *F*. Ergo, *V*'s right of possession precedes any declaration of a constructive trust. A constructive trust implies *V*'s right to self-help, just as any presently possessory property right does. Title, under the circumstances, is just an airy abstraction (which nevertheless signifies a power to give perfect title to a bona fide purchaser for value).[41] The right of possession is with *V*.

Here is a further test to prove that *V* has property in the absence of a court declaration. Suppose *V* conveys Blackacre to *F* in a rescindable conveyance. *F* conveys to *B*, a bad faith purchaser, for value. *B* inherits *F*'s duty to convey the land back to *V*.[42] This proves *V* had the equitable interest in Blackacre as soon as *V* conveyed title to *F*. If, at the time of the *F*-*B* transaction, *F* had *no* interest in Blackacre because no court has yet imposed the constructive trust, then *B* buys both legal and equitable title from F, and *B* has no duty to convey to *V*. But clearly *B does* have that duty, because *B* has only obtained what *F* had—a legal title held for the benefit of *V*.[43]

The idea that *B* inherits the duty to convey title back to *V* proves that a constructive trust pre-exists its declaration. No other concept but *V*'s pre-existing equitable ownership explains why *B* has a duty to convey to *V* when *V* was induced to convey to F.

It is sometimes said that "constructive trust" is a label, not an argument.[44] If such statements are simply reminders that unjust enrichment is the source of constructive trust—that a constructive trust is not self-grounding—I have no objection. But if such statements signify that constructive trusts do not precede their judicial declaration, I deny that constructive trust is just a label. Unjust enrichment has, under well-recognized conditions, property consequences that arise as soon as the unjust enrichment arises. The fact that, *après la lettre*, a court recognizes property consequences makes constructive trusts no different from any other property concept.

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41. On the other hand, if *F* files for bankruptcy, the automatic stay from *F*'s bankruptcy petition would prevent *V* from exercising self-help. Georgia Pac. Corp. v. Sigma Serv. Corp., 712 F.2d 962, 967–68 (5th Cir. 1983); *see* 11 U.S.C. § 362 (2012).

42. This has been called the "transitive feature" of restitution. Kull, *Madoff, supra* note 2, at 946.

43. Professor Robert Stevens views the matter differently. *V* does not have an equitable interest in *Blackacre*. *V* has an interest in *F*'s interest in Blackacre, which, in *F*, is a unified interest. Stevens, *supra* note 14, at 923. This view is based upon *V*'s incapacity to exclude trespassers, *id*. at 922, a proposition which I doubt.

44. Emily Sherwin, *Why* In re Omegas Group *Was Right*: *An Essay on the Legal Status of Equitable Rights*, 92 B.U. L. REV. 885, 886 (2012) [hereinafter Sherwin, *Omegas*] ("If, as the *Restatement (Third)* assumes, a constructive trust is a vehicle for prevention of unjust enrichment, equitable title should be a conclusion rather than a premise of the decision to impose a trust.").

Does fee simple absolute pre-exist the judicial declaration of it in subsequent litigation? I doubt it. An owner (*O*) may be confident that she owns Blackacre in fee simple absolute, but this is always contestable, and a court may decide that *O* is not the owner after all. If I am right, then constructive trust precedes a court's declaration in precisely the same way that legal title to land pre-exists a judicial declaration of it. Nothing in law is final until the Supreme Court says it is, and even then, some subsequent Supreme Court may say otherwise. Restitutionary claims are therefore not different from *any* legal claim to property. Either both or neither pre-exist judicial recognition.

E. *Bona Fide Purchasers*

Beneficial interests in constructive trusts share most features with other equitable interests. In general, when legal and equitable title are cleft in twain, so that *F* has legal title and *V* has equitable title, *F* has a power (in the Hohfeldian sense)[45] over *V*'s equitable property interest. By that I mean *F* has the ability to transform the legal "present," in which *V* has a right of possession. *D* has power to make a bona fide purchaser for value the "present" rightful possessor. "In effect, the constructive trust claim is cut off because the bona fide purchaser has not been unjustly enriched."[46]

Significantly, unsecured creditors of *F* can obtain judicial liens on *F*'s legal title, but these lien creditors are not purchasers.[47] "Purchase" implies that *F* (the holder of legal title) has made a voluntary conveyance.[48] A creditor obtains a property interest in the debtor's property as a (remote) consequence of obtaining a money judgment.[49] But creation of a judicial lien, though a

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45. Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 YALE L.J. 16, 24 (1913).

46. Sherwin, *Constructive Trusts*, *supra* note 11, at 306 n.41.

47. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 60(1) (AM. LAW INST. 2011).

48. 11 U.S.C. § 101(43) (2012) ("The term 'purchaser' means transferee of a voluntary transfer . . . ."); N.Y. REAL PROP. LAW § 290(2) (Consol. 2019) ("The term 'purchaser' includes every person to whom any estate or interest in real property is conveyed for a valuable consideration, and every assignee of a mortgage, lease or other conditional estate.); U.C.C. § 1-201(29) (AM. LAW INST. & UNIF. LAW COMM'N 2012) ("'Purchase' means taking by sale . . . or any other voluntary transaction creating an interest in property.").

49. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 60(1) cmt. b ("As a formal matter, the judicial lien creditor is not a purchaser because the judicial lien is the result of an involuntary transaction.").

transfer,[50] is not a purchase. Judicial liens arise by operation of law, over the opposition of *D*. Typically, *D* does not voluntarily convey a judicial lien.[51]

F. *Creditor or Property Owner?*

Suppose *D* defrauds *V* out of title to a gold brick. If no constructive trust is ever declared, the creditors of *D* are the winners. The increased size of *D*'s estate means that *D*'s unsecured creditors are more likely to collect. But if *V* makes a claim to the gold brick, the creditors are back where they started before *D* defrauded *V*.

Two contradictory normative instincts inhabit the field. First, there is the notion that *F*'s creditors should not benefit from *F*'s thefts.[52] Second, there is the notion that *V* is a creditor like any other.[53] Why should *this* creditor (*V*) be preferred over the other creditors, who may well be victims of *F*'s other tortious acts?[54]

But is it even true that *V* is a "creditor"? Properly the answer is no,[55] if a deep inquiry is made into what a creditor is. On this score, we must consult the common law notion and also the definition that the Bankruptcy Code directly supplies.[56]

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50. 11 U.S.C. § 101(54)(A) (defining "transfer" to include "the creation of a lien").

51. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 60(1) cmt. b. Cognovit judgments are perhaps an exception.

52. Austin W. Scott, *The Right to Follow Money Wrongfully Mingled with Other Money*, 27 HARV. L. REV. 125, 128 (1913) ("The creditors of the wrongdoer . . . should not stand in a better position than their debtor; they should not be allowed to profit by his wrongful act."). According to RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 55 cmt. d:

> Even if A's suit for restitution is formally asserted against B as defendant, A's implicit claim—to justify in equitable terms the remedy of constructive trust—is that B's unsecured creditor C will be unjustly enriched, at A's expense, if B's debt to C is satisfied from assets that B obtained from A by fraud. The intuitive objection is that a debtor should not be allowed to rob Peter to pay Paul.

53. Scott, *supra* note 52, at 128.

54. Anthony Duggan, *Proprietary Remedies in Insolvency: A Comparison of the Restatement (Third) of Restitution & Unjust Enrichment with English and Commonwealth Law*, 68 WASH. & LEE L. REV. 1229, 1237 (2011).

55. *Accord* Lionel Smith, *Equity is Not a Single Thing*, *in* PHILOSOPHICAL FOUNDATIONS OF THE LAW OF EQUITY (Dennis Klimchuk, Irit Samet, & Henry E. Smith eds., forthcoming 2020) [hereinafter Smith, *Equity*], https://ssrn.com/abstract=3376874 [https://perma.cc/8HLF-CXAL]; LIONEL D. SMITH, THE LAW OF TRACING 307 (1997) [hereinafter SMITH, *Tracing*].

56. 11 U.S.C. § 101(10) (2012).

According to the common law notion, a creditor is a person who, when tendered legal currency, is obliged to take it in satisfaction of an underlying obligation.[57]

A creditor can also be defined as a person who is entitled to get a money judgment against the debtor. This is sometimes referred to as having "recourse" against the debtor personally.[58]

A creditor can also simultaneously be a property owner, as where a creditor has a security interest in some or all of a debtor's property.[59]

A secured creditor can be of a nonrecourse variety. Outside of bankruptcy, nonrecourse creditors are not considered creditors for the purpose of state fraudulent transfer law.[60] The Bankruptcy Code, however, has a rather different definition of "creditor." Under § 101(10), "creditor" means an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." "Claim" is defined in § 101(5) to include the:

> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
> (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.[61]

As a rule of construction, § 102(2) adds, "'claim against the debtor' includes claim against property of the debtor."

In *Johnson v. Home State Bank*,[62] *D* granted a lender (*SP*) a mortgage on his farm. *D* filed for bankruptcy in chapter 7 where *D* received a discharge of all in personam liability to *SP*. *SP* was therefore a nonrecourse creditor. After the chapter 7 case ended, *SP* recommenced foreclosure proceedings. *D* responded with a chapter 13 case. *D* filed a plan in which *SP* would be paid over the life of the plan, with a big balloon payment at the end. *SP* argued that *SP* was not a creditor, and its nonrecourse mortgage was not a "claim." The Supreme Court ruled that nonrecourse mortgages are indeed claims under § 101(5)(A):

> [W]e have no trouble concluding that a mortgage interest that

57. Smith, *Equity, supra* note 55, at 13–14.
58. 11 U.S.C. § 1111(b)(1)(A).
59. *See infra* text accompanying notes 65–66.
60. Travelers Ins. Co. v. 633 Third Assocs., 973 F.2d 82, 84 (2d Cir. 1992).
61. 11 U.S.C. § 101(5).
62. 501 U.S. 78, 80–82 (1991).

> survives the discharge of a debtor's personal liability is a "claim" within the terms of § 101(5). Even after the debtor's personal obligations have been extinguished, the mortgage holder still retains a "right to payment" in the form of its right to the proceeds from the sale of the debtor's property. Alternatively, the creditor's surviving right to foreclose on the mortgage can be viewed as a "right to an equitable remedy" for the debtor's default on the underlying obligation. Either way, there can be no doubt that the surviving mortgage interest corresponds to an "enforceable obligation" of the debtor.[63]

Thus, nonrecourse secured creditors are "creditors" in bankruptcy, even though they can claim only designated collateral and cannot otherwise share in the bankruptcy estate.[64]

As property owners, secured creditors are entitled to their collateral under Bankruptcy Code § 725.[65] But, as is well known, a bankruptcy trustee may use, sell, or lease a secured creditor's collateral if the trustee proffers adequate protection of the collateral's value.[66] Key to this vision is the fact that the collateral *is* property of the bankruptcy estate. For instance, suppose *D* grants a valid perfected security interest in a truck and then files for bankruptcy. The entire truck rides into the bankruptcy estate under § 541(a)(1). The trustee may use, sell, or lease the truck consistent with the terms of § 363.

A constructive trust is different from a secured claim. *V*'s right is to get the property back. *D* has no right of redemption, as is true of secured creditors.[67] Nor is *V*'s equitable interest "property of the estate." The encumbered truck, in its entirety, is property of the estate, and for that reason it could be used, sold, or leased by the bankruptcy trustee. An equitable interest in any sort of trust property never enters the bankruptcy estate.[68] According to § 541(a)(1), only *D*'s legal title enters the estate. *V*'s equitable title is outside the estate. Granted, the automatic stay that is engendered by a bankruptcy petition prevents *V* from retaking *D*'s legal title,[69] but the trustee's ability to use, sell, or lease is entirely

63. *Id*. at 84.

64. In chapter 11 cases, nonrecourse secured creditors are given recourse. 11 U.S.C. § 1111(b)(1)(A).

65. 11 U.S.C. § 725.

66. *Id.* § 363(e).

67. N.Y. REAL PROP. ACTS. LAW § 1341 (Consol. 2019); U.C.C. § 9-623 (AM. LAW INST. & UNIF. LAW COMM'N 2012).

68. There is an alarming exception for cash. *See infra* text accompanying 135–138.

69. *See* 11 U.S.C. § 362(a). Even stolen things in *D*'s possession are protected by the automatic stay. 48th St. Steakhouse, Inc. v. Rockefeller Grp., Inc. (*In re* 48th St. Steakhouse, Inc.), 835 F.2d 427,

different from the case of the truck. In the case of *D*'s voidable title, the trustee can only use, sell, or lease the legal title, which is useless, worthless, and not worth renting. The equity is outside the bankruptcy estate.

A point that challenges that above conclusion is the existence of the tort of conversion. Does not *V* have an in personam cause of action when *D* possesses constructive trust property?[70] This is clearly an option for *V*, when *D* has substantially interfered with *V*'s right of possession. But *D* cannot "buy" the stolen property by tendering the value of the property stolen. That is, *D* cannot redeem stolen property. The absence of an equity of redemption proves that *V* is not a creditor.

In support of this concept is a fundamental truth of conversion. The tort is a forced sale: if *V* obtains a tort judgment, *V* affirms *D* has both legal and equitable title. *V* thus ceases to be a property owner when the conversion theory is pressed to its conclusion. So long as *V* retains a property right against the stolen item, *V* is not a creditor. Properly, *V* is a property owner with the power to "put" the trust property to *D* in exchange for an obligatory price. Until the put option is exercised, *V* is no creditor.

One may say that the Bankruptcy Code's definition of "creditor" and "claim" that it serves two purposes. First, if *V* is a creditor, then *V* is entitled to a share of the bankruptcy estate.[71] But *V* does not seek a share of *D*'s property. *V* seeks to repossess the whole of *V*'s own property. Second, if *V* is a creditor then *D* is potentially eligible to have the claim discharged.[72] This would never be relevant to *V*'s property right. Discharge concerns in personam liability. Discharge cannot sanctify the theft of *V*'s property that *D*'s wrongful prepetition activity only commenced.

Accordingly, *V* is no creditor, and the constructive trust is not the preference of one "creditor" over the others.[73]

430 (2d Cir. 1987) ("Indeed, a mere possessory interest in real property, without any accompanying legal interest, is sufficient to trigger the protection of the automatic stay.").

70. *See* Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1995) ("The limited partners were tort creditors of the corporations from which they had been inveigled into buying limited-partner interests . . . ."); Steven Walt & Emily L. Sherwin, *Contribution Arguments in Commercial Law*, 42 EMORY L.J. 897, 905 (1993) (assuming *cestuis que trust* are creditors).

71. Abboud v. Ground Round, Inc. (*In re* Ground Round, Inc.), 482 F.3d 15, 20 (1st Cir. 2007).

72. *Id.*

73 Douglas J. Whaley, *The Dangerous Doctrine of* Moore v. Bay, 82 TEX. L. REV. 73, 112 (2003) (*V* not a creditor for purposes of Bankruptcy Code § 544(b)(1)).

G. *Other Equitable Interests Compared*

Is a constructive trust a trust?[74] The word "constructive" confesses doubt. "Constructive" is an adjective that means, in legal contexts, "it's a lie, but let's pretend it is true."[75] Indeed, the Restatement (Second) of Trusts defines the term:

> A trust . . . when not qualified by the word "charitable," "resulting" or "constructive," is a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which *arises as a result of a manifestation of an intention to create it*.[76]

The emphasis of the above definition dabbles in ontogeny. A *proper* trust is intentionally created. A *constructive* trust arises by operation of law. But origins be hanged! The salient fact is that both versions of the trust split legal from equitable title. Each implies fiduciary duties on the person who holds legal title. Thus, some courts are willing to say constructive trusts are trusts.[77] Indeed they are, if we disinterest ourselves in origin and focus on one aspect of the substance—the fact that legal and equitable title are split between two persons.[78]

An express trust and a constructive trust are not the only ways that the law splits legal and equitable title. In the bankruptcy cases we shall soon visit, constructive trusts are suspect. Other splits between legal and equitable title are not suspect. So when courts make category errors, taking some other kind of equitable title to be a constructive trust interest, the equitable title of *V* is at risk. Here are a series of ideas that split legal and equitable title and yet, are not constructive trusts.

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74. XL/Datacomp, Inc. v. Wilson (*In re* Omegas Grp., Inc.), 16 F.3d 1443, 1449 (6th Cir. 1994) ("A constructive trust is not really a trust.").

75. Stevens, *supra* note 14, at 936 ("'[C]onstructive' may be thought to mean 'constructed' (i.e. made up) . . . .").

76. RESTATEMENT (SECOND) OF TRUSTS § 2 (AM. LAW INST. 1959) (emphasis added).

77. City Nat'l Bank of Miami v. Gen. Coffee Corp. (*In re* Gen. Coffee Corp.), 828 F.2d 699, 706 (11th Cir. 1987) ("A constructive trust . . . is a trust relationship . . . ."). *Cf.* Strom v. Goldman, Sachs & Co., 202 F.3d 138, 144 (2d Cir. 1999) ("[C]onstructive 'trusts' . . . 'are not really trusts . . . .'").

78. Stevens, *supra* note 14, at 937 ("We need a label to describe those trusts that arise other than by virtue of having been intentionally created, and 'constructive trusts' is as good a label to capture this idea as any."). One must account for this difference. In an express trust, the trustee does not necessarily have the duty to convey legal title directly to the beneficiary. In a constructive trust, this duty is immediate and omnipresent. Sherwin, *Constructive Trusts*, *supra* note 11, at 301 ("A constructive trust is merely a means by which the court can say that the defendant must relinquish to the plaintiff property that represents an unjust enrichment.").

1. Equitable Lien

Closely related to the constructive trust is the equitable lien.[79] The equitable lien splits legal and equitable title as well—with this difference. A constructive trust implies *V* is entitled to possession. An equitable lien does not imply a right of possession. Rather, the lien constitutes a power to sell *F*'s right of possession in order to pay a debt to *V*.[80] When we have an equitable lien before us, we must admit that *V* is a secured creditor.

V is usually invited to choose an equitable lien over a constructive trust. This might occur where the value embezzled exceeds the total value of the identifiable property, in which case *V* might prefer to have an unsecured claim for the deficit.[81]

An equitable lien might displace a constructive trust[82] (to the consternation of *V*) if the recovery of a monetary amount (as opposed to a possessory right) protects an innocent recipient.[83] The classic case is when *F* spends trust money improving *X*'s land, where *X* is not a purchaser for value of the trust money. In such a case, a court might deny to *V* a possessory right and may limit *V* to a lien on the improved real estate to recover the amount of the trust money. "Equitable lien" may also displace a constructive trust if a constructive trust awards profits to the plaintiff—*e.g.*, when *F* embezzles a dollar and buys a winning lottery ticket. In such a case, an equitable lien (for a dollar) is appropriate if *F* is insolvent and has creditors.[84]

2. Equitable Conversion

A contract for the sale of real property splits legal and equitable title to the affected property.[85]

When *B* and *S* enter into a contract for the sale of goods, *B* typically has no right to specific performance of the contract. But when *B* and *S* enter into a contract for the sale of real property, *B* *always* has the right of specific

79. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 56 cmt. b (AM. LAW INST. 2011). Equitable liens have been described as "a special and limited form of a constructive trust." *In re* Marriage of Allen, 724 P.2d 651, 658 (Colo. 1986).

80. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 56(3).

81. Sherwin, *Constructive Trusts*, *supra* note 11, at 302.

82. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 50(4).

83. *Id.* § 50(3) ("The liability in restitution of an innocent recipient of unrequested benefits may not leave the recipient worse off (apart from the cost of litigation) than if the transaction giving rise to the liability had not occurred.").

84. *Id.* § 61(a).

85. *See* Robert L. Flores, *A Comparison of the Rules and Rationales for Allocating Risks Arising in Realty Sales Using Executory Contracts and Escrows*, 59 MO. L. REV. 307, 319, 345–55 (1994).

performance, because real property is considered unique and money damages are considered inadequate. Inadequacy of the legal remedy provokes the equity courts to provide an injunctive remedy. Of course, as a condition to getting the injunction, *B* must perform *B*'s side of the contract by tendering the purchase price to whomsoever has legal title only. This is called the doctrine of equitable conversion—a rather confusing and inadequate name. The name relates to the fact that the real estate contract "converts" *S*'s legal title into *B*'s purchase price.[86] The consequence is a trust relationship, wherein *B* is the beneficiary.[87]

The right to an injunction with regard to property always implies a split between legal and equitable title.[88] Courts dislike *F*'s conveying to a *male fide* purchaser (*M*), thereby defeating the equitable remedy. Therefore, it is said that the eventual right to an injunction implies that *B* is already the equitable owner of the real property. This explains why *B* can obtain an injunction against *M*. *B*, however, must tender to *M* the purchase price (promised to *S*) in order to obtain the injunction.

The doctrine of equitable conversion splits legal and equitable title but it is not a constructive trust. In equitable conversion, *B* has not conveyed legal title to *S*. *S* had legal title prior to the equitable conversion. Equitable conversion implies that the equitable title is conveyed to *B*, whereas in a constructive trust, *V retains* the equitable interest and conveys the legal title. Nor, in the case of equitable conversion, does *B*'s equitable title depend on *S*'s wrongdoing. *B* is the equitable owner in cases where *S* is the punctilio of honor itself.

Courts err in confusing equitable conversion and constructive trust. When they do so, equitable title is at risk because, to some courts, constructive trusts are suspect.

Equitable conversion arises when the issue is risk of loss. Suppose there is a temporal gap between the real estate sales contract and the delivery of the deed by S. Delivery of the deed would make B both the legal and equitable owner, but we presume this has not yet happened. Suppose some evil is visited upon the premises, such as a damaging fire. Courts have derived a dizzying

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86. STEPHEN MARTIN LEAKE, AN ELEMENTARY DIGEST OF THE LAW OF PROPERTY IN LAND 306 (1874) ("A contract of sale of which a court of equity would decree specific performance further operates in equity as a conversion, according to the terms of the contract, of the land into money on the part of the vendor, and of the amount of purchase money into the land on the part of the purchaser . . . .").

87. Flores, *supra* note 85, at 319.

88. Paine v. Meller (1801) 31 Eng. Rep. 1088, 1089; 6 Ves. Jun. 350, 352–53 ("[I]f the party by the contract has become in equity the owner of the premises, they are his to all intents and purposes. They are vendible as his, chargeable as his, capable of being incumbered as his; they may be devised as his; they may be assets; and they would descend to his heir").

array of solutions as to who bears the risk of loss and who has the right to receive fire insurance proceeds.[89] In this discussion, the doctrine of equitable conversion often gets bandied about.

Personal property scholars will recall a similar scandal involving the sale of goods in the 1930's. Courts assigned the risk of loss depending who had title. Karl Llewellyn thoroughly flogged the courts of his time for circular reasoning.[90] He thought location of title merely announced the result. As an argument, the question was begged.[91] This very controversy played a huge role in the promulgation of the Uniform Commercial Code, and has led to the rookie assumption that Article 2 of the U.C.C. abolished title.[92] It does no such thing. It is true that the Article 2 sections dealing with risk of loss don't use the word "title"—though plenty of other provisions do.[93]

Similarly, in real estate sales, courts used "equitable conversion" to locate the risk of loss, with similar dissatisfaction.[94] As a result, legislative intervention—such as the Uniform Risk of Loss Act—removes the concept from the allocation of the loss.[95]

This legislative intervention has led to the serious misconception that the doctrine of equitable conversion has been abolished and that the formation of a real estate sales contract no longer splits legal and equitable title.[96] This is a false view. To my knowledge, every jurisdiction in the United States recognizes a split in title as soon as the real estate sales contract is formed. The concept is, however, not always relevant in adjudicating risk of loss.

3. Estoppel By Deed

Another occasion for splitting legal and equitable title is estoppel by deed. In such a case, *F* does not own Blackacre. Nevertheless, *F* writes out an apparent deed granting *V* an interest in Blackacre. Later, *F* acquires Blackacre. Equity presumes that *F*, smitten with conscience (that blushing shame-faced spirit that mutinies in man's bosom), acquires Blackacre for the benefit of *V*.

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89. *See* 3 AMERICAN LAW OF PROPERTY §§ 11.30–.31 (A. Casner ed., 1952) [hereinafter *ALP*].

90. Jeanne L. Schroeder, *Death and Transfiguration: The Myth that the U.C.C. Killed "Property,"* 69 TEMP. L. REV. 1281, 1295 (1996).

91. *Id.* at 1282.

92. *Id.* at 1294.

93. *See* U.C.C. §§ 2-312, 2-401 (AM. LAW INST. & UNIF. LAW COMM'N 2012).

94. Milton M. Hermann, *The Doctrine of Equitable Conversion: I, Conversion by Contract*, 12 DEPAUL L. REV. 1, 12–13 (1962).

95. *ALP*, *supra* note 89, § 11.30.

96. CRS Steam, Inc. v. Eng'g Res., Inc. (*In re* CRS Steam, Inc.), 225 B.R. 833, 843 (Bankr. D. Mass. 1998) (declaring equitable conversion to be a relic of the past).

Thus, legal and equitable title are split. *V* has the right to an injunction compelling *F* to convey legal title to *V*.[97]

Estoppel by deed is sometimes taken to be the origin of the after-acquired property security interest authorized by Article 9 of the U.C.C.[98] As such, it has become so familiar that it is not always recognized. Prior to Article 9, we observe chattel mortgage courts proclaiming that the secured lender had an "equitable lien" on after-acquired collateral obtained by the borrower.[99]

Estoppel by deed is not a constructive trust. In an estoppel case, *V* does not convey legal title to *F*. Rather, *F* obtains legal and equitable title from some stranger. Equitable title is deemed obtained for the benefit of *V*. In addition, the doctrine does not depend on wrongdoing by *F*. It is an ordinary after-acquired property concept.

4. Resulting Trust

Another idea floating about the law is resulting trust. Suppose all we know is that *O* has delivered cash to a transferee (*T*) and *T* has bought something. It is possible *O* intended a gift of the cash, in which case *T* owns the purchased thing outright. But it is also possible *O* did not intend a gift, and there is no evidence *T* defrauded *O*. Then we say that a trust *results* just because a gift was not intended. *T* owns the thing in resulting trust for the benefit of *O*.[100]

A resulting trust does not depend on *T*'s wrongdoing. Rather, it is an interpretation of what *O* fully intended. In contrast, in a constructive trust, *O*'s intent to convey legal title is present, but that intent is defective.

5. *In Custodia Legis*

Yet another idea is occasionally confounded with constructive trust, and it is one that does not entail a split between legal and equitable title. It is the

97. Mickles v. Townsend, 18 N.Y. 575, 582–83 (1859); 9 WILLIAM S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 154–55 (3d ed. 1944); Joel M. Ngugi, *Promissory Estoppel: The Life History of an Ideal Legal Transplant*, 41 U. RICH. L. REV. 425, 450–51 (2007).

98. Galveston R.R. v. Cowdrey, 78 U.S. (11 Wall.) 459, 481 (1871); *see* David Cohen & Albert B. Gerber, *The After-Acquired Property Clause*, 87 U. PA. L. REV. 635, 642–43 (1939) (criticizing this genealogy).

99. 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 2.4 (1965); Russell A. Hakes, *According Purchase Money Status Proper Priority*, 72 OR. L. REV. 323, 331 (1993).

100. Jamie Glister, *Lifetime Wealth Transfers and the Equitable Presumptions of Resulting Trust and Gift*, 103 IOWA L. REV. 1971, 1974–75 (2018); *see* Fleet Nat'l. Bank v. Valente (*In re* Valente) 360 F.3d 256, 263–66 (1st Cir. 2004) (because a conveyance resulted in a trust, the transaction was not a fraudulent transfer); Doster v. Manistee Nat'l. Bank, 55 S.W. 137, 141 (Ark. 1900) ("[F]or where a conveyance is made to defraud creditors a resulting trust never arises in favor of the fraudulent debtor.").

notion of *in custodia legis*, which states that, once a court has jurisdiction over property, the court may dispose of it in the litigation before it, in spite of subsequent litigation in a different, perhaps higher, court.[101] A small claims court could dispose of property that was *in custodia legis*, even though a federal court case has subsequently commenced where title to the property was at stake. Federal bankruptcy legislation has changed that tradition. Bankruptcy itself is said to be founded on the principle of *in custodia legis*,[102] but it is prepared to dishonor custody already established by other courts—including federal diversity or federal question courts. Thus, the automatic stay prevents other courts from disposing of property *in custodia legis*.[103] "Custodians" (conditionally) must account to the bankruptcy courts for property under their custody, no matter if authorized by a nonbankruptcy court of proper jurisdiction.

Opinions differ as to when property is *in custodia legis*. Classically, commencement of litigation[104] put the disputed property in the jurisdiction of the court. Often the moment of custody is deferred to the time a court issues a remedial order.[105]

The *in custodia legis* principle is not a constructive trust. First, it is not necessarily the case that legal and equitable title are split. It is typically said that *in custodia legis* gives rise to a lien on the property before the court, on behalf of the creditor who claims it. Nor is fraudulent acquisition necessarily at stake. All that matters is that a court has rightly obtained jurisdiction over property.

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101. Kline v. Burke Constr. Co., 260 U.S. 226, 229 (1922) ("Where the action is in rem the effect is to draw to the federal court the possession or control, actual or potential, of the res, and the exercise by the state court of jurisdiction over the same res necessarily impairs, and may defeat, the jurisdiction of the federal court already attached. The converse of the rule is equally true, that where the jurisdiction of the state court has first attached, the federal court is precluded from exercising its jurisdiction over the same res to defeat or impair the state court's jurisdiction."); Metcalf v. Barker, 187 U.S. 165, 175 (1902) ("The state courts had jurisdiction over the parties and the subject matter, and possession of the property. And it is well settled that where property is in the actual possession of the court, this draws to it the right to decide upon conflicting claims to its ultimate possession and control."); Peck v. Jenness, 48 U.S. (7 How.) 612, 624 (1849).

102. Acme Harvester v. Beekman Lumber Co., 222 U.S. 300, 306–07 (1911); Robert W. Miller, *Everything Old is New Again: Why the In Rem Summary Jurisdiction of the 1898 Bankruptcy Act Still Limits the Constitutional Authority of Bankruptcy Judges*, 89 AM. BANKR. L.J. 1, 2 (2015).

103. 11 U.S.C. § 362(a)(1), (3) (2012).

104. *Metcalf Bros.*, 187 U.S. at 173–75; *see* David Gray Carlson, *Critique of Money Judgment (Part Two: Liens on New York Personal Property)*, 83 ST. JOHNS L. REV. 43, 177–78 (2009).

105. N.Y. C.P.L.R. § 5202(b) (Consol. 2019).

III. ARE CONSTRUCTIVE TRUSTS VALID IN BANKRUPTCY?

The whole point of constructive trusts is to keep unsecured creditors of *F* from profiting off *F*'s crime.[106] Where *F* has no creditors, the remedy of money judgment quite suffices to assure that at least *V* gets monetary compensation. Where *V* elects to treat the wrong as a conversion, *V* gets, not just *V*'s former property, but any other property of *F* that cannot be traced to the *V-F* conveyance.

Therefore, constructive trust doctrine denies that the victim is an unsecured creditor equal to the fraudster's other unsecured creditors. In fact, constructive trust doctrine denies that the victim is a "creditor" who must accept legal tender in satisfaction of an unsecured claim. Rather, *V* is a property owner, and *F* is in wrongful possession of *V*'s property.

A. *Legal v. Equitable Title and the Bankruptcy Estate*

Constructive trust requires that *F*'s legal title be administered for the benefit of the victim. As such, a constructive trust is no different from a trust expressly created by a grantor in an estate planning environment.

Assume, in the prepetition period, bankrupt *D* was a trustee and *V* was the beneficiary of a trust. *D* could be a fraudster and the trustee of the constructive variety, but our analysis does not turn on this. What we say applies whenever legal and equitable title are split.

Under the Bankruptcy Code, all of *D*'s prepetition property enters the bankruptcy estate under Bankruptcy Code § 541(a)(1). According to § 541(a)(1), the bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case . . . ." So far, the bankruptcy estate of a constructive trust inherits *D*'s legal title to the trust property.

According to § 541(d):

> 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 a mortgage, sold by the debtor, but as to which the debtor retains legal title to service or supervise the servicing of such

106. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 55 cmt. d (AM. LAW INST. 2011) ("Priority in this three-way context may be explained without reference to formal notions of title. Even if A's suit for restitution is formally asserted against B as defendant, A's implicit claim . . . is that B's unsecured creditor C will be unjustly enriched, at A's expense, if B's debt to C is satisfied from assets that B obtained from A by fraud. The intuitive objection is that a debtor should not be allowed to rob Peter to pay Paul.").

> 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.[107]

This section seems to have been added at the behest of participants of the secondary mortgage market. The section says remarkably little.[108] When property enters the estate by means of §541(a)(1),[109] only *D*'s legal title comes in. *B*'s beneficial interest in the trust does not.[110] We don't need § 541(d) to justify this conclusion. The matter can be reasoned from § 541(a)(1) alone.

B. *Real Estate Held in Trust*

One of the doctrinal embarrassments in the Bankruptcy Code is that, logically, beneficial interests in real estate are wiped out if the trustee files for bankruptcy.

According to § 544(a)(3):

> 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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> . . . .

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107. 11 U.S.C § 541(d).

108. Kull, *Bankruptcy*, *supra* note 6, at 266 (stating that § 541(d) has "essentially nothing to say about the problem" of constructive trusts in bankruptcy); *see also id.* at 269 n.11 ("In truth, it is difficult to see any idea behind § 541(d) other than legislative solicitude for the secondary mortgage market"); *id.* at 291 ("pure tautology").

109. Prior to 1984, beneficial interests in trusts were expelled from the estate if brought into the estate "under subsection (a)" of § 541. Some courts therefore held that the strong-arm power was never adequate to avoid the beneficial interests of even constructive trusts. Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1013–14 (5th Cir. 1985). Under this theory, the strong-arm power cannot destroy constructive trusts in real estate. *Accord* McTevia v. Adamo (*In re* Atlantic Mortg. Corp.), 69 B.R. 321, 330 (Bankr. E.D. Mich. 1987). In 1984, Congress increased the analytical barriers for disposing of the strong-arm power by substituting "under subsection (a)(1) or (2)" for "under subsection (a)." Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 456, 98 Stat. 363, 376 (1984). It is therefore a fair reading of the 1984 amendments that Congress intended to subject the secondary mortgage market to the strong-arm power. *See* Nat'l Bank of Alaska v. Erickson (*In re* Seaway Express Corp.), 912 F.2d 1125, 1128 (9th Cir. 1990); Belisle v. Plunkett, 877 F.2d 512, 516 (7th Cir. 1989). For a case holding that the strong-arm power overrides a constructive trust even before the 1984 amendments to § 541(d), see Elin v. Busche (*In re* Elin), 20 B.R. 1012, 1017 (D.N.J. 1982), *aff'd*, 707 F.2d 1400 (3d Cir. 1983).

110. Begier v. IRS, 496 U.S. 53, 59 (1990) ("Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not 'property of the estate.'").

> (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.[111]

A bona fide purchaser takes free of equitable title in real estate generally.[112] Let's take this point seriously. Suppose an executor in a will is appointed to administer Blackacre for the minor heirs. The executor files for bankruptcy. The unsecured creditors take Blackacre away from the orphan heirs. The orphans have next to nothing (unless someone had the wit to file, on behalf of our orphans, a lis pendens against the soon-to be-bankrupt trustee).

To make matters worse, a bankruptcy trustee under § 544(a)(3) is not deemed to be a bona fide purchaser of *fixtures*. So our minor heirs retain the pipes and windows—arguably all of the building. The bankruptcy trustee takes only the land underneath.

This is absurd and unthinkable. Accordingly, there are no reported cases in which orphans have funded bankruptcy dividends for the unsecured creditors of their fiduciary.[113] Section 544(a)(3) is simply shunned under these circumstances. Nevertheless, the absurdity of disinheriting orphans of their real estate is the "plain meaning" of the Bankruptcy Code.[114]

Section 544(a)(3) has been applied to constructive real estate trusts. In *Belisle v. Plunkett*,[115] a real estate developer took money from investors and bought a leasehold interest in the Virgin Islands.[116] Instead of putting title in the limited partnership, as he should have, he took title in his own name. Soon he was bankrupt. The bankruptcy trustee took title to the leasehold free and

111. 11 U.S.C. § 544(a)(3).

112. United States v. Clark, 200 U.S. 601, 607–08 (1906).

113. Such a challenge arose in Mills v. Brown (*In re* Brown), 182 B.R. 778, 783 (Bankr. E.D. Tenn. 1995). The court upheld the equitable interest against the strong-arm power on the authority of *In re* Mill Concepts Corp., 123 B.R. 938 (Bankr. D. Mass. 1991), discussed *infra* in the text accompanying notes 119–20. 182 B.R. at 782.

114. If the heirs get the fixtures, do unrecorded mortgagees also get fixtures? Probably not. The bankruptcy trustee is a hypothetical judicial lien creditor against fixtures. 11 U.S.C. § 544(a)(1). Unless the unrecorded mortgagee has filed a financing statement pursuant to Article 9 of the U.C.C., the trustee takes the fixtures free and clear of this part of the mortgages.

115. 877 F.2d 512 (7th Cir. 1989).

116. *Id.* at 513. Under ancient common law, leases ("chattels real") were thought to be personal property. Placer Sav. & Loan Ass'n v. Walsh (*In re* Marino), 813 F.2d 1562, 1566 (9th Cir. 1987). But the Virgin Islands aided the cause of fraud by deeming leases to be real property. V.I. CODE ANN. tit. 27, § 421 (2019).

clear of the equitable title claimed by the limited partnership that should have had title.

A different result adheres, however, when the cestui que trust is in possession of the real property. In that case inquiry notice applies. The doctrine of inquiry notice states that a purchaser is deemed to visit the property being purchased and to observe that someone is in possession. This possession gives rise to a duty to ask the possessor, "What are your rights?" If the question is not asked, the purchaser is charged with all the knowledge that a successful inquiry would produce. The bankruptcy trustee, as purchaser, is deemed *not* to have asked the possessor about her rights.[117] Accordingly, constructive trusts on real estate survive when the beneficial owner is actually in possession.[118]

In *In re Mill Concepts Corp.*, Judge James F. Queenan tried to end the absurdity of these results with an extremely close reading of § 544(a), which turned on the words "such transfer" in subparagraph (a)(3).[119]

Mill Concepts Corp. actually involved a fraudulent transfer. *A* had conveyed real property to *B*.[120] If *A*'s conveyance was a fraudulent transfer, *B* was the trustee of the real property for the benefit of *A*'s creditors.[121] *B* then filed for bankruptcy. *A* did not.[122] *C*, *A*'s creditor claimed *A*'s conveyance was fraudulent. *B*'s bankruptcy trustee claimed to be a bona fide purchaser of *B*'s property and therefore had a defense against *C*'s fraudulent transfer cause of action. Judge Queenan denied that *B*'s bankruptcy trustee could use § 544(a)(3) as a defense to *C*'s fraudulent transfer theory.

Here is how the arguments works. Recall that the preamble of § 544(a) promises the trustee the "rights and powers" of a hypothetical type, and that the trustee "may avoid any transfer of property" made by the debtor that a

117. McCannon v. Marston, 679 F.2d 13, 16–17 (3d Cir. 1982). For a case assuming that inquiry notice saves a constructive trust from the trustee's strong-arm power, see Helbling v. Thomas (*In re* Thomas), No. 12-14916, 2013 Bankr. LEXIS 5644 (Bankr. N.D. Ohio Nov. 12, 2013). Inquiry notice would have saved the plaintiffs in Carrick v. Hagan (*In re* Carrick Trucking, Inc.), No. 15-cv-13115, 2016 U.S. Dist. LEXIS 53980, at *7–8 (E.D. Mich. Apr. 22, 2016), but the court held, as a matter of Michigan law, that constructive trusts never relate back to the time of the wrong—a doctrinal error.

118. *See* David Gray Carlson, *The Trustee's Strong Arm Power Under the Bankruptcy Code*, 43 S.C. L. REV. 841, 896–911 (1992).

119. 123 B.R. 938, 940–42 (Bankr. D. Mass. 1991) (Queenan, J.).

120. *Id.* at 939.

121. Carlson, *Conduit*, *supra* note 1, at 485.

122. That *A* was not bankrupt was important. If *A* had been bankrupt, *A*'s bankruptcy trustee would have expropriated *C*'s cause of action against *B*'s bankruptcy trustee. 11 U.S.C. § 544(b)(1) (2012); Deutsche Bank Tr. Co. Ams. v. Large Private Beneficial Owners (*In re* Tribune Co. Fraudulent Conveyance Litig.), 818 F.3d 98, 111 (2d Cir. 2016). In such a case we would observe a suit by *A*'s bankruptcy trustee against *B*'s bankruptcy trustee.

hypothetical entity could avoid. A stripped-down version of the statute, illustrating Judge Queenan's grammatical point, states:

> (a) The trustee shall have . . . the rights and powers of, or may avoid any transfer of property of the debtor . . . that is voidable by
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> . . . .
>
> (3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits *such transfer* to be perfected, that obtains the status of a bona fide purchaser and has perfected *such transfer* at the time of the commencement of the case, whether or not such purchaser exists.[123]

According to Judge Queenan:

> The words "such transfer" necessarily have reference to the transfer previously described in the body [i.e. preamble] of § 544(a) in the phrase "may avoid any transfer of property of the debtor . . . ." Nowhere in subparagraph (3) is there any indication of a grant of power beyond the ability to avoid transfers of property made by the debtor.[124]

The idea of this interpretation is that "such transfer" knocks out "rights and powers."[125]

Although this reading would save the constructive trust in real property, it is not sound grammar. "Such transfer" would appear to refer to the *hypothetical* transfer that the debtor makes to the bankruptcy trustee. Thus, the trustee is a

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123. *In re Mill Concepts*, 123 B.R. at 940 (emphasis added) (citing 11 U.S.C. § 544(a) (1988)).

124. *Id.* at 941. For a rehearsal of Judge Queenan's theory, see Kull, *Bankruptcy*, *supra* note 6, at 296–97. Professor Kull would later write this interpretation of § 544(a)(3) into the RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT (AM. LAW INST. 2011) itself. Professor Kull does thicken the soup by noting that "such transfer" appears twice in § 544(a)(3). Kull, *Bankruptcy*, *supra* note 6, at 298. The first time "such transfer" supposedly refers to a transfer the debtor *actually* made before bankruptcy. *Id.* The second "such transfer" refers to the hypothetical transfer from the debtor to the bankruptcy trustee. *Id.* He writes: "If we attempt (with the court in *Belisle v. Plunkett*) to read both references to "such transfer" as referring to the debtor's hypothetical transfer to the trustee as hypothetical bona fide purchaser, the perfectibility qualification to the trustee's status is rendered nonsensical." *Id.* (footnote omitted) (citing Belisle v. Plunkett, 877 F.2d 512 (7th Cir. 1989). Professor Kull further complains that the disfavored reasoning "would require either: (i) that the hypothetical transfer be perfectible against the debtor as transferor; or (ii) that the hypothetical transfer be perfectible by the bona fide purchaser against himself." *Id.* at 298 n.76. In my view, this argument from nonsense does not function. The trustee can be a transferee *against* whom an earlier transfer might be perfected *and* a purchaser who has perfected. There's nothing nonsensical about that!

125. For a similar interpretation by Judge Queenan to save the doctrine of equitable conversion from bankruptcy avoidance, see Rodolakis v. Pedone (*In re* Belba), 226 B.R. 738, 743 (Bankr. D. Mass. 1998) (Queenan, J.).

purchaser of property in a hypothetical transfer from the debtor, where "such transfer" is of the sort that can be perfected.[126]

In effect, bankruptcy *is* a transfer, and § 544(a) describes what *kind* of transfer. The transfer of personal property from the debtor to the bankruptcy trustee is a nonvoluntary creation of a lien. The transfer of real property is by purchase. Judge Queenan's interpretation denies that § 544(a)(3) characterizes the nature of the transfer of which bankruptcy consists.

Although Judge Queenan's reading saves the constructive trust in real property (as well as *express* trusts),[127] it does presuppose that Congress intended to reserve "rights and powers" for personal property cases only. Yet both "rights and powers" and "avoid any transfer" seem generally applicable to real and personal property cases alike.

A later Massachusetts bankruptcy court refused to follow this interpretation. In *In re Pina*, Judge Joan Feeney used § 544(a)(3) to knock out an equitable interest arising from the doctrine of equitable conversion.[128] Under such a doctrine, when the holder of legal title to real property enters into a real property sales contract, the buyer is considered to be the equity owner and is entitled to an injunction requiring a deed to pass legal title, contingent on tendering the agreed price.[129]

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126. Belisle v. Plunkett, 877 F.2d 512, 515 (7th Cir. 1989) ("The statute mentions 'transfer' only in the sense of the *hypothetical* transfer that measures the trustee's rights . . . .").

127. This position is memorialized in RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 60 cmt. f, illus. 17, but without the grammatical analysis of 11 U.S.C. § 544(a)(3).

128. 363 B.R. 314, 316 (Bankr. D. Mass. 2007) (Feeney, J.).

129. Actually, Judge Feeney denied that Massachusetts even has a doctrine of equitable conversion, citing some "risk of loss" cases. *Id.* at 327–28. In these cases, courts allocate the loss of misfortunes that occur between the contract and closing. Massachusetts is more pro-seller than many states, but it does not go so far as to deny equitable title if the buyer arises at the time the contract is executed. Dooley v. Merrill, 104 N.E. 345, 345 (Mass. 1914) ("It is well settled that when by the terms of a binding contract a conveyance of land ought to be made, equity will regard that done which ought to be done, and, if the holder of the legal title refuses to make conveyance, will treat him as trustee for the purchaser ready and able to perform his part of the contract.")

Thus, under *In re Pina*, constructive trusts in real estate do not survive,[130] unless a lis pendens has been filed.[131]

C. *Personal Property Held in Trust*

The rules are quite different when a constructive trustee has title to personal property and then files for bankruptcy. In such a case, the bankruptcy trustee has no strong-arm theory against the owners of equitable title. The trustee is no bona fide purchaser of personal property—only of real property that is not fixtures. Judicial lien creditors are not considered purchasers,[132] and so the trustee inherits *D*'s duty to deliver possession to *V*.[133] This duty is imposed by § 725, which provides:

> After the commencement of a case under this chapter, but before final distribution of property of the estate under section 726 of this title, the trustee, after notice and a hearing, shall dispose of any property in which an entity other than the estate has an interest, such as a lien, and that has not been disposed of under another section of this title.[134]

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130. A noble try by Professor Kull goes as follows: The equitable interest in constructive trust property does not enter the bankruptcy estate through the front door of 11 U.S.C. § 541(a)(1) ("all legal or equitable interests of the debtor in property as of the commencement of the case"). Kull, *Bankruptcy*, *supra* note 6, at 269 n.11. It enters through the postern gate of § 541(a)(3) ("'property that the trustee recovers' under . . . § 550 . . ."). *Id.* at 300.

> [T]he power to appropriate for the estate the equitable interest represented by a claim of constructive trust cannot be described either as the recovery of property or as the avoidance of a transfer. The claimant's equitable interest cannot, therefore, come into the bankruptcy estate by the literal terms of §§ 550(a) and 541(a)(3). Nor is there any other statutory route by which such property becomes part of the bankruptcy estate.

Id. This argument assumes that § 550(a) organizes all avoidance actions, including the use of the strong-arm power. But in fact, strong-arm cases involve an automatic feature. To illustrate, suppose *D* grants an unperfected security interest to *SP* and *SP* declines to perfect. *D* then files for bankruptcy. On the day of bankruptcy, the trustee has a lien that is already senior to the unperfected security interest, without any reference to § 550(a). *See* David Gray Carlson, *The Res Judicata Worth of Illegal Bankruptcy Reorganization Plans*, 82 TEMP. L. REV. 351, 381–87 (2009). True, § 550(a) implies that the debtor has conveyed a thing to a third party that the trustee must retrieve or "recover." But the strong-arm power has a life above and beyond § 550(a).

131. Hurst Concrete Prods., Inc. v. Lane (*In re* Lane), 980 F.2d 601, 602–03 (9th Cir. 1992).

132. *See* C. Scott Pryor, *Third Time's the Charm: The Coming Impact of the Restatement (Third) Restitution and Unjust Enrichment in Bankruptcy*, 40 PEPP. L. REV. 843, 862 (2013).

133. *See* City Nat'l Bank of Miami v. Gen. Coffee Corp. (*In re* Gen. Coffee Corp.), 828 F.2d 699, 704 (11th Cir. 1987).

134. 11 U.S.C. § 725.

One serious impediment to *V*, however, is the definition of "cash collateral." Cash collateral is defined in § 363(a) as:

> [C]ash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.[135]

This definition encompasses funds held in trust—or in constructive trust. *D*'s legal title is inherited by the bankruptcy estate and "the estate and an entity other than the estate have an interest" in the funds. That is, the estate has the legal title and *V* has the equitable title.

What this means is that the trustee can "use, sell, or lease" *V*'s cash, if a bankruptcy court so approves. The trustee, however, will have to provide "adequate protection" to *V*. "Adequate protection," in this context, probably means substitute collateral.[136] That is to say, the bankruptcy trustee can compel *V* to "lend" the funds back to the bankruptcy estate. There is some reason to believe, however, that this expropriation of cash collateral (in exchange for other collateral) can only happen in a reorganization case, where *D* is conducting a business.[137]

As with the invalidity of express trusts on real property, courts have failed to confront the plain meaning of the Bankruptcy Code. A conspiracy of silence has so far managed to suppress the use of § 363(a) to bring cash held in trust under the sway of the bankruptcy trustee's power to use, sell, or lease cash collateral.[138]

D. *The Sixth Circuit*

In the Sixth Circuit, constructive trusts have been found inconsistent with the bankruptcy policy of unsecured creditor equality. According to Judge

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135. *Id.* § 363(a).

136. *Id.* § 363(c), (e).

137. This is apparent from the structure of 11 U.S.C. § 363(c). Subsection (1) permits a trustee to execute transactions if in the ordinary course of business. Subsection (2) prohibits use of cash collateral in this context unless the secured creditor or the bankruptcy court consents.

138. I rudely spell out the implications in David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055 (1998).

Batchelder in *XL/Datacomp, Inc. v. Wilson (In re Omegas Group, Inc.*):[139] "Constructive trusts are anathema to the equities of bankruptcy since they take from the estate, and thus directly from competing creditors, not from the offending debtor."[140] "The ermine robe of unjust enrichment is hardly a fitting adornment for creditors who are typically paid a pittance on their claims,"[141] as Judge Queenan would later put it. Of course, these holdings assume that beneficiaries of constructive trusts are creditors, which I have disputed.

Omegas involved a claim to constructive trust which has been criticized as poor in quality, because the claimant had "unclean hands" or because it is not clear *V* was actually defrauded by *D*.[142] In *Omegas*, *V* wished to pull a fast one on IBM. *V* had signed a disadvantageous redistribution contract with "Big Blue." In desperate financial shape, *D* approached *V* and proposed skullduggery. *D* had a better deal with IBM. *D* proposed that *D* would order computers for *V* without IBM's knowledge, *V* would advance the purchase price, and *D*, as *V*'s agent, would buy IBM computers. *V* would pay *D* a commission on each computer.

V advanced $1.1 million to buy IBM computers. Instead of buying the computers, *D* held the money and proposed that *V* lend *D* that sum. *V* refused. *D* filed for bankruptcy instead. The cash advanced was identifiable in the bankruptcy estate of *D*. *V* claimed this cash from *D*'s bankruptcy trustee.

The bankruptcy court imposed a constructive trust on part of the funds. Both sides appealed.

Speaking for a plurality of the Sixth Circuit, Judge Batchelder ruled that a constructive trust is nothing until, prior to bankruptcy, a court proclaims it to exist. The bankruptcy court itself is forbidden to recognize the constructive trust.

> We think that § 541(d) simply does not permit a claimant in the position of [*V*] to persuade the bankruptcy court to impose the remedy of constructive trust for alleged fraud committed against it by the debtor in the course of their business dealings, and thus to take ahead of all creditors, and indeed, ahead of the trustee. Because a constructive trust, unlike an express trust, is a remedy, it does not exist until a plaintiff obtains a judicial decision finding him to be entitled to a judgment "impressing"

139. 16 F.3d 1443 (6th Cir. 1994).

140. *Id*. at 1452.

141. CRS Steam, Inc. v. Eng'g Res. Inc. (*In re* CRS Steam, Inc.), 225 B.R. 833, 842 (Bankr. D. Mass. 1998).

142. *In re Omegas Grp., Inc.*, 16 F.3d 1443, 1445–46; Kull, *Bankruptcy*, *supra* note 6, at 271–75; Pryor, *supra* note 132, at 856–57; Sherwin, *Omegas*, *supra* note 44, at 888.

> defendant's property or assets with a constructive trust. Therefore, a creditor's claim of entitlement to a constructive trust is not an "equitable interest" in the debtor's estate existing prepetition, excluded from the estate under § 541(d).[143]

Trusts created by *state statute* were distinguished.[144] But constructive trusts imposed by common law were not permitted. The principal reason: constructive trusts do not pre-exist their judicial declaration—a doctrinal error.[145]

The Sixth Circuit was influenced by the "well known"[146] law review article by Professor Emily Sherwin early in her career. Professor Sherwin also insisted that constructive trusts do not pre-exist their declaration,[147] but, rather inconsistently,[148] she supported the imposition of constructive trusts by bankruptcy courts, under a standard that does not match the typical state-law notion that equitable title under constructive trusts are good against judicial lien creditors.[149] Judge Batchelder seems to have ignored the nuanced part of the

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143. *In re Omegas Grp., Inc.*, 16 F.3d at 1451.

144. *Id.*

145. *Id*. at 1449 ("Unless a court has already impressed a constructive trust upon certain assets or a legislature has created a specific statutory right to have particular kinds of funds held as if in trust, the claimant cannot properly represent to the bankruptcy court that he was, at the time of the commencement of the case, a beneficiary of a constructive trust held by the debtor.").

146. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 55 reporter's note d. (AM. LAW INST. 2011).

147. Sherwin, *Constructive Trusts*, *supra* note 11, at 326.

148. If undeclared constructive trusts imply no property in *V*, then the trustee's strong-arm power means that the bankruptcy trustee's hypothetical judicial lien encumbers both legal and equitable title, and a constructive trust is quite useless to *V*. Davis v. Cox (*In re* Cox), 274 B.R. 13, 29–30 (Bankr. D. Me. 2002) (trustee's hypothetical judicial lien primed ex-wife's claim to marital asset), *rev'd*, 356 F.3d 76 (1st Cir. 2004).

149. The thrust of Professor Sherwin's view is in the following passage:

> This article rejects the *Restatement*'s position on creditors' rights. According to the analysis proposed here, priority over general creditors should not follow automatically from the plaintiff's right to a constructive trust against the defendant's property. Instead, the priority of a restitution claimant in bankruptcy . . . should be based on the strength of her claim in relation to the claims of competing parties who will bear the burden of the remedy. Put another way, the right to a constructive trust in bankruptcy should depend on whether *creditors* would be unjustly enriched by sharing in the property the plaintiff claims.

Sherwin, *Constructive Trusts*, *supra* note 11, at 306. Professor Sherwin assumes state law is completely insensitive to the effect of insolvency on constructive trusts. *See id*. at 317. But this does not follow. Insolvency exists under state law and should be construed as part of constructive trust doctrine.

article and instead followed the logic according to which constructive trusts never pre-exist their declaration.[150]

Omegas is not in the spirit of *Butner v. United States*.[151] *Butner* holds:

> Unless some federal interest requires a different result, there is no reason why such interests [i.e. property interests created under state law] should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.[152]

Of course, Judge Batchelder has identified equality of unsecured creditors as the federal interest requiring that the state law concept of constructive trust be overridden.[153] But this presupposes that beneficiaries of constructive trusts are indeed creditors, which I have disputed. Even so, Supreme Court dicta prior to the Bankruptcy Code support the concept of constructive trust.[154] It was certainly the case that equality of creditors was also a policy of the 1898 Act. It never occurred to the Supreme Court that equality of creditors mandates the abolition of constructive trust doctrine in bankruptcy proceedings.

Since *Omegas*, the Sixth Circuit has backpedaled.[155] In *McCafferty v. McCafferty (In re McCafferty)*, *D* and *W* divorced.[156] In the divorce decree, *W* received a property settlement according to which *W* was granted a 50% interest in *D*'s pension (not yet collectible). In effect, *D* was to buy back the pension by making installment payments to *W*. *W* had an equitable lien on *D*'s pension

150. *See* Kull, *Bankruptcy*, *supra* note 6, at 289 n.61. Judge Ralph Guy concurred, but on the ground that Kentucky state law denies that constructive trusts pre-exist their judicial declaration. *In re Omegas Grp., Inc.*, 16 F.3d at 1445. For this he relies on Commonwealth Cabinet for Human Res. v. Sec. of Am. Life Ins. Co., 834 S.W.2d 176, 180–81 (Ky. Ct. App. 1992). The point was an alternative holding. The *cestui que trust* also could not trace the purloined funds into *res* in question.

151. 440 U.S. 48 (1979).

152. *Id*. at 55.

153. BFP v. Resolution Tr. Corp., 511 U.S. 531, 546 (1994) (citations omitted) ("[W]here the 'meaning of the Bankruptcy Code's text is itself clear,' . . . its operation is unimpeded by contrary state law or prior practice.").

154. Pearlman v. Reliance Ins. Co., 371 U.S. 132, 135–36 (1962) ("Property interests in a fund not owned by a bankrupt at the time of adjudication, whether complete or partial, legal or equitable, mortgages, liens, or simple priority of rights, are of course not a part of the bankrupt's property and do not vest in the trustee. The Bankruptcy Act simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors. So here if the surety at the time of adjudication was . . . either the outright legal or equitable owner of this fund, or had an equitable lien or prior right to it, this property interest of the surety never became a part of the bankruptcy estate to be . . . distributed to general creditors of the bankrupt."); Cunningham v. Brown, 265 U.S. 1, 11 (1924) (implying that Ponzi victims could claim a constructive trust if they could identify assets through tracing).

155. For a faithful application of *Omegas* to bar a constructive trust in a mistaken payment case, see *In re* Dow Corning Corp., 192 B.R. 428, 440–41 (Bankr. E.D. Mich. 1996).

156. 96 F.3d 192, 193 (6th Cir. 1996).

(not yet payable by the pension plan).[157] We may note that no constructive trust was really before the court. *W* did not convey anything to *D* subject to a right of rescission, as constructive trust doctrine requires.[158]

D then filed for bankruptcy and commenced an adversary proceeding seeking a declaration that *W*'s secured claim against *D* was dischargeable. In short, the case is really about bankruptcy discharges, not equitable liens.

A few notes about discharge are appropriate. Under Bankruptcy Code § 523(a)(5), alimony payments are not dischargeable, but debts arising from a property settlement are.[159] From this principle, we can deduce the answer to the adversary proceeding: *D* was entitled to a discharge of the debt. But discharge never affects the security interest in collateral that may happen to exist with regard to the discharged debt.[160] At the end of the day, when the bankruptcy was over and the automatic stay was laid to rest,[161] *W* was entitled to enforce the equitable lien against the pension. To be sure, the pension plan could not be made to pay out before *D*'s retirement, but perhaps a court of equity could order the sale of a half-pension to some buyer willing to wait and gamble actuarially on the ultimate payout.

In *McCafferty*, the bankruptcy court agreed with all this. *W*, however, appealed. She did not actually disagree that debts connected with property settlements were dischargeable. Rather, *W* "reasserted her argument that by virtue of the divorce decree, her share of the pension benefits was her sole and separate property held in constructive trust by [*D*] and could not be considered property of [*D*'s] bankruptcy estate."[162]

Properly, this question should not have been before the court of appeals. The status of the equitable lien (not a constructive trust) should have been decided after bankruptcy by a state court. In such a state court proceeding *Omegas* would presumably have no bite. A state court could freely recognize the equitable lien.

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157. Equitable liens have been described as "a special and limited form of a constructive trust." *In re* Marriage of Allen, 724 P.2d 651, 658 (Colo. 1986).

158. Harris Tr. & Sav. Bank v. Salomon Smith Barney Inc., 530 U.S. 238, 250–51 (2000) (quoting Moore v. Crawford, 130 U.S. 122, 128 (1889) ("Whenever the legal title to property is obtained through means or under circumstances 'which render it unconscientious for the holder of legal title to retain and enjoy the beneficial interest, equity impresses a constructive trust on the property thus acquired in favor of the one who is truly and equitably entitled to the same . . .'").

159. Shine v. Shine, 802 F.2d 583, 585–86 (1st Cir. 1986).

160. 11 U.S.C. § 522(c)(2) (2012).

161. *Id.* § 362(c).

162. McCafferty v. McCafferty (*In re* McCafferty), 96 F.3d 192, 194 (6th Cir. 1996).

Nevertheless, *D* sought a declaration from the court of appeals that *W*'s "constructive trust" was automatically void by the mere fact of *D*'s bankruptcy petition. If *W* was a dischargeable *unsecured* creditor, *D*'s discharge would have the effect of burying all hope in *W* for a recovery.

The proper answer was for the court to affirm the bankruptcy court and to say nothing about constructive trusts or equitable liens. The court of appeals, however, ruled that a *court* in the divorce proceeding had already established *W*'s equitable interest in the pension.[163] Therefore, *Omegas* did not apply.[164] And even if this were not true, *Omegas* was about vindicating the policy of ratable distribution between creditors. Since *D*'s pension was *exempt* property, recognition by the bankruptcy court of a constructive trust on the pension did not affect *D*'s creditors, and so *Omegas* was no impediment to recognition of a constructive trust.[165]

A divorce court, evidently, may split legal and equitable title between husband and wife, but that does not mean it is imposing a *constructive* trust. A *constructive* trust suggests a right of rescission to prevent unjust enrichment. The court, however, announced that "[s]ince it would result in an unjust enrichment for [*D*] to receive the entire value of the retirement benefits, a constructive trust arose."[166] This rather perverts the "constructive trust" notion. A constructive trust arises to prevent unjust enrichment. Here, the unjust enrichment *is* the hypothetical violation of a pre-existing fiduciary duty. In short, a court-created *trust* existed, but there is no compelling reason to call it a *constructive* trust.[167]

Omegas was more directly compromised in *Kitchen v. Boyd (In re Newpower)*.[168] The case involved the *V*s' motion to lift the automatic stay to continue state court actions in which the *V* sought a declaration of the constructive trust. It is rather hard to discern the final result from this difficult opinion, but it appears that the bankruptcy court permitted actions against third party transferees from *D*, but declined to lift the stay with regard to constructive trust property still possessed by *D* at the time of the bankruptcy. This is a result that coheres with *Omegas*. The district court reversed in part, holding that the

163. "The domestic relations court clearly did not use the magic words 'constructive trust' in its divorce order." *Id.* at 197. The court of appeals nevertheless ruled that such was the state court's intent. *Id.* at 198.

164. *Id.* at 197.

165. *Id.*

166. *Id.* at 199.

167. *See* FDIC v. AmFin Fin. Corp., 757 F.3d 530, 537 (6th Cir. 2014) (finding that *Omegas* does not apply to a resulting trust).

168. 233 F.3d 922 (6th Cir. 2000).

automatic stay should be obliterated entirely. This would allow the *V* in state court to dispossess the bankruptcy trustee of all constructive trust property. The court of appeals apparently affirmed the district court, in spite of a contrary statement in the "majority" opinion.[169]

In *Newpower*, *D* defrauded *V* into investing in a corporation (NPI). Part of the investment was a loan to NPI made before NPI was incorporated. For this part of the investment, *V* wrote *D* a personal check, on the assumption that *D* was agent for the soon-to-be-born corporation.[170] *D*, however, deposited the check in his personal account. As to this aborted loan, the court thought that *D* never had title to the funds before the embezzlement and no title after.[171] Still, as will be emphasized below,[172] *V* or NPI prevails *only* if constructive trusts are valid in bankruptcy. So this part of the opinion overrules *Omegas* in the case of constructive trusts arising from stolen funds.

A different part of the investment was in the form of a loan directly to NPI (now incorporated). As agent of NPI with the power to write checks, *D* embezzled the money from NPI accounts. *D* spent some of it on things, including a power boat.[173] Part of the money was still identifiable in *D*'s bankruptcy estate.

V commenced suits against third parties who had received proceeds of these funds. *D* filed for bankruptcy shortly thereafter, which triggered the

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169. Judge Kennedy, ostensibly for the majority ruled,

> In sum, we AFFIRM the district court's conclusion that none of the money misappropriated by debtor was property of the debtor's bankruptcy estate although some of the proceeds are. We REVERSE the district court to the extent it concluded that debtor's bankruptcy estate did not have legal title to the property that debtor bought with such funds, and that he still possessed at the time he filed his bankruptcy petition.

Id. at 934 (Kennedy, J.). But two of the three-member paneled "concurred" that the district court should be affirmed entirely. *Id.*

170. The check was payable to *D* but the "memo portion of the check stated that the check was for NPI . . . " *Id.* at 926.

171. The court viewed *D* as agent to *V*, so that title to the funds never left *V*. *Id.* at 933–34.

172. *See infra* text accompanying note 193. The point will be that stolen funds always implicate constructive trusts, unless the stolen currency is located as such in *D*'s possession at the time of *D*'s bankruptcy petition.

173. *Newpower*, 233 F.3d at 927 ("Among other things, [*D*]: bought a Corvette, a four-wheel drive pickup truck, and a power boat; built a new house for his girlfriend; loaned $60,000 to a former fiance; invested $50,000 in the production of a music CD for another girlfriend; spent tens of thousands of dollars in 'loan repayments' to customer trust accounts for [D's] real estate business; and made thousands of dollars of cash distributions to himself for 'walking around money.'").

Bankruptcy Code's automatic stay against general state law collection actions.[174]

A procedural note is in order. We are not told very much about the state court actions against third parties, but one of them seemed to be based on *D*'s building "a new house for his girlfriend,"[175] whom we shall call *G*. We shall use this presumed action against *G*'s land as a paradigm action against the other third parties.

As we are not told whether *G* was actually sued, or what form the suit took, let us assume that *D* wrote checks to a construction company that built a house on land *G* already owned. In exchange for *D*'s check, the construction company built a house. If without knowledge of the source of the funds, the construction company had a bona fide purchaser defense against a conversion cause of action.[176] The construction company, however, bestowed labor and materials on *D*, which *D* then directed toward *G*. The claim was that the benefits of the construction contract (materials and labor) could be traced into *G*'s real property. Ergo this real property (to the extent of value added) was held in trust by *G* for the benefit of the *V*. Undoubtedly, it is best to think of this claim as an equitable lien.[177] In other words, *V* and NPI would have the right to a

174. 11 U.S.C. § 362(a) (2012).

175. *Newpower*, 233 F.3d at 927.

176. Recognizing that bank deposits fall between the cracks of negotiable instrument law, with its concept of holding in due course, many states have enacted the Uniform Fiduciaries Act (U.F.A.). The U.F.A. repeals inquiry notice for third parties who take bank checks drawn on stolen funds. UNIF. FIDUCIARIES ACT § 6 (UNIF. LAW COMM'N 2019) ("If a check or other bill of exchange is drawn by a fiduciary . . . and is thereafter transferred by the fiduciary . . . in payment of a personal debt of the fiduciary . . . the transferee is not bound to inquire whether the fiduciary is committing a breach of his obligation unless he takes the instrument with actual knowledge of such breach or with knowledge of such facts that his action in taking the instrument amounts to bad faith"). Thus, the third party is privileged to assume that, when *D*, a fiduciary for *V*, writes a check on *D*'s deposit account containing *V*'s traceable funds, *D* is acting consistently with fiduciary duty. If, however, the third party knew or should have known of the misconduct, then the third party has converted *V*'s funds. DeLaRosa v. Farmers State Bank, 474 S.W.3d 240, 244–46 (Mo. Ct. App. 2015). For nonstatutory cases, *see* RESTATEMENT (THIRD) TRUSTS § 108(3) (AM. LAW INST. 2012) ("In dealing with a trustee, a third party need not: (a) inquire into the extent of the trustee's powers or the propriety of their exercise.").

177. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 56 cmt. d (AM. LAW INST. 2011) ("Equitable lien is the typical response when improvements to realty have been made with misappropriated funds . . . ."). According to Professor Rendleman:

> A judge will impose an equitable lien when a constructive trust would "overkill." For example, if the defendant embezzles $250,000 and buys a house for that amount, the judge will impose a constructive trust . . . . On the other hand, if the defendant embezzles $25,000 and spends it to remodel the kitchen in his $250,000 house, the judge will impose an equitable lien for $25,000, a security interest the plaintiff can foreclose.

foreclosure against a whole or part of the property to raise cash in order to reimburse *V* or NPI for the theft of funds.

If this is correct, we observe that *D* indirectly transferred materials and labor to *G*. Having conveyed away legal title to this value, *D*, at the time of the bankruptcy, could claim no property interest in *G*'s real property. Therefore, the automatic stay did not apply to prevent this lawsuit. This was basically the position of the bankruptcy court.

But suppose constructive trusts *are* void—that is, they do not pre-exist their declaration. Then *D* had both legal and equitable title to the funds. If so, *D* made a fraudulent transfer to *G*. The proceeds of the fraudulent transfer are property of the estate and the automatic stay ought not to be lifted.[178] Thus, in anticipation of the main theme of this Article, either we have a constructive trust, in which case *D* has transferred legal title to *G* and the automatic stay does not apply because *D* has no property interest. Or there is no constructive trust, and *D* has conveyed *D*'s *own* property in violation of fraudulent transfer law. In that case, the automatic stay *does* apply.

Moving to lift the stay with regard to third party actions already commenced makes some sense. But as to the things *D* possessed at the time of the bankruptcy petition (such as the power boat bought with stolen funds), moving to lift the automatic stay was a curious way to pursue the boat. Presumably, the way to obtain the power boat from *D*'s bankruptcy trustee was to seek a court order directing the trustee to make a § 725 distribution of the boat to *V*.[179] This entails a judicial recognition that the trustee had mere legal title and that *V* had equitable title under a constructive trust. As it is, limitation of the case to lifting the automatic stay suggests that *V* would have to join *D*'s bankruptcy trustee to a state court action, and it is the state court that would order the trustee to do his duty under § 725.

Newpower is an odd opinion in that, with little warning, what appears to be Judge Cecilia Kennedy's majority opinion morphs into the dissenting opinion. The *real* majority opinion can be found in the concurring opinion of Judge Alice Batchelder, the erstwhile enemy of the constructive trust in *Omegas*.

Doug Rendleman, *Measurement of Restitution: Coordinating Restitution with Compensatory Damages and Punitive Damages*, 68 WASH. & LEE L. REV. 973, 991 (2011).

178. Am. Nat'l Bank of Austin v. MortgageAmerica Corp. (*In re* MortgageAmerica Corp.), 714 F.2d 1266, 1277 (5th Cir. 1983).

179. This could be done under FED. R. CIV. P. 70(a) ("If a judgment requires a party to . . . perform any . . . specific act and the party fails to comply within the time specified, the court may order the act to be done . . . by another person appointed by the court."). *See* Mid-Atl. Supply, Inc. of Va. v. Three Rivers Aluminum Co., 790 F.2d 1121,1122 (4th Cir. 1986).

According to Judge Batchelder, the automatic stay should be lifted entirely with respect to *V*. Thus, *V* was invited to get a judicial declaration from a state court that third parties are constructive trustees for *V*. Judge Batchelder offered four different propositions as to why *Omegas* did not apply to the facts in *Newpower*:

1. Because *V* owned the equity and *D* did not, § 362(d)(2) entitles *V* to relief from the stay.[180] By contrast, in *Omegas* it was *not clear D* owned the equity. Obviously, a bankruptcy court can know *V* owns the equity only if it is permitted to recognize the state law doctrine of constructive trust (even before a state court has imposed the trust). On this view, *Omegas* never applies when the constructive trust status of property is *clear*.[181]
2. *Omegas* did not involve an attempt by *V* to lift the automatic stay. Therefore, *Omegas* never applies in automatic stay litigation.[182] As to whether the ultimate declaration of the constructive trust by a state court should bind a bankruptcy court, no opinion is expressed.[183] But *Omegas* does not bar that conclusion either.[184]
3. *Omegas* applies to transfers of title in the ordinary course

180. Judge Batchelder implied that there *was* a constructive trust, even though no state court had so declared:

> The automatic stay imposed by the filing of a bankruptcy petition shall be lifted upon motion by a party in interest in cases . . . (2) where the debtor does not have an equity interest in the property and the property is not necessary to an effective reorganization. *See* 11 U.S.C. § 362(d). [*V* qualifies] under the second condition set forth in § 362(d). As we have already held, the debtor did not obtain equitable title to these proceeds, and this case does not involve a reorganization . . . .

Newpower, 233 F.3d at 935 (Batchelder, J.).

181. In *Newpower*, *D* obtained legal title to the proceeds of stolen money, but "he clearly did not obtain equitable title in the goods." *Id.* at 936.

182. *Id.* at 935, 937.

183. "We express no opinion on whether, in the event [*V* was] successful in obtaining such a [state court] judgment [of constructive trust], it would have an effective date prior to the filing of the bankruptcy petition—a matter that is governed by state law." *Id.* at 937.

184. *Id.* at 937. There is a hint that if a state court were to impose a constructive trust, it would be honored by a bankruptcy court: "In our view, the state court where [*V*] initiated [his] action before the bankruptcy petition was filed is best suited to determine who holds the equitable interest in the property at issue under Michigan law." *Id.* at 936 n.2. In a subsequent opinion, Poss v. Morris (*In re* Morris), 260 F.3d 654 (6th Cir. 2001), Judge Batchelder, in recalling *Newpower*, leaves out the part wherein *Newpower* gives no opinion on whether a postpetition declaration of constructive trust (where the stay has been lifted) is binding on a bankruptcy court. *See In re Morris*, 260 F.3d at 667. Instead, *Newpower* is said to stand for the bindingness of state law. *Id.*

of business, not to thefts.[185] If this were not so, thieves could launder stolen funds by buying things that would be free of a constructive trust claim.[186]

4. *Omegas* does not apply because *V* commenced a state court action (even though an imposition of the constructive trust had not yet occurred).[187] Commencement implies that the automatic stay itself is the only reason a declaration of a constructive trust had not occurred.[188] Of course, a bankruptcy court cannot know this unless it peeks beneath the blanket of dark to discern that the constructive trust is actually there.

These disparate thoughts do not exactly cohere. It is tempting to conclude that, in the Sixth Circuit, constructive trusts are valid in bankruptcy in case of theft (and perhaps only when the victim has already commenced an attempt to foment a state-court declaration). Also, a constructive trust can be recognized as a reason to lift the automatic stay. Otherwise, constructive trusts are invalid in Sixth Circuit bankruptcies.

Meanwhile, Judge Cecilia Kennedy thought that stolen funds were not part of the bankruptcy estate.[189] She would have applied *Omegas* in any case involving *proceeds* of stolen money, where a bona fide purchaser of the stolen money conveyed some valuable thing to *D*. In such cases, *D* had title to the thing. The only way to recognize *V* as the holder of equitable title is to

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185. *Newpower*, 233 F.3d at 936.

186. *Id*. at 936.

187. According to Judge Batchelder, *Omegas* did not apply here because *C* "initiated a state court action to recover the stolen property before the debtor filed his bankruptcy petition, and the sole reason that the state court has not yet issued a decision is the stay imposed by the bankruptcy court." *Id.* at 935. In *Omegas*, "we were not faced with the question of either obtaining or enforcing a state court judgment." *Id.* at 936.

188. "[A]nd the sole reason that the state court has not yet issued a decision is the stay imposed by the bankruptcy court." *Id.* at 935. Actually, the Bankruptcy Code, not the bankruptcy court, imposes the stay automatically. 11 U.S.C. § 362(a) (2012).

189. *Newpower*, 233 F.3d at 931 ("Thus, we hold that the bankruptcy court erred in concluding that money which debtor embezzled from NPI was part of debtor's bankruptcy estate. Consequently, we also hold that the debtor's bankruptcy estate has no property interest in such embezzled funds which are now in the hands of third parties.").

recognize a constructive trust that splits legal and equitable title.[190] But this is precisely what is not permitted under *Omegas*.[191]

A serious flaw in Judge Kennedy's view is that, when *funds* are stolen, *everything* is proceeds, unless the funds are paper currency and the currency can still be located in *D*'s possession. For example, in *Newpower*, *D* stole funds from NPI by writing a check to himself on NPI's account and depositing the NPI check in *D*'s deposit account. Under these circumstances, *D*'s bank (*D Bank*) is a good faith purchaser of the funds from NPI.[192] As such, *D Bank* has a bona fide purchaser defense against NPI. Meanwhile, *D Bank* gave *D* "title" to that part of *D*'s deposit account that is attributable to the stolen funds. NPI's only remedy is to ratify *D*'s act and make *D* a constructive trustee for *D*'s deposit account. This proves that, when deposit accounts are involved, it is constructive trust theory all the way down.[193] It is not clear that *Omegas* survives *Newpower* at all when stolen funds are involved.

In *Poss v. Morris (In re Morris)*, Judge Batchelder enforced what the beneficial owner called constructive trust.[194] This holding arose in a mass of tedious procedural knots that profits no one to untangle.[195] Suffice it to say that,

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190. "The general rule 'that a constructive trust will arise when stolen or embezzled funds are used to purchase other property . . . often is qualified by the provision that the owner may follow and recover the property or its proceeds as long as it has not been transferred to a bona fide purchaser.'" SEC v. Universal Express, Inc., 04 Civ. 2322, 2008 U.S. Dist. LEXIS 35342 at *13 (S.D.N.Y. Apr. 30, 2008) (citing J.A. Bryant, Annotation, *Imposition of a Constructive Trust in Property Bought with Stolen or Embezzled Funds*, 38 A.L.R.3d 1354 § 3 (1971)).

191. Per Judge Kennedy's opinion:

> Thus, the $382,463 that [*D*] embezzled directly from NPI was never property of [D's] estate . . . . However, the same cannot be said of property that [*D*] purchased for himself with the stolen money. The good faith seller from which the thief purchases property intends to pass both title and possession of the property sold to the thief, and obtains good title to the money the thief provides. . . . Accordingly, the thief obtains legal title to the goods purchased, which thereby become part of his estate . . . .
>
> The original owner would normally not be without remedy in such a situation, as a constructive trust may be imposed on the proceeds held by the thief or embezzler . . . However, under *In re Omegas*, a constructive trust is an equitable interest that exempts property from the bankrupt's estate under § 541(d), *only* if the trust is declared by a court in a separate *prepetition* proceeding or a state statute provides that the property is to be held in trust for a particular purpose.

Newpower, 233 F.3d at 930–31.

192. Carlson, *Conduit*, *supra* note 1, at 485–91.

193. SMITH, *Tracing*, *supra* note 55, at 7–8.

194. 260 F.3d 654, 668 (6th Cir. 2001).

195. I share one sentence from *In re Morris* to scare off readers from this unrewarding Gordian knot: "The structure of this second transaction resulted in an anomalous situation in which Poss owned

in response to a state money judgment lawsuit, *D* promised *V* that *D* would convey real estate to *V*. The settlement was solemnized as a judgment of the state court. *D* defaulted and filed for bankruptcy. The stay was lifted at *V*'s behest, and a state court affirmed that *V* had equitable title to the real property.

What we have here is, basically, a real estate sales contract—a case of equitable conversion.[196] There is no need to call this a "constructive trust." "Constructive trust" implies that legal title in the constructive trustee can be rescinded. But equitable conversion does not turn on the right of rescission. It exists independently of any such right.

Nevertheless, *V* labeled the right as one of constructive trust, and Judge Batchelder, accepting this questionable taxonomy,[197] upheld *V* and distinguished *Omegas*.

Omegas, Judge Batchelder reminisced, merely counsels the parsimonious use of constructive trust doctrine to override "the bankruptcy policy of ratable distribution among creditors" which "conflicts with the constructive trust remedy . . . "[198] Also, since *V* had obtained a lift of the automatic stay and since a state court announced *V* had equitable title, the "constructive trust" (that is, equitable title arising under the doctrine of equitable conversion) declared by a state court was binding in bankruptcy.[199]

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the building housing Morris's business, Morris owned the land on which the building was situated, and each leased his or her respective interest to the other." *Id.* at 658. Needless to say, neither Poss nor Morris had benefit of counsel before cooking up this legal back-of-a-napkin relationship.

196. *See supra* text accompanying notes 86–96.

197. In her opinion, Judge Batchelder writes:

> Ohio follows the traditional rule of the common law that regards contracts for the conveyance of real property as falling within the jurisdiction of courts of equity because of the inherent inadequacy of any legal remedy . . . . Although the availability of an equitable remedy . . . depends upon on the inadequacy of a remedy at law, "where land is the subject matter of the agreement, the jurisdiction of equity to grant specific performance does not depend upon the existence of special facts showing the inadequacy of a legal remedy in the particular case." . . . . In other words, under Ohio law a contract for the conveyance of real property falls squarely within the equitable jurisdiction to fashion an appropriate remedy.

In re Morris, 260 F.3d at 667–68 (citations omitted). There follows a non sequitur: "Essentially, Ohio courts will use the remedy of constructive trust 'where there is some ground . . . upon which equity will grant relief.'" *Id*. (citing Henkle v. Henkle, 600 N.E.2d 791, 796 (Ohio Ct. App. 1991)). The ellipses substitute for "such as fraud, duress, undue influence or mistake." *Henkle*, 600 N.E.2d at 796. In short, a real estate contract is equated with fraud, distress, etc., by Judge Batchelder.

198. *Morris*, 260 F.3d at 666.

199. *Id*. at 667 ("Of course, whether a judgment obtained by a creditor in a state court proceeding initiated prepetition . . . following the lifting of the automatic stay has an effective date prior to the filing of a bankruptcy petition is a matter left to state law.").

Finally, Judge Batchelder admitted that *Omegas* had already been overruled in one crucial respect:

> Although in *Omegas Group* we said that a constructive trust "does not exist until a plaintiff obtains a judicial decision finding him to be entitled to a judgment 'impressing' defendant's property or assets with a constructive trust," . . . we recognized in *McCafferty* that a constructive trust can arise without a formal judicial decision under Ohio law. This case addresses one of the questions *Newpower* noted remained open following *Omegas Group*, namely whether the bankruptcy court may give effect to a state court judgment obtained postpetition in an action initiated prepetition. We answer that question affirmatively, reaffirming that state law governs the effective date of such a judgment.[200]

To underscore this holding, the *Morris* court also overruled the bankruptcy court's holding that the constructive trust was a voidable preference. A voidable preference it was, if constructive trusts do not pre-exist their declaration.[201] But since a constructive trust *does* pre-exist its declaration if state law says it does, the voidable preference holding became untenable and had to be reversed.[202]

In the name of completeness, reference should be made to a case appearing early in the above-described sequence of Sixth Circuit opinions. In *Blachy v. Butcher*, the court of appeals ruled, as a matter of Michigan state law, that a constructive trust on real property never pre-exists its judicial declaration.[203]

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200. *Id*. at 669.

201. Mason v. Clark (*In re* Book), No. 11-62686, 2013 Bankr. LEXIS 3303 at *13 (Bankr. N.D. Ohio Aug. 1, 2013).

202. *In re Morris*, 260 F.3d at 669–70. How was a postpetition declaration of the trust a prepetition transfer to *V* (in the opinion of the bankruptcy court)? Prior to bankruptcy, *V* had sued on breach of the settlement agreement and had obtained on an *ex parte* basis an order directing the registrar of deeds to record *V* as the owner of the disputed real property. *Id.* at 659. After bankruptcy, the state appellate court ruled that the *ex parte* order was procedurally inappropriate. *Id*. at 660. On postpetition remand, the trial court ruled that, although it could not order the registrar of deeds to record *V* as the owner, *V* was invited to seek specific performance based upon a prepetition equitable title. *Id*. at 661. Thus, the bankruptcy court thought, the constructive trust had been declared prepetition in a *nunc pro tunc* style. *Id*. at 662.

203. 221 F.3d 896, 905 (6th Cir. 2000). Judge Ronald Lee Gilman, would write:

> Even a *diabolical* bar examiner would be reluctant to impose this case's complex mixture of subject matter jurisdiction, fraud, real estate, marital property, bankruptcy, tax liens, contributory negligence, equitable remedies, and civil procedure upon hapless law school graduates. Because reality often marches in where creators of hypotheticals fear to tread, however, we are the "hapless" appellate court judges obliged to struggle with this twisted tale of true-

Omegas was cited, but only to prove that constructive trusts not yet judicially declared are "inchoate"[204] and therefore subordinate to a tax lien under federal tax law.

LTDC was a land-owning partnership owned by *H* and *W* (husband and wife). LTDC granted to *H* and *W* a tenancy by the entirety (duly recorded) to 17.83 acres of a residential development. LTDC then double-conveyed 12.6 acres of the *H*-*W* 17.83 acres to HCDC, yet another partnership owned by *H* and *W*. *H* and *W* permitted LTDC and HCDC to sell to various *V*. Of course, legal title was not theirs to sell. *H* and *W* continued to own the 17.83 acres.

The *V* would later claim that *H* and *W* held title in constructive trust because the *V* had been defrauded by the sales by LTDC and HTDC to the *V*. This must be sharply questioned. *H* and *W* were not transferees of title from the *V*. This is what is required if *H* and *W* are to be considered constructive trustees. In fact the *V* were not transferors. They were transferees—or more precisely non-transferees since their vendors had no title to sell.

Quite unrelatedly, the *V* were duped by non-owners of real estate to part with their money. If anything, LTDC and HTDC were constructive trustees of the *V*s' *money*. To the extent *H* and *W* received this money as the owners of LTDC and HTDC, *H* and *W* were constructive trustees of *money*. Their title to the 17.83 acres was unaffected by the actions of LTDC and HTDC.

To add fuel to the fire, the Internal Revenue Service (IRS) assessed a tax against *H* and *W*, thereby giving rise to a federal tax lien.[205] An issue would be whether or not the IRS was senior to the *V* with regard to the real property owned by *H* and *W*. Properly, the *V* had no claim to the *H*-*W* lands at all.

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life conflict.

Id. at 900.

204. *Id.* at 906. In the early 20th century, state law began to experiment with floating security interests in personal property. Starting in 1929, however, the Supreme Court ruled, in effect, that inchoate liens were not really liens. *See* Spokane Co. v. United States, 279 U.S. 80, 94 (1929); Frank R. Kennedy, *From Spokane County to Vermont: The Campaign of the Federal Government against the Inchoate Lien*, 50 IOWA L. REV. 724 (1965). Inchoate liens were uncertain as to "(1) the identity of the lienor, (2) the property subject to the lien, and (3) the amount payable were fixed beyond possibility of change or dispute." William T. Plumb, Jr., *Federal Liens and Priorities–Agenda for the Next Decade*, 77 YALE L.J. 228, 230 (1967); *see* United States v. City of New Britain, 347 U.S. 81, 86 (1954). Any creditor with a prior "floating" security interest found it could not claim to have a lien at all, insofar as the tax lien was concerned. *See generally* William H. Baker, Drye *and* Craft*—How Two Wrongs Can Make a Property Right*, 64 U. PITT. L. REV. 745, 748–57 (2003). Thus, at an early stage, federal law felt entitled to call the bluff of state law. Just because state law called the inchoate interest "property" did not make it so. Inchoate interests are not property at all, insofar as federal tax liens are concerned.

205. 26 U.S.C. § 6321 (2012).

Later *W* (but not *H*) filed for bankruptcy. After the bankruptcy, *H* conveyed his interest in the debatable lands to *W*, so that *W*'s bankruptcy trustee and *W* were cotenants to the property.[206]

W's 50% share was her postpetition property, not subject to the automatic stay emanating from her bankruptcy. I shall refer to this 50% as *W*'s nonbankruptcy half. *V* commenced litigation against this half, first in state court and then, after removal, in federal district court. Hence, litigation continued in bankruptcy court for the bankruptcy half and in the federal district court for the nonbankruptcy half. The district court responded by remanding the nonbankruptcy litigation to the bankruptcy court, which then had before it both halves of the cotenancy.[207]

First, with regard to the bankruptcy litigation, but for the constructive trust claim of the *V*, *W*'s prepetition 50% share went into *W*'s bankruptcy estate. The entireties could (if *W* so wished) be exempted,[208] but no exemption claim could be valid against a joint creditor, such as the IRS.[209] Since the *V* were all joint creditors,[210] they (together with the IRS) guaranteed that the entireties was completely nonexempt in *W*'s bankruptcy. *W*'s bankruptcy trustee, though, could sell the whole and retain 50% for *W*'s creditors within the bankruptcy.[211] The 50% surplus was postpetition property that would belong to *W* free and clear of *W*'s bankruptcy.[212]

But now we must add the issue of constructive trust. Properly, any constructive trust claim by the *V* lay against the money conveyed to LTDC and HTDC. The *H*-*W* title to the 17.83 acres was quite free and clear of a constructive trust theory. Nevertheless, the bankruptcy court ruled that *V* had the equitable interest in the 17.83 acres and that *W*'s bankruptcy trustee and *W*

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206. In a Michigan tenancy by the entirety, the conveyance of *H* to a non-spouse is a nullity. But *H*'s conveyance to *W* (making *W* the 100% owner) will be honored. United States v. Craft, 535 U.S. 274, 282–84 (2002) (explaining that *H* has power to alienate with consent of *W*).

207. *Blachy*, 221 F.3d at 901–02.

208. 11 U.S.C. § 522(b)(3)(B) (2012).

209. Sumy v. Schlossberg (*In re* Sumy), 777 F.2d 921, 925–29 (4th Cir. 1985) (applying Virginia and Maryland law).

210. The *V* claimed the right to compel *H* and *W* to convey to them legal title to their homes. Yet we have emphasized that the beneficiaries of a constructive trust are not creditors. *See supra* text accompanying notes 52–72. But the *V* would find themselves subordinate to the IRS tax lien. Given no access to the constructive trust property, the *V* would have to locate in the concept of unjust enrichment an in personam right to payment if for some reason *H* and *W* could not convey legal title.

211. 11 U.S.C. § 363(h).

212. For details on the mysterious status of Michigan tenancy by the entirety in bankruptcy proceedings, see David Gray Carlson, *The Federal Law of Property: The Case of Inheritance Disclaimers and Tenancy by the Entireties*, 75 WASH. & LEE L. REV. 3, 60–203 (2018).

held their 50% shares in constructive trust for the *V*. We shall treat the mistaken constructive trust claim as valid for the purposes of our discussion.

Under Bankruptcy Code § 544(a)(3), the trustee is a bona fide purchaser for value of *W*'s share of the tenancy by the entirety. But bankruptcy trustees are subject to the doctrine of inquiry notice. According to this doctrine, the bankruptcy trustee is charged with knowledge of the rights of persons in possession of real estate.[213] The *V* alleging constructive trust were all in residence, and so the constructive trust was valid in bankruptcy, in light of inquiry notice. This is so, at least, outside the Sixth Circuit.[214]

Omegas, however, interfered with this conclusion. Thus, in *W*'s bankruptcy, the bankruptcy court had allowed the constructive trust on *W*'s share. The district court reversed and remanded on the ground of *Omegas*.

On remand, the bankruptcy court lifted the automatic stay so that the *V* and the IRS could pursue *W*'s postpetition 50% and also the bankruptcy trustee's half. After this point, the district court had sole jurisdiction over both halves. When the case eventually reached the Sixth Circuit Court of Appeals, the appeal dealt entirely with a nonbankruptcy case. It was not an appeal from the bankruptcy case.

The district court declared a constructive trust on both halves of the 17.83 acres. It also found that the constructive trust related back to the time of the wrong. Thus the *V*s' equitable title was free and clear of the subsequent IRS tax lien.

The court of appeals reversed. It first ruled (without citing *Omegas*) that the constructive trust did not exist—either on the bankruptcy half of the land or on the non-bankruptcy half:

> Under Michigan law, a "constructive trust is strictly not a trust at all, but merely a remedy administered in certain fraudulent breaches of trusts." Accordingly, a constructive trust does not arise until a judicial decision imposes such a trust under Michigan law.[215]

For this the court cited *Soo Sand & Gravel Co. v. M. Sullivan Dredging Co*.[216] In fact, *Soo* stands for the opposite conclusion. In *Soo*, a plaintiff with an equitable interest in land held in constructive trust by another was allowed to bring a suit for trespass, even though, prior to the trespass suit, no court had ever declared a constructive trust. Therefore, *Soo* actually affirms that

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213. *See supra* text accompanying notes 117–18.

214. Blachy v. Butcher, 221 F 3d. 896 (6th Cir. 2000).

215. *Id.* at 905 (citations omitted).

216. 244 N.W. 138, 140 (Mich. 1932).

constructive trusts pre-exist their judicial declaration.[217] Thus *Blachy* aligns with the *Omegas* holding, but it (erroneously) attributed the federal *Omegas* rule to the law of the state of Michigan.

Alternatively, the court of appeals ruled that the constructive trust claim of the *V* was "inchoate" and therefore not valid against the IRS tax lien, as a matter of federal law.[218] Therefore, the IRS had a senior tax lien against both shares—the one owned by *W*'s bankruptcy trustee and the share owned by *W* personally. The IRS could sell the homes of the *V* who were living on the premises, because these *V* mistakenly believed their predecessor in interest had legal title to the property they bought. Happily, they had title insurance protecting them from the IRS lien.[219]

Where is the Sixth Circuit after these cases? If *V* has commenced an action to impress a constructive trust, and if the automatic stay is lifted and a state court impresses a constructive trust, the state court declaration is binding on the bankruptcy court.[220] The Sixth Circuit has not expressly permitted an *Erie*[221] guess *by* a bankruptcy court predicting that a state court would impose a constructive trust, but such a practice makes perfect sense. If it does, *Omegas* is dead.

One Ohio case implies *Omegas* is dead, and there is no need to drum up an exception via *Newpower* or *Poss*. In *Helbling v. Thomas (In re Thomas)*,[222] a homeowner was persuaded to make a son and daughter joint tenants with him of his home to solve probate problems. The scrivener botched the deed and made the son fee simple owner of the home. Later, the son was bankrupt. The trustee sought to sell the house for the benefit of the son's creditors. The court blocked the sale and imposed a constructive trust on the son's interest. Here there was no motion to lift the stay and no prior judicial declaration. *Omegas*

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217. In *In re Carrick Trucking, Inc.*, the district court distinguished the contrary *Poss* decision: *Poss* was under Ohio law, where constructive trusts relate back. Carrick v. Hagan (*In re* Carrick Trucking, Inc.), No. 15-cv 13115, 2016 U.S. Dist. LEXIS 53980, at *7 (Bankr. E.D. Mich. Apr. 22, 2016). But, according to *Blachy*, there is never a relation-back in Michigan. *Id.* at *6. "Appellants provide no authority for the claim that Michigan law does not require a court of law to impose a constructive trust before one is recognized." *Id*. at *7. In fact, *Soo Sand* is a contrary authority. 244 N.W. at 140.

218. *Blachy*, 221 F.3d at 905–06. For this *Omega* was cited, as if this bankruptcy holding clinched inchoateness outside of bankruptcy. *Id*. at 906.

219. *Id.* at 906.

220. *In re* Blume, 582 B.R. 178, 180 (Bankr. E.D. Mich. 2017).

221. Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938).

222. No. 12-14916, 2013 Bankr. LEXIS 5644 (Bankr. N.D. Ohio Nov. 12, 2013).

was treated as a dead letter.[223] In so ruling, the court ignored cases like *Belisle v. Plunkett*, which hold that a bankruptcy trustee is a hypothetical bona fide purchaser of real property pursuant to Bankruptcy Code § 544(a)(3) who takes free and clear of constructive trusts on real property.[224]

Yet another case suggests that *Omegas* is basically alive and that exceptions must be located. In *Mason v. Clark (In re Book)*,[225] *A* and *D* were cotenants. *A* paid *D* for her 50% share but never took a deed. Just before *D*'s bankruptcy *D* executed the deed. The trustee claimed that *D*'s deed was a voidable preference. *A* defended on the ground that *A* had an equitable interest in the premises before the 90-day preference period commenced. If true, this was a valid defense.[226] Judge Russ Kendig found that no motion to lift the stay was involved (per *Newpower*). Nor (the court surmised) was there an enforceable real estate contract (as in *Poss*).[227] Therefore *A* had no equitable interest before receiving the deed and so was guilty of voidable preference. It may be noted that, even if *A* had an equitable interest in the real property, it was an

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223. *Id.* at *5–8. In fact, the court went too far in blocking the sale. It appears that the homeowner intended his son to get *some* beneficial interest in the property. According to the court, "It was [the homeowner's] understanding that the document would allow his children to become joint owners . . . upon his death." *Id*. at *5. From this it appears that the son was intended to have a legal and equitable 50% of a vested remainder following the homeowner's life estate. There was no reason why the son's bankruptcy trustee should not sell this interest.

224. 877 F.2d 512, 514–15 (7th Cir. 1989).

225. No. 11-62686, 2013 Bankr. LEXIS 3303 (Bankr. N.D. Ohio Aug. 1, 2013) (Kendig, J.).

226. 11 U.S.C. § 547(b)(5) (2012) provides that a transfer is a voidable preference if it

> [E]nables such creditor to receives more than such creditor would receive if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

If, however, *A* has the right to force transfer of legal title to *A* in the bankruptcy, the prepetition conveyance does not enable A to receive more than what *A* would have received in the bankruptcy.

227. This last remark seems to contradict other parts of the *In re Book* opinion. Judge Kendig had ruled that the prepetition deed was not a fraudulent transfer in that *A* paid value. *In re Book*, 2013 Bankr. LEXIS 3303, at *8–9. If *A* paid value, then either the advance of $35,000 was pursuant to a real estate contract or the advance was a loan, and the prepetition deed was payment on antecedent debt. Judge Kendig certainly implied there was a real estate contract when he wrote: "[*A*] paid [*D*] $35,000 for [*D*'s] interest in the property." *Id.* at *2. Judge Kendig also recognized that the $35,000 was "for" the title to D's 50% cotenancy: "[*A*] paid $35,000 to [*D*]. At the time the property was transferred to [*A*], it was valued at $30,000. On these figures, the benefit in the transaction tilts in [*D*'s] favor: she received more than she gave, especially if the time value of money is factored." *Id*. at *8–9. Certainly Judge Kendig *could* have found that A qualified for the *Poss* exception. For present purposes, we note that Judge Kendig did *not* think *Omegas* was dead.

unperfected interest until *D* actually executed the deed before bankruptcy.[228] Therefore, the equitable interest was deemed to arise when it was perfected—when *D* signed and delivered the deed.[229] A constructive trust (more accurately, equitable conversion) theory would not have helped *A* in the slightest.

A third case assumes that *Omega* lives on, but under circumstances in which an undersecured creditor was denied the right to an equitable interest in a valueless equity. In *In re Warns*,[230] *D* owned an LLC which had granted a mortgage and a security interest to *SP*, a secured creditor. At a time when the loan was underwater, the LLC conveyed its interest in real and personal property to *D*.[231] *D* then filed for bankruptcy in chapter 13. *SP* moved to lift the automatic stay and, apparently wishing to avoid the controversy of whether the property was necessary to an effective reorganization,[232] sought the declaration of a constructive trust on its valueless equity. The court invoked *Omega* to prevent this gesture, acknowledging but holding irrelevant the various exceptions. In fact, there was no constructive trust here. *SP* was a nonrecourse mortgagee with a claim in the chapter 13 proceeding.[233]

It is fair to say that, in the Sixth Circuit, constructive trust claims are imperiled, where they have not been declared prior to bankruptcy.

E. *The First Circuit*

Danger lurks in the First Circuit due to Judge James Queenan, an outstanding theorist of bankruptcy law. Finding constructive trusts to be contrary to federal bankruptcy policy, Judge Queenan adds new ideas to those to be found in *Omegas*.

In *CRS Steam, Inc. v. Engineering Resources (In re CRS Steam, Inc.)*,[234] *D* had signed an Illinois employment contract which provided that anything *D* invented belonged to *E*, his employer. In addition, *E* was to own any new patent developed within 90 days after termination of employment.

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228. 11 U.S.C. § 547(e)(1)(B).

229. *Id.* § 547(e)(2)(B).

230. No. 12-16420, 2013 Bankr. LEXIS 2379, at *2–3 (Bankr. N.D. Ohio June 3, 2013).

231. *Id.* The real property conveyance did not seem in any way fraudulent. The personal property conveyance was accomplished after the LLC had filed dissolution papers, which gave rise to a duty by the LLC to use its assets for pay the creditors. *Id.* *A* alleged that this breach of duty justified declaration of a constructive trust. *Id.* at *3–4.

232. This would have been grounds to sustain continuance of the automatic stay. 11 U.S.C. § 362(d)(2).

233. *See* Johnson v. Home State Bank, 501 U.S. 78, 83–84 (1991).

234. 225 B.R. 833 (Bankr. D. Mass. 1998). This case is discussed in Ashley S. Hohimer, Comment, *Constructive Trusts in Bankruptcy: Is an Equitable Interest in Property More Than Just a "Claim"?*, 19 BANKR. DEV. J. 499, 518–27 (2003).

D's employment terminated. *D* invented some gizmos and also (said a jury) stole trade secrets. *D* formed a corporation (CRS) and assigned the patent to it. *E* sued for breach of contract and expropriation of trade secrets. A jury adjudged in favor of *E*. *D* therefore was probably thus rendered insolvent. As Judge Queenan describes the subsequent events:

> [*E*] thereafter requested injunctive relief to prevent future use or disclosure of its trade secrets. It asked the court to enjoin the defendants from further conduct in violation of either [Illinois trade secrets law] or the employment agreement. [*E*] also sought a mandatory injunction requiring them to assign to [*E*] all their right, title and interest in the patents.
>
> On April 29, 1997, [within 90 days of the bankruptcy petitions for *D* and CRS], the district court granted the requested injunctive relief, including a mandatory injunction ordering [*D* and CRS] to assign the patents. It did so after concluding that the jury found [*D*] had misappropriated the designs encompassed within the patents. . . . On May 22, 1997, [*D*] executed and delivered to [*E*] an assignment of the patents . . . .[235]

Apparently, the district court supplemented *E*'s unsecured claim for trade secret violations with an equitable remedy vaguely representing a proceeds theory: because the purloined trade secrets were the stuff of the later patent, *E* owned the patent that arose from the trade secrets.[236]

Judge Queenan thought it important that this particular equitable claim (and perhaps all equitable claims) were bankruptcy "claims" within the meaning of 11 U.S.C. § 101(5)(B).[237] But it is not clear what purchase this observation has. What really decides the case is the assumption that a constructive trust does not pre-exist a judicial decree imposing it.[238]

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235. *In re CRS Steam, Inc.*, 225 B.R. at 835–36.

236. *Cf.* Snepp v. United States, 444 U.S. 507, 508–16 (1980) (United States owned proceeds of a book written by a CIA agent on the basis of "trade secrets"); Flannery v. Flannery Bolt Co., 108 F.2d 531, 532–34 (3d Cir. 1939) (embezzled funds used to fund research which resulted in a patent; patent held to be proceeds of a constructive trust).

237. According to this provision, "claim" includes the "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured."

238. *In re CRS Steam, Inc.*, 225 B.R. at 845.

Subsequently, however, the Court of Appeals for the First Circuit, in *Davis v. Cox*, upheld what it called a constructive trust.[239] Superficially, this could be viewed as overruling *CRS*. But the property interest in *Davis* did not meet our definition of a rescindable transfer of legal title to *D* by *V*. Rather, the court had before it a classic case of *in custodia legis*. Therefore, one can view *Davis* as misusing the phrase "constructive trust," so that *CRS* is not really overruled.

In *Davis*, prior to his bankruptcy, *D* was subject to divorce proceedings instigated by W. Maine law required the divorce court to issue an injunction against alienating marital assets out of the ordinary course.[240] *D* violated the injunction by withdrawing funds from an IRA account.[241] *D* soon filed for bankruptcy before distribution of marital property could be accomplished.[242]

In bankruptcy, the automatic stay was lifted so that divorce proceedings could continue.[243] *D*'s trustee appeared in the divorce proceeding, urging that the divorce court determine whether *W'*s rights arose only at the time of the divorce decree (not yet issued) or whether *W*'s rights in property pre-existed the degree.

The divorce court did not exactly comply.[244] It did award the remaining funds in the IRA to *W* as a sanction against *D* for violating the divorce injunction.

In bankruptcy, the IRA was, under ordinary circumstances, *D*'s exempt property. *W* moved to lift the stay so that the divorce judgment could be enforced.[245] In other words, *W* wanted the divorce court's injunction to have free reign in the hope that it would induce *D* to write a check to *W* for her share of the IRA.

The bankruptcy court ruled that the bankruptcy estate took the IRA free and clear of any equitable interest of *W* and that the IRA could be exempted by *D*. In particular, Maine law gave *W* the right to an attachment lien on marital property before the divorce decree.[246] The availability of the attachment

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239. 356 F.3d 76, 84 (1st Cir. 2004); *see generally* Andrew Cosgrove, Note, *Breaking Up Is Hard to Do . . . Especially When Bankruptcy Is Involved: A Look at the Unfair Results That Occur When Bankruptcy Intervenes in Domestic Relations Cases*, 14 AM. BANKR. INST. L. REV. 235 (2006).

240. ME. REV. STAT. ANN. tit. 19-A, § 903(1)(B)(1) (1995).

241. *Davis*, 356 F.3d at 79.

242. *Id*. at 79–80.

243. *Id*. at 80.

244. *Id*. at 81, 97.

245. *Id*. at 81.

246. ME. REV. STAT. ANN. tit. 19-A § 903(5) (1995).

remedy implies that *W* had no ownership of the IRA prior to the decree in the absence of the attachment.[247]

On appeal *W* maintained that Maine law provided a "non-owner spouse an inchoate equitable interest in all marital assets separately owned by the other spouse."[248] Alternatively, she claimed a constructive trust in the IRA that pre-dated the divorce decree.

Judge Levin Campbell punted as to the complicated first issue on the theory that the Maine Supreme Court, not a federal court, should determine so momentous a question.[249] Instead, Judge Campbell proceeded "narrowly on the remedial theory of constructive trust."[250] Judge Campbell observed that an injunction had prohibited withdrawals from the IRA. *D* violated that injunction. Therefore, *W* had a constructive trust (or more precisely, an equitable lien) on the IRA to compensate for withdrawals to the detriment of *W*'s share.[251]

Judge Campbell reviewed Maine's statutory scheme and concluded that commencement of the divorce proceeding, giving rise to a restraining injunction, was intended to have property consequences. He specifically disagreed that the attachment remedy implies no equitable interest prior to attachment. Indeed, the IRA was exempt from attachment under Maine law, and so that remedy could not assist *W* where she sought *D*'s exempt property. The legal remedy of attachment was inadequate. Where legal remedies are inadequate, "they may be supplemented by appropriate equitable ones."[252]

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247. *Davis*, 356 F.3d at 82 (citation omitted) ("If a divorcing spouse's contingent rights to a distribution of marital property from assets held in the other's name can be protected by attachment, it follows they are unprotected without it (or its functional equivalent) . . . .").

248. *Id.* at 83.

249. *Id.* at 84 ("We need not decide, and indeed think it inappropriate for a federal court to decide without first seeking more specific guidance from Maine's Supreme Judicial Court, whether Maine law, broadly applied, gives to non-owner spouses in ordinary circumstances after commencement of a divorce case, but before entry of judgment, an inchoate equitable interest in marital assets owned by the owner spouse.").

250. *Id*. On the narrowness of its holding, the court states:

> All we need hold here is that where one spouse held title to marital property that, as a practical matter, was exempt from attachment, and where the specific facts and equities were such as have been described, the non-owner spouse may claim to have held an undeclared beneficial interest in the property awarded by the divorce court, her interest having been held for her prior to bankruptcy upon a constructive trust by the owner-spouse until such time as the divorce decree became final and the marital assets were divided.

Id. at 91.

251. *Id.* at 90 ("[T]he $65,250 award was to redress the loss to [*W*] caused by that misconduct" of withdrawing the IRA in violation of the injunction.).

252. *Id.* at 89.

"Enactment of these particular remedies also betrayed a more general legislative intent, once divorce proceedings had begun, to shelter and sequester marital assets for the benefit of both spouses until the court could effect their just division."[253] The scheme "strongly suggest[s] . . . legislative approval of supplemental measures that a court might find reasonable and necessary to achieve the goal of safeguarding the marital estate until it can be properly divided."[254]

It should be apparent that Judge Campbell is describing the concept of *in custodia legis*, not constructive trust. A constructive trust is a remedy in aid of rescission.[255] Yet *W* never made a rescindable conveyance to *D*. Nor is it clear that *D* had legal title in trust for *W*. Rather, the divorce court had taken the IRA *in custodia legis* as security for H's good behavior, pending a later equitable division of the property. The issuance of the restraining injunction is the moment of the court's expropriation of *D*'s property.

If so, then the status of IRA exactly matches the status of certain funds that the prepetition divorce court ordered be held in escrow accounts of the attorneys for the parties. "Those funds were not to be moved, used, or transferred absent a court order."[256]

> As to the funds held in escrow, the bankruptcy court held that the state court's pre-petition order placing the funds in escrow operated effectively as an attachment of those funds. . . . As a result, [*W*]'s right to benefit from the distribution of the escrow funds in accordance with the divorce judgment was superior to the rights of the bankruptcy estate in the funds.[257]

The court held that the escrow funds were *in custodia legis*.[258] The meaning of this is that "the funds held *in custodia legis* did not pass into the bankruptcy estate."[259] This goes too far. Surely *D* has some interest in the escrowed funds. The interest matches the "debtor equity" that exists after a judicial lien attaches to *D*'s property. In any case, the point is that if the escrow funds were *in*

253. *Id.* at 86.

254. *Id*. at 90. The court also found that *W* was the beneficiary of a resulting trust. *See* RESTATEMENT (SECOND) OF TRUSTS § 200 cmt. c (AM. LAW INST. 1959).

255. Cosgrove, *supra* note 239, at 267 ("there [was] not fraud in the ordinary sense of the word").

256. *Davis*, 356 F.3d at 79.

257. *Id*. at 82 (citations omitted). On appeal, *D* argued that some of the escrowed funds were exempt, and if the escrow was an attachment, the funds were exempt and that *D* should have them. *Id.* at 94. The court of appeals noted that, according to the bankruptcy court, the property was "effectively attached," not "*actually* attached." *Id.* Therefore, the funds were not beyond the competence of the divorce court to order disposition of the funds. *Id.*

258. *Id.* at 93.

259. *Id.*

custodia legis, so were the IRA funds. There is no distinction between these two funds.

Since *CRS* and *Davis*, the First Circuit picture is confused. In *Piccerelli v. Piccerelli (In re Piccerelli)*,[260] the court was presented with a straight case of the doctrine of equitable conversion. The court seemed not to know that such a doctrine existed and proclaimed that it could not be a constructive trust, since a constructive trust requires that legal title be transferred to a transferee. Since the debtor's legal title pre-existed the real estate contract, it could not be a constructive trust and so the plaintiffs were simple breach-of-contract creditors. Nevertheless, if it *were* a constructive trust, the court was prepared to deny recognition of it. The plaintiffs could be made whole by money damages and, so on the authority of *CRS*, the constructive trust claim, if it existed, should be denied.

In *Cellceutix Corp. v. Nickless (In re Formatech, Inc.)*,[261] the court also shows a shaky grasp of equity jurisprudence. In *Formatech*, *V* made an asset payment to a vendor that was not licensed to provide the service. *V* filed an adversary proceeding seeking to "rescind." No one mentioned the word "constructive trust," but the court did note that the bankruptcy estate had within in it a mere voidable title—a conclusion consistent with constructive trust. The court refused to give summary judgment for the trustee, and so the case leaves open the possibility that a constructive trust might be imposed by a Bankruptcy Code.[262]

More directly, in *Carlson Orchards, Inc. v. Linsey (In re Linsey),*[263] *D* embezzled funds and used them to enhance real property and to buy a car for her nondebtor spouse. The court recognized constructive trusts on the real property and car, noting that, in light of a claimed real property exemption, *V* was not in competition for these assets with *D*'s general creditors.

In *Davis v. Cox*,[264] the First Circuit upheld what it called a constructive trust. But in fact it really dealt with the concept of *in custodia legis*.[265] Therefore, it is less than clear that *Davis* compels the conclusion that *CRS* is overruled. The fate of the constructive trust in the First Circuit is cloudy.

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260. 525 B.R. 184, 190–93 (Bankr. D. Mass. 2015).

261. 496 B.R. 26 (Bankr. D. Mass. 2013).

262. *See id.* at 35–40; *see also* Lassman v. McQuillan (*In re* Charles River Press Lithography, Inc.), 338 B.R. 148, 156, 162 (Bankr. D. Mass. 2006) (upholding a trust in an insurance policy because it was either a resulting or constructive trust).

263. 296 B.R. 582, 585–86, 590 (Bankr. D. Mass. 2003).

264. 356 F.3d 76. *See generally* Cosgrove, *supra* note 239.

265. *See supra* text accompanying notes 101–05.

Finally, just before press time, the First Circuit Court of Appeals, in *Darr v. Dos Santos* (*In re TelexFree, LLC*),[266] has ruled that all constructive claims are "derivative"[267] (i.e. duplicative) of constructive trust claims. Therefore, *V* was barred from pursuing a constructive trust claim against *X*, and the bankruptcy trustee was able to displace *V* with fraudulent transfer claims against *X*. I will criticize this conclusion in due course.[268] For the nonce, I note that *TelexFree* cites the notorious *Omegas* opinion with favor,[269] suggesting that *TelexFree* must be read as announcing the death of constructive trusts in bankruptcy cases.

F. *The Ninth Circuit*

The Ninth Circuit has held that, as a matter of California law, a constructive trust does not antedate a court order imposing it. In effect, this opinion, if followed, eliminates constructive trusts in any California case.[270]

In *CHoPP Computer Corp. v. United States*,[271] *D* made a short sale of stock in *V Corp*. and then made disparaging remarks about *V Corp*., hoping to drive down the price of the shares. *D* then presumably bought covering shares on the cheap, thereby completing its short sale. This tactic resulted in a profit for *D*.

V Corp. brought some sort of tort action in state court and obtained a preliminary injunction prohibiting *D* from transferring out the short sale profits from *D*'s brokerage account. While the injunction was pending, the Internal Revenue Service obtained a money judgment and levied the brokerage account. After the levy, the state court imposed a constructive trust on all short-sale profits.

It should be easy to see that a constructive trust in the case was inappropriate. A constructive trust requires *V Corp.* to make a conveyance of some property to *D*. No such thing happened here. Actually, a better claim for *V Corp.* was that, by issuing a preliminary injunction, the court brought the brokerage account *in custodia legis* before any creditor could obtain a lien.

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266. 941 F.3d 576 (1st Cir. 2019).

267. *Id*. at 588.

268. *See infra* text accompanying notes 423–28.

269. *In re TelexFree*, 941 F.3d at 586 n.8 ("Allowing one group of victims to bring its claims first 'thwarts the policy of ratable distribution" at the heart of bankruptcy law.") (*citing* XL/Datacomp, Inc. v. Wilson (*In re* Omegas Grp, Inc.), 16 F.3d 1443, 1451 (6th Cir. 1994).

270. *See* Wadsworth v. Talmage, 911 F.3d 994, 995 (9th Cir. 2018) (certifying a similar question to the Oregon Supreme Court).

271. 5 F.3d 1344, 1345–48 (9th Cir. 1993).

Such a theory would have allowed *V Corp.* to prevail without any reliance on constructive trust theory.

V Corp. then sued the IRS and the broker maintaining the account, claiming that the IRS had converted *V Corp.* property by means of the levy.

The court, however, ruled that *V Corp.* had no constructive trust until the court declared the constructive trust to exist.[272] Its reasoning seemed to emphasize, however, that the trial court was wrong to declare a constructive trust in a case that only sought money damages. But because the case did not really have a constructive trust before it, it is perhaps best ignored.

Earlier, the Ninth Circuit gave lukewarm endorsement of constructive trusts in bankruptcy cases, but found that imposition of the trust was inappropriate on the facts of the case.

In *Torres v. Eastlick (In re North American Coin & Currency, Ltd.)*,[273] *V* paid in advance for precious metals that *D*, a broker, promised to procure. Before the procurement, *D* filed for bankruptcy. *V* sought to receive its money back, but the court declined to find a constructive trust.

> While we agree that any constructive trust that is given effect must be a creature of Arizona law, we cannot accept the proposition that the bankruptcy estate is automatically deprived of any funds that state law might find subject to a constructive trust . . . 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 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.[274]

The case falls short of ruling that constructive trusts are not valid in bankruptcy. Indeed, it recognizes that "[t]he principle underlying this rule is that the creditors should not benefit from fraud at the expense of those who have been defrauded."[275]

272. *Id*. at 1348–49. The court cites GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 472 (rev. 2d ed. 1978).

273. 767 F.2d 1573 (9th Cir. 1985).

274. *Id*. at 1575 (citations omitted).

275. *Id*. at 1576.

G. *Summary*

We have seen that the doctrine of constructive trust is in great disarray. Many cases are called "constructive trust" cases but are really something else. In three circuits, constructive trusts have been proclaimed not to exist prior to their declaration by a court before bankruptcy. Where such a doctrinal error is insisted upon, a constructive trust cannot survive in bankruptcy. In most circuits, however, constructive trust theory dates back to the wrong it addresses. Where the trust property is real estate, the constructive trust may fall to the trustee's strong-arm power under § 544(a)(3) (though, bizarrely, there is a surviving constructive trust on the fixtures). Constructive trusts in personal property are on solid ground, however, in most circuits.

IV. WHAT IS A FRAUDULENT TRANSFER?

Very roughly speaking, fraudulent transfers are gifts by *D* for no valuable consideration at a time when *D* is insolvent.[276] In the alternative, they are "midnight liquidations" with the idea of hiding the cash from creditors (bulk sales).[277] In such cases, there is a buyer for some kind of consideration. If the buyer knows of *D*'s intent to hinder the creditors, the buyer has received a fraudulent transfer. If the buyer is a good faith transferee for a reasonably equivalent value, the buyer takes both legal and equitable title free and clear of *D*'s creditors.[278]

Taken in isolation, courts (indeed the uniform fraudulent transfer statutes) are deeply confused about the nature of a fraudulent transfer. Courts puzzle over whether a fraudulent transfer is *void* or merely *voidable*. If *void*, *X* has no

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276. 11 U.S.C. § 548(a)(1)(B)(i), (ii) (2012) (listing insolvency and proxies for insolvency); UNIF. VOIDABLE TRANSACTION ACT § 4(a)(2) (UNIF. LAW COMM'N 2014) (proxies for insolvency); *Id.* § 5 (insolvency).

277. 11 U.S.C. § 548(a)(1)(A) ("actual intent to hinder, delay, or defraud any entity . . ."); UNIF. VOIDABLE TRANSACTION ACT § 4(a)(1).

278. 11 U.S.C. § 548(c); UNIF. VOIDABLE TRANSACTION ACT § 8(a). These conform with two of the three "paradigm examples" in Boston Trading Grps., Inc. v. Burnazos, 835 F.2d 1504, 1508 (1st Cir. 1987). One paradigm I think does not describe a fraudulent transfer:

> First (and most important), suppose that a debtor conveys property to a friend whom he expects will use the property in a way that benefits the debtor (suppose, for example, the friend lets the debtor retain possession of the property or secretly agrees to return the property after the debtor's creditors have given up). In such a case, the debtor in effect lies to his creditors, pretending he has no property left, when he really has some (in the hands of his friend).

Id. A fraudulent transfer requires a complete alienation of legal and equitable title to *X*. Where *X* retains rights in the thing transferred, we do not have a fraudulent transfer. The creditors do not need an avoidance theory if *D* retains present or future rights in the property.

property interest in the thing conveyed. The thing remains *D*'s property.[279] If *voidable*, *D* has no interest in the thing conveyed to *X*. The transfer must be "set aside,"[280] at which point it becomes *D*'s property again, and *C* may "levy execution"[281] on the thing.[282]

Whether a fraudulent transfer is *void* or *voidable* is a deep, unanswerable question, just as is the question whether light is a wave or a particle. In physics light is a wave for some theoretical inquiries. It is a particle for others. Neither position is able to exclude the other. So it is with fraudulent transfers, Courts cannot legitimately declare for all purpose that they are void or voidable. Either theory does violence to some aspect of the doctrine.[283] The controversy will influence our consideration of colliding worlds.

Fraudulent transfers are very different from constructive trusts yet they share many features. First, the differences. From the perspective of a bankrupt *D*, as regards a constructive trust, a conveyance *to D* in trust makes *D* the holder of legal title (but not equitable title). A fraudulent transfer *by* the *D* makes someone else (we'll designate him as *X*) the title holder. Thus, from *D*'s perspective, legal title *arrives* under constructive trust doctrine. Legal title *departs* under fraudulent transfer law.

Yet the two doctrines overlap. Suppose *D* holds title in constructive trust. *D* then conveys title to a bad faith purchaser for value or to a purchaser for no consideration (*X*), *X* holds title in trust for *V*, the victim.[284] Similarly, suppose *D* (owning both legal and equitable title) fraudulently transfers a thing to *X*. In a fraudulent transfer situation, *X* holds title in trust for the benefit *D*'s creditors (*C*).[285] When *D* conveyed trust property, *V* owns the cause of action. In the case of fraudulent transfer, *C* owns the cause of action. If *D* is bankrupt, the

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279. Am. Nat'l Bank v. MortgageAmerica Corp. (*In re* MortgageAmerica Corp.), 714 F.2d 1266, 1272–73 (5th Cir. 1983).

280. UNIF. FRAUDULENT CONVEYANCE ACT § 9(1)(a) (UNIF. LAW COMM'N 1918).

281. *Id.* § 9(1)(b); UNIF. VOIDABLE TRANSACTIONS ACT § 7(b).

282. David Gray Carlson, *The Logical Structure of Fraudulent Transfers and Equitable Subordination*, 45 WM. & MARY L. REV. 157, 169–70 (2003).

283. I document this in a forthcoming manuscript. David Gray Carlson, *Civil Procedure and Fraudulent Transfers* (2020) [hereinafter Carlson, *Civil Procedure*] (on file with the author).

284. Harris Tr. & Sav. Bank v. Salomon Smith Barney Inc., 530 U.S. 238, 250 (2000) ("[I]t has long been settled that when a trustee in breach of his fiduciary duty to the beneficiaries transfers trust property to a third person, the third person takes the property subject to the trust, unless he has purchased the property for value and without notice of the fiduciary's breach of duty.").

285. Nat'l Tradesmen's Bank v. Wetmore, 26 N.E. 548, 551 (N.Y. 1891) ("The fraudulent transferee holds the legal title as a trustee *ex maleficio* for the benefit of the defrauded creditors . . . .") (Follett, C.J., dissenting).

trustee, as fiduciary for *D*'s unsecured creditors, owns the fraudulent transfer cause of action (and the individual *C* does not).[286]

The duties imposed on *X* differ, depending on whether the theory is constructive trust or fraudulent transfer. In a constructive trust context, *X*'s duty is to surrender title to *V*. Upon doing so, legal and equitable title are reunited in *V*. In a fraudulent transfer context, *C* has no right of possession. Rather, *C* has a right of sale. *C*'s right therefore resembles an equitable lien, except that often *C* works through a sheriff or receiver as auctioneer of the fraudulently transferred property. *C* must get a *judicial* lien, which is usually not thought of as *equitable* lien (though in conjunction with a fraudulent transfer theory it more or less is).[287]

As every bankruptcy practitioner knows, a bankruptcy trustee can avoid *D*'s fraudulent transfers by one of two means. First, the trustee has direct standing (on behalf of all the unsecured creditors) to recover from *X* pursuant to Bankruptcy Code § 548(a).[288] This right is subject to a two-year look-back period.[289] *X* is accorded a bona fide transferee defense under § 548(c).[290]

Second, under § 544(b)(1), the trustee inherits the right of any existing unsecured creditor to avoid a transfer by *D*.[291] The chief utility of this alternative is that state fraudulent transfer rights are typically subject to a longer statute of limitations than the two years accorded under § 548(a).[292]

If, however, *D* did not have both legal and equitable title to convey to *X*, then the trustee has no cause of action for fraudulent transfer against *X* at all. If *D* only conveys legal title to *X*, *V*'s constructive trust rights are unaffected. *V*, not *D*'s bankruptcy trustee, owns the cause of action.

286. *See* David Gray Carlson, *The Supreme Court, Dischargeability, and Actual Fraud*, 27 AM. BANKR. INST. L. REV. 535 (forthcoming 2019).

287. Judicial liens can be valid against bona fide purchasers. N.Y. C.P.L.R. § 5202(a)(2) (Consol 2019) (pertaining to tangible personal property). Equitable liens are no good against subsequent bona fide purchasers for value, consistent with the UVTA. UNIF. VOIDABLE TRANSACTION ACT § 8(a) (UNIF. LAW COMM'N 2014). Whether *C*'s lien is legal or equitable is controversial. The difference turns on bona fide purchaser protection. Carlson, *Civil Procedure*, *supra* note 283.

288. 11 U.S.C. § 548(a) (2012).

289. *Id.*

290. *Id.* § 548(c).

291. *Id.* § 544(b)(1).

292. *Id.* § 548(a).

V. When Worlds Collide

The world of constructive trust collides with the world of fraudulent transfer when, just prior to bankruptcy, insolvent *D* makes a conveyance of legal title to *X* for no consideration.

If *D* owns equitable as well as legal title to personal property and *D* conveys both to *X*,[293] *X* is the initial transferee of a fraudulent transfer. Accordingly, *X* must return the thing transferred to *D*'s bankruptcy trustee or, if the court so orders, *X* is liable in personam for the value of the thing transferred.[294]

If, however, *D* holds *only* legal title to personal property in trust for *V*, *X* only receives *D*'s legal title. *V* continues to hold the equitable interest. *X* is liable to *V* for the return of the thing. If *X* has wrongfully interfered with *V*'s right of possession, *X* is liable in personam to *V*. *X* has no liability to *D*'s bankruptcy trustee.

In the case of constructive trust, may *D*'s bankruptcy trustee recover the legal title from *X* as a fraudulent transfer? In such a case, the trustee takes back only legal title. *V* continues to have the equitable title, if the property in question is personal property. But if *D* has conveyed only a valueless legal title to *X*, the "gift" is for a reasonably equivalent value after all. That is to say, legal title is worth nothing to *D* and that is what *X* (a bad faith purchaser) has paid to *D*. (Any surplus transferred by *X* to *D* is held in trust by *D* for *V*.) The predicate for fraudulent transfer is not met, and so there cannot be a fraudulent transfer after all.[295]

Even if the transfer of a valueless legal title to *X* was a transfer for no reasonably equivalent value, the trustee still faces the difficulty that she is supposed to be a representative of *D*'s unsecured creditors. The trustee is not supposed to be acting for *V*, who is not even a creditor.[296] Rather, *V* claims the

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293. *D* sometimes conveys legal title to *X* for the benefit of *Y*. Citibank, N.A. v. Bombshell Taxi LLC (*In re* Hypnotic Taxi LLC), 543 B.R. 365, 367–76 (Bankr. E.D.N.Y. 2016). In such a case, *X* and *Y* together are the initial transferees of a fraudulent transfer.

294. 11 U.S.C. § 550(a)(1).

295. Belford v. Cantavero (*In re* Bassett), 221 B.R. 49, 54 (Bankr. D. Conn. 1998) ("[B]ecause a resulting trustee has an absolute duty to reconvey legal title to the beneficial owner upon demand . . . , bare legal title is not an interest of any value to the Debtor, or to his bankruptcy estate upon a putative avoidance and recovery of such bare legal title.") (citation omitted); David Gray Carlson, *Voidable Preferences and Proceeds: A Reconceptualization*, 71 AM. BANKR. L.J. 517, 542–43 (1997) [hereinafter Carlson, *Reconceptualization*]. *Bassett* had a second facet to it. There, *D* was not only a resulting trustee of legal title but had an equitable lien on equitable title. 221 B.R. at 55. If conveyance of legal title was not a fraudulent transfer, conveyance of the equitable lien was a transfer for no reasonably equivalent value. This *was* a fraudulent transfer.

296. *See supra* text accompanying notes 70–71.

equitable title in the thing transferred. Accordingly, courts deny standing to enforce *V*'s rights in the thing transferred to *X*.[297]

The governing authority on the trustee's standing to pursue claims on behalf of a subset of a debtor's creditors is *Caplin v. Marine Midland Grace Trust Co. of New York*, where a bankruptcy trustee sought to represent debenture holders in suing an indenture trustee for negligence in monitoring the debtor-issuer.[298] The courts at all levels (over dissents) denied the bankruptcy trustee standing. One of the points made for the majority by Justice Thurgood Marshall was that the bankruptcy trustee succeeds to the causes of action of the debtor. The negligence action did not belong to the debtor but to a subset of creditors. Another point was that the creditors themselves should have the right to control the litigation, where the creditors were endowed with this right by the Trust Indenture Act. In particular, a bankruptcy trustee's settlement with the indenture trustee might not be binding on the individual creditors.

Therefore, the possibility arises that *X* can defend against the fraudulent transfer theory by alleging that *V* (not the bankruptcy trustee) owns the equitable title and that therefore *X* has not received a fraudulent transfer.

This puzzle is legislatively solved by the Securities Investors Protection Act (SIPA)[299] in stockbroker bankruptcies, where the broker is a Ponzi artist. In such a case, what *V* entrusted to the broker is "customer property."[300] Customer property must be distributed to customers only.[301] According to SIPA section 78fff-2(c)(3):

> Whenever customer property is not sufficient to pay in full the claims set forth in subparagraphs (A) through (D) of paragraph (1),[302] the trustee may recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under [the Bankruptcy Code]. Such recovered property shall be treated as customer property. *For purposes*

297. Stevenson v. J.C. Bradford & Co. (*In re* Cannon), 277 F.3d 838, 855 (6th Cir. 2002). Analogous are cases in which a bankruptcy trustee is not permitted to bring in personam claims against third parties where the third parties have negligently or intentionally led to fraudulent investments. Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1093 (2d Cir. 1995).

298. 406 U.S. 416, 417 (1972).

299. 15 U.S.C. § 78aaa-lll (2012).

300. "The term 'customer property' means cash and securities . . . held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted." 15 U.S.C. § 78lll(4) (2012).

301. *Id.* § 78fff-2(c)(1).

302. These include customer claims and subrogees (such as the Securities Investor Protection Corp.) of customer claims.

> *of such recovery, the property so transferred shall be deemed to have been the property of the debtor* and, if such transfer was made to a customer or for his benefit, such customer shall be deemed to have been a creditor, the laws of any State to the contrary notwithstanding.[303]

Thus, anticipating the issue just posed, SIPA *deems* the broker to own the equitable interest in customer property, and it authorizes the trustee to recover transfers as if fraudulent transfer really applies, reserving the proceeds for the investors. This confesses congressional doubt that, but for the above-quoted intervention, fraudulent transfer law does apply when *D* conveys trust property to *X*.[304]

Outside of the context of stockbroker bankruptcies, the Sixth Circuit, in *Stevenson v. J.C. Bradford & Co. (In re Cannon)*, has ruled that trust property cannot be fraudulently transferred by a debtor—that only *V* can recover from *X*.[305] To be noted is that *Cannon* arose in Tennessee and so Sixth Circuit precedents as to constructive trust apply. The case, however, involved a *real* (not a constructive) trust, but the holding is instructive for constructive trusts in other circuits.

In *Cannon*, *D* was a lawyer who took funds in trust for real estate transactions. As such, *D* was *expressly* a trustee for his clients.[306] *D* embezzled funds from his clients to play the commodities market. *D* incurred losses. To make up these losses, *D* "borrowed" money from a bank[307] and deposited them in his trust account.

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303. 15 U.S.C. § 78ff-2(c)(3) (emphasis added).

304. Picard v. Fairfield Greenwich Ltd., 762 F.3d 199, 212–13 (2d Cir. 2014); Carlson, *Reconceptualization*, *supra* note 295, at 545–46; Kull, *Madoff*, *supra* note 2, at 958–65. Professor Kull documents some bad side effects. Because the broker's trustee proceeds under fraudulent transfer law, § 546(e) safe-harbors payees from state-law fraudulent transfer theories, thereby shortening the statute of limitations to two years (a big deal in the Madoff legislation). In addition, payees are entitled to a jury trial under *Granfinanciera v. Nordberg*, 492 U.S. 33 (1989). For an inference that a specific congressional empowerment implies a general disempowerment, see *Texas & Pac. Ry. Co. v. Pottorff*, 291 U.S. 245 (1934). In *Pottorff*, a bank receiver disaffirmed a pledge of a bank deposit on the ground that the pledge was not authorized by the Federal Banking Act. *Id.* at 251–52. The would-be pledgee pointed out that pledges were permitted to secure a deposit of public money by a state, but this simply proved to Justice Brandeis that the Banking Act did not empower pledges for ordinary deposits. *Id.* at 258–59.

305. 277 F.3d 838, 851 (6th Cir. 2002).

306. *Id.* at 850; *see* Tenn. Sup. Ct. R. 9 § 35.1(a)(1) (2013) (requiring attorneys to deposit client funds in trust account).

307. More accurately, *D* began kiting checks, *In re Cannon*, 277 F.3d at 844, which amounts to borrowing from a bank. Check kites are themselves frauds. But are they constructive trusts? The answer is no. Here is a super-simple check kite to illustrate why not. Suppose *D* opens an account

Ordinarily, under the lowest intermediate balance test for trust funds commingled with personal funds, the deposit of personal funds does not replenish the trust.[308] A different rule applies when personal funds are deposited in a trust account with the intent to reimburse the *V*. In *Cannon*, *D* (so the courts found)[309] intended to reimburse his *V*, and so the entire deposit account was held in trust for the *V*.[310]

Just before *D*'s eventual bankruptcy, *D* owed his commodities broker (*X*) a debt for commodity futures and commissions. *D*'s eventual bankruptcy trustee would claim that these payments were intentional fraudulent transfers. Preliminarily, however, the claim does not function. The transfers were on antecedent debt, which is a reasonably equivalent value for the purpose of fraudulent transfer law. *X* was not in good faith in the sense that *X* knew or was on notice that *D* was embezzling funds. But it cannot be the case that *D* was

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with *V Bank* by depositing a check written on *D Bank*. *V Bank* gives *D* a provisional credit. U.C.C. § 4-104(a)(11) (AM. LAW INST. & UNIF. LAW COMM'N 2012) ("'Settle' means to pay in cash, by clearing-house settlement, in a charge or credit or by remittance, or otherwise as agreed. A settlement may be either provisional or final."). A provisional credit is not withdrawable as of right. Pioneer Liquidating Corp. v. San Diego Tr. & Sav. Bank (*In re* Consol. Pioneer Mortg. Entities), 211 B.R. 704, 708 n.1 (S.D. Cal. 1997), *aff'd in part, rev'd in part on other grounds*, 166 F.3d 342 (9th Cir. 1999). So far *D* has nothing. *D* then draws a check on *V Bank*, made out to cash. *D* deposits the check with *D Bank*. *D Bank* memorializes the occasion with a provisional credit, not withdrawable as of right by *D*. *D Bank*, however, permits *D* to withdraw an amount equivalent to the provisional credit. In effect, *D* Bank has lent funds to *D*. By law, *D* Bank has a lien on the deposited *V* Bank check. U.C.C. § 4-210(a). So *D Bank* is *D*'s secured creditor. *D Bank* advances funds to *D* because *D Bank* expects to collect the *V Bank* check from *V* Bank. When it collects, *D Bank* receives cash proceeds of its security interest. Having obtained these proceeds, *D Bank* can (indeed must) reduce the secured claim against *D* by the amount of proceeds received. Suppose further that *V Bank*, holding *D*'s check drawn on *D Bank*, now presents that check to *D Bank*. *D Bank* rightfully dishonors, as *D* has no funds on deposit with *D Bank*. Thus, *D* is enriched by fraud. *V Bank* is impoverished. Notice that *V Bank* can trace no funds into the possession of *D*. *D* received a loan from *D Bank* and therefore received *D Bank* funds. The entity that received *V Bank* funds was *D Bank*. If there is a constructive trust in this case, it applies to the funds *D Bank* now holds. On whether *V Bank* can make this claim, see David Gray Carlson, *Check Clearing and Voidable Preference Law Under the Bankruptcy Code*, 73 BUS. LAW. 627, 704–08 (2018). Therefore, *D* has received nontrust funds when he kited checks.

308. Connecticut Gen. Life Ins. Co. v. Universal Ins. Co., 838 F.2d 612, 619–20 (1st Cir. 1988). It is odd that the LIB test presumes *F* in good faith withdraws his own funds from a commingled deposit account until it is impossible to deny that *F* has embezzled. Yet when *F* deposits funds in the account, *F* is *not* attributed with the good faith intent to reimburse the embezzlement. In any case, if *F really did intend* to reimburse, the trust is replenished.

309. *In re Cannon*, 277 F.3d at 850; *see also* Mitchell v. Dunn, 294 P. 386, 388 (Cal. 1930).

310. *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59(2)(b) (AM. LAW INST. 2011) ("Subsequent contributions by the [conscious wrongdoer] do not restore property previously misappropriated from the claimant, unless the recipient affirmatively intends such application.").

defrauding creditors. In fact, *D*'s unsecured creditors were positively delighted that *X*, a creditor, might be paid with other people's money. With *X* paid off with other people's money, the more property *D* had to divide amongst his unsecured creditors. *D*'s creditors were not aggrieved. Rather, it was the *V* who were aggrieved by the embezzlements.

X defended by claiming that it never received *D*'s funds. It received *embezzled* funds actually owned (equitably) by the *V*, victims of *D*'s larcenous behavior.

Judge Alice Batchelder (author of the *Omegas* opinion) agreed and held that *X* was off the hook. Receipt of embezzled funds was a defense to bankruptcy avoidance.

More precisely, Judge Batchelder ruled that *D* had *stolen* the funds and had no title to them.[311] This goes too far. As an express trustee, *D already* had legal title to the funds.[312] Theft implies *no* title. Nevertheless, the court was quite correct that a fraudulent transfer requires *D* to convey both legal and equitable title to *X*. *D* conveyed only legal title, and so this was no fraudulent conveyance. Rather, the *V* were the ones who could sue *X* for conversion of the trust property. *D*'s bankruptcy trustee had no theory to recover from *X*.

On a theory different from fraudulent transfer, *D*'s bankruptcy trustee also argued that *D* could have recovered the trust funds that he himself transferred. Such a cause of action, the trustee alleged, was part of the bankruptcy estate under § 541(a)(1). A debtor has no ability to recover fraudulent transfers on behalf of the creditors.[313] A fraudulent transfer theory belongs either to the individual creditors or to a creditor representative. But where *D* is a fiduciary and transfers property to a bad faith *X*, *D* can recover *D*'s own defalcations from *X*. Indeed it is *D*'s duty to do so. The recovery is required as part of administering the trust. But, Judge Batchelder reasoned, *bankruptcy* trustees should not be administering trust property for noncreditor beneficiaries. Rather, outside of the bankruptcy proceeding, the beneficiaries are entitled to a replacement trustee, if *D* cannot be relied upon to do his duty with regard to the trust.[314]

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311. *In re Cannon*, 277 F.3d at 851.

312. *See* Notinger v. Migliaccio (*In re* Fin. Res. Mortg., Inc), 468 B.R. 487, 501 (Bankr. D.N.H. 2012) (criticizing *Cannon* on this score).

313. GLENN, *supra* note 9, §§ 101a, 114.

314. RESTATEMENT (SECOND) OF TRUSTS § 37 (AM. LAW INST. 1959).

Accordingly, the *Cannon* court held that bankruptcy trustees lacked standing to assert property rights that belonged to the beneficiaries of the trust.[315]

Cannon holds that trust property cannot be fraudulently transferred. A case that more or less says the same thing is *Boston Trading Group, Inc. v. Burnazos*,[316] a case often cited for its observations on the morality of fraudulent transfers. *Boston Trading* encounters the dilemma of colliding worlds. It does so in the context of an equity receivership, where *R* was appointed at the behest of the Commodity Futures Trading Commission to administer the assets of a failed commodities broker.[317]

To give a schematic treatment of *Boston Trading*, *D Corp*.[318] was a broker holding fiduciary funds for its customers (whom we shall call the *V*).[319] *X* was the owner of *D Corp*. *X* bought *D Corp*. from *Y*[320] for a down payment and a nonrecourse note.[321] *X* caused *D Corp*. to embezzle *V* funds and use them to (i) make the $400,000 down payment to *Y*, (ii) pay an installment of $73,000 on the note, and (iii) to fund a $400,000 settlement of a law suit by *Y* against *X*.[322]

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315. *In re Cannon*, 277 F.3d at 855–56. For a case holding that *Cannon* does not apply in this regard if *D* is a bankrupt ERISA fiduciary, see McLemore v. Regions Bank, 682 F.3d 414, 420 (6th Cir. 2012). A related idea is that the bankruptcy trustee inherits the *in pari delicto* defense that a third party wrongdoer has against the debtor wrongdoer. These cases arise in the context of a corporate bankruptcy. *D Corp.* is the bankrupt, and *D*'s officer has wrongly caused a loss to the corporation, aided and abetted by a third party. In such cases, it is said that the officer's wrong is attributed by agent-principal ideas to *D Corp.* When *D Corp.* sues the third party for aiding and abetting, the third party has the defense of *in pari delicto*. *See* Jeffrey Davis, *Ending the Nonsense: The* In Pari Delicto *Doctrine Has Nothing to Do with what Is § 541 Property of the Bankruptcy Estate*, 21 EMORY BANKR. DEV. J. 519, 520–22 (2005) (criticizing the doctrine as applied in bankruptcy cases). *In pari delicto* involves a tort claim against third parties. In *Cannon*, *D* may have been a wrongdoer and the broker may have been a wrongdoer, but *D*, in his capacity of trustee for the beneficiaries of the trust, is a separate person from D the wrongdoer.

316. 835 F.2d 1504 (1st Cir. 1987).

317. *Id*. at 1506.

318. *D Corp.* is Boston Trading Group. *Id.*

319. *X* is a composite of Richard Shaw and Theodore Kepreos. *Id*.

320. *Y* was Robert Burnazos, former owner of *D Corp.* The debt arose from *X*'s acquisition of *D Corp. Id*.

321. The debt seemed to be a nonrecourse note signed by *X* and secured by *D Corp.* assets. *Id*. (stating that "Burnazos's only recourse for payment of the note was against the assets of BTG" and another firm not pertinent here.). In short, the parties were engaging in a leveraged buyout. Nonrecourse creditors are not considered creditors for the purpose of the UFCA. Travelers Ins. Co. v. 633 Third Assocs., 973 F.2d 82, 84–86 (2d Cir. 1992).

322. *Boston Trading*, 835 F.2d at 1506.

Y was innocent of knowledge as to (i)[323] but had guilty knowledge with respect to (ii) and (iii).

D Corp. failed, and a receiver (*R*) was appointed to administer the assets of *D Corp*.

R could not decide, however, what his theory was, except that it sounded in fraudulent transfer. So he pleaded in the alternative. Perhaps *X* was the debtor of *D Corp*. and *D Corp*. was the creditor. In that case, *D Corp*. "lent" the embezzled money to *X*, so that *X* had both legal and equitable title to the funds. Thereafter, *X* conveyed *X*'s own property to *Y*. Under these assumptions, *R* theorized that *X*'s transfer to *Y* was an intentional fraud on the creditor, *D Corp*. So conceived, *D Corp*.'s chose in action against *Y* for fraudulent transfer was a corporate asset. *R* succeeded to *D Corp.*'s causes of action and thus *R* could recover the fraudulent transfer from *Y*.

But perhaps *D Corp*. was debtor to *V* and the *V* were the creditors.[324] On that assumption, *X* was merely the agent who, on behalf of *D Corp*., fraudulently transferred *D Corp*. property to *Y*.[325] If *D Corp*. was the debtor, then (*R* figured) *D Corp*.'s creditors had a fraudulent transfer cause of action against *Y*. Implicitly, *V* would have to share the proceeds of the cause of action with the non-*V* creditors of *D Corp*.[326] *R* pleaded both that *X* (or *D Corp*.) had made intentional and constructive fraudulent transfers to *Y*.

Both theories of the case ignored the fact that *Y* received funds embezzled from *V*. In fact, fraudulent transfer was the wrong theory for *R*. *D Corp*. was fiduciary to *V* under an express or implied trust. *D Corp*. gave legal title to the embezzled funds to *X*. *X* directed these funds to *Y* in satisfaction of *X*'s antecedent debt. *Y* thus had legal title to the trust funds, and *V* retained equitable title. If *Y* had knowledge of the embezzlement, *Y* was liable to *V* to return the funds. Under *Cannon*, *D Corp*. (as fiduciary for *V*) had the duty to take back the funds now held by *Y*. Since *R* succeeded to *D Corp*.'s causes of action, *Y* had standing to recover the funds from *Y* (if *Y* was in bad faith).

The case proceeded, however, on *R*'s fraudulent transfer theories. As to the intentional fraud claims, the trial court awarded summary judgment to *Y* for

323. As Macbeth quips, "Be innocent of the knowledge, dearest chuck, Till thou applaud the deed." WILLIAM SHAKESPEARE, MACBETH act 3, sc. 2.

324. This is contrary to what I have argued. *See supra* text accompanying notes 1–2.

325. *Y* was paid with bank checks, which did not indicate who had procured them. *Boston Trading*, 835 F.2d at 1509.

326. It troubled Justice Breyer that, if *R* could step into *V*'s shoes and recover embezzlement proceeds, these proceeds would be shareable with the unsecured creditors of *D Corp.*, whereas if *V* alone had standing to recover, *V* need not share unpaid creditors. *Id*. at 1515.

want of evidence of actual intent to hinder a creditor by whomever the transferor was supposed to be.

With respect to the constructive fraud claims, these the trial court submitted to a jury. As to the $400,000 down payment, the jury decided that *Y* had given a fair equivalent in good faith, presumably to *X*. But as to the $73,000 installment and the $400,000 settlement, the jury found that *X* (or perhaps *D Corp*.)[327] did not receive a fair equivalent in "good faith."[328] Here we should allude to the fact that the Massachusetts UFCA defined "fair consideration" as that which is paid *in good faith*.[329] *Y* had paid these two sums in bad faith.[330] The UVTA has eliminated the "good faith" component in its definition of value.[331] It is an interesting datum that, under current law, *Y* would walk away free and clear of liability.[332] Only under the constructive trust theory just described would *Y*'s bad faith count against him.

R appealed from the summary judgment (intentional claims) and *Y* appealed from the jury verdict (constructive fraud claims).

Judge Stephen Breyer was understandably perplexed by the procedural mess that had been dumped on his desk. On the one hand, he clearly saw the difference between a restitutionary theory of constructive trust and a fraudulent transfer theory.[333] Thus summary judgment on the intentional fraud was upheld

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327. *Id*. at 1509 (The jury verdict "did not explicitly state *who* had made the transfers.").

328. *Id*. at 1507.

329. UNIF. FRAUDULENT CONVEYANCES ACT § 3(a) (UNIF. LAW COMM'N 1918) defines fair consideration as "when in exchange for such property, or obligation, as a fair equivalent therefor, *and in good faith*, property is conveyed or an antecedent debt is satisfied . . . ." The good faith component of the definition perplexed and confounded a generation of lawyers. *See* Note, *Good Faith and Fraudulent Conveyances*, 97 HARV. L. REV. 495 (1983). Massachusetts has since enacted the Uniform Fraudulent Transfer Act, 1996 Mass. Acts, ch. 157, approved July 8, 1996, which omits "in good faith" from the definition of reasonably equivalent value. MASS. GEN. LAWS ch. 109A § 4 (1996).

330. Inexplicably, the jury awarded R a money judgment of $436,000 rather than $473,000. *Boston Trading*, 835 F.2d at 1514.

331. UNIF. VOIDABLE TRANSACTION ACT § 3(a) (UNIF. LAW COMM'N 2014) ("Value is given for a transfer . . . if, in exchange for the transfer . . . property is transferred or an antecedent debt is secured or satisfied, but value does not include an unperformed promise made otherwise than in the ordinary course of the promisor's business to furnish support to the debtor or another person").

332. Of "constructive" fraudulent transfer liability that is. Bad faith purchasers for value are liable in *actual* fraud cases. But actual fraud was off the table via the trial court's summary judgment against *R*.

333. *Boston Trading*, 835 F.2d at 1507 (Breyer, J.) ("The suggested pattern in one in which B, with C's full knowledge, dishonestly takes money from A and gives it to C. It seems fair (given C's knowledge) that ordinarily A should be able to sue C for return of his money. . . . Thus, the Massachusetts courts treat an investment advisor's wrongful taking of his clients' money as an embezzlement, they impose a 'constructive trust' upon these funds, and those who take such funds 'with knowledge' must return them to the original owner.").

because fraudulent transfer law simply did not apply.[334] In this respect, *Boston Trading* lines up with *Cannon*.

On the other hand, this good point was mysteriously forgotten as to the constructive fraud claim. Instead, Judge Breyer reversed the fraudulent transfer theory, not because no fraudulent transfer ever occurred, but because the jury instructions did not require the jury to consider whether *X* was insolvent at the time *X* paid *Y*.[335] Also, Judge Breyer feared that the jury might have wrongly believed that a preference of *Y* over other creditors is *per se* bad faith.[336]

A new trial was ordered, but what Judge Breyer should have done was to reverse the jury verdict because a debtor cannot make a fraudulent transfer with embezzled funds.

Judge Breyer raised questions about *R*'s standing to bring causes of action belonging solely to the *V*. Judge Breyer thought that *R* was a receiver charged only with marshaling assets of *D Corp*. As such, *R* was not authorized to collect fraudulent transfers that *D Corp*. may have made. These were claims belonging to the *V* (based on the erroneous assumption that the *V* were creditors). Judge Breyer noted that *R* drew his "authority to sue from a court order that gives him 'full power to prosecute all claims . . . *on behalf of* [*D corp*] . . . ,'" and that in the court's view, "a verdict for [*R*] under [the UFCA] is legally improper because . . . [*R*] is suing not on behalf of [*D Corp.*] itself, but solely on behalf of the investors in [*D Corp.*'s] commodity pools, and [*R*] lacks the legal authority to bring this kind of suit."[337]

Thus, Judge Breyer thought *R* had no standing to bring any claim belonging to *V*:

> [P]erhaps, if [*R*] had requested authorization to bring such a suit, the district court would have granted it (or would do so now). We express no opinion on the lawfulness or the desirability of any such expanded authority; we simply find

334. *Id.* at 1510 (Breyer, J.) ("Suppose that S & K, officers of Corporation C, obtain C's money through dishonest means (larceny, fraud, etc.) and use it to pay a debt that S & K owe B, a transferee who knows of, *but did not participate in*, S & K's dishonesty. Does § 7 of the Massachusetts Fraudulent Conveyance Act permit C to recover its money from B? We think the district court correctly ruled that § 7 does not.").

335. *Id.*

336. *Boston Trading* is frequently cited for the proposition that, without more, getting paid is not bad faith. Securities Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Madoff Sec.), 476 B.R. 715, 727 (S.D.N.Y. 2012). On the "something more" required to make receipt of payment a fraudulent transfer, see Meoli v. Huntington Nat'l Bank (*In re* Teleservices Grp., Inc.), 469 B.R. 713, 755–59 (Bankr. W.D. Mich. 2012); Emil A. Kleinhaus & Alexander B. Lees, *Debt Repayments as Fraudulent Transfers*, 88 AM. BANKR. L.J. 307 (2014).

337. *Boston Trading*, 835 F.2d at 1514 (Breyer, J.).

> that the authorizing language, in its present form . . . does not now permit [*R*] to assert [*V*] claims . . . .[338]

In any case, whatever may be true for bankruptcy trustees, a receiver liquidating a commodities broker very plausibly could be given broad powers to administer trusts[339] *or* to avoid fraudulent transfers.[340] Yet to the extent the theory is fraudulent transfer, the proceeds of *these* choses in action belong to the general creditors, not to the beneficiaries of a constructive trust. The *V* are not even creditors if the *V* are beneficiaries of a constructive trust. Only if tracing has failed (or if *V* opts to assert her conversion tort action) is *V* a general creditor. As such, *V* can only obtain a pro rata share of the fraudulent transfer recovery. Asymmetrically, if tracing is possible, *V* alone has the right to the constructive trust proceeds, and these must be kept away from the general creditors. Generally applicable, *Cannon* (and half of *Boston Trading*) would mean that, basically, bankruptcy trustees cannot administer Ponzi scheme liquidations where all the "creditors" are beneficiaries of a constructive trust and where tracing of trust proceeds into the bankruptcy estate is possible. If *X* could assert that the bankruptcy trustee succeeds only to *D*'s legal title, not to *V*'s equitable title, then fraudulent transfer theory disintegrates in the Ponzi

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338. *Id*. at 1516. Further confusing matters is this remark: "We recognize that the pool investors [*V*] arguably have a valid fraudulent conveyance claim . . ." *Id*. This observation contradicts Judge Breyer's earlier distinction between restitution and fraudulent transfer law. The *V* do not need an avoidance theory to recover embezzled funds. They already own them. Indeed, they are not even creditors. Furthermore, recall that Judge Breyer remanded a constructive fraudulent transfer claim, implying that *R did* have standing to bring *that* action. Indeed, one of *R*'s alternative theories was that *D Corp*. did not embezzle but rather lent its own funds to *X* who then fraudulently transferred *X*'s own funds to *Y*. This was indeed *D Corp*.'s chose in action and, on Judge Breyer's theory of standing, *R* was authorized to bring it. Of course, I have asserted that there were no fraudulent transfers in the case at all.

339. Federal Sav. Loan Ins. Corp. v. Dixon, 835 F.2d 554, 562 (5th Cir. 1987) (receiver had standing to pursue constructive trust theories); SEC v. Credit Bancorp, Ltd., 290 F.3d 80, 89 (2d Cir. 2002) (receiver could distribute constructive trust funds to victims pro rata); *see* Donell v. Kowell, 533 F.3d 762, 777 (9th Cir. 2008) (SEC-sponsored receiver had authority to pursue "fraudulent transfers" on behalf of Ponzi victims). *See generally* Ralph S. Janvey, *An Overview of SEC Receiverships*, 38 SEC. REG. L.J. 89 (2010).

340. Texas & Pac. Ry. Co. v. Pottorff, 291 U.S. 245, 261 (1934) ("It is the duty of the receiver of an insolvent corporation to take steps to set aside transactions which fraudulently or illegally reduce the assets available for the general creditors, even though the corporation itself was not in a position to do so."). *But see* Eberhard v. Marcu, 530 F.3d 122, 134–35 (2d Cir. 2008) (denying receivers have standing to pursue fraudulent transfers). *Eberhard* is discussed *infra* in the text accompanying notes 362–72.

environment.[341] So does voidable preference theory.[342] Both presuppose that *D* has, before the bankruptcy, conveyed both legal and equitable title to a third party. But that is not the case when the funds held by *D* are all constructive trust property.

Scholes v. Lehmann[343] is a receivership case where the worlds collide. In *Scholes*, three *D Corps*. were each the general partner of limited partnerships purportedly dedicated to investment in commodities. They sold limited partnership interests to *V* and then looted their respective partnerships. The loot was passed on to the evil mastermind (*EM*) who then enriched an ex-spouse and several religious institutions. As in *Boston Trading*, a receiver (R) was obtained for the *D Corps*.—this time by the Securities & Exchange Commission.

R brought fraudulent transfer actions against *EM* and *EM*'s transferees. Properly, these were not fraudulent transfer cases. They were constructive trust cases. More precisely, *R* was acting for the limited partnerships that the *D Corps*. had looted. The limited partners stood in place of the *V*.[344]

EM's transferees maintained that fraudulent transfer claims belonged only to creditors of *D Corp*. whereas the SEC was empowered to represent victims of investment fraud. Therefore, *R* had no standing to bring these claims. Judge Posner, however, begged the question by conceptually confusing embezzlements and fraudulent transfers.

> Though injured by [*EM*], the corporations would not be heard to complain as long as they were controlled by him, not only because he would not permit them to complain but also because of their deep, their utter, complicity in [*EM*'s] fraud.

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341. *See* 11 U.S.C. § 548(a)(1) (2012) (emphasis added) ("The trustee may avoid any transfer . . . of an interest *of the debtor* in property . . . .").

342. *Id*. § 547(b) (emphasis added) ("[T]he trustee may avoid any transfer of an interest *of the debtor* in property . . . ."); *see* Begier v. IRS, 496 U.S. 53, 59 (1990) ("Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not 'property of the estate.'").

343. 56 F.3d 750 (7th Cir. 1995).

344. Judge Randolph Haines has written:

> [W]hat *Scholes* upheld was really a corporate law action for waste or *ultra vires* transactions although they were couched as fraudulent transfer actions. That it really was such a corporate law cause of action rather than a vesting of creditors' fraudulent transfer actions in the receiver was made explicitly clear by the Seventh Circuit's acknowledgement that "we can find no cases in which a receiver for a sole proprietorship recovered a fraudulent conveyance."

Aaron v. Rosepink (*In re* Glob. Grounds Greenery, LLC), 405 B.R. 659, 664 (Bankr. D. Ariz. 2009). While Judge Haines is entirely correct that *Scholes* was no fraudulent transfer case, he sees the receiver representing the shareholders of the *D Corps*. (that is, *EM*), not the victims of the fraud.

> The rule is that the maker of the fraudulent conveyance and all those in privity with him—which certainly includes the corporations—are bound by it. But the reason, of course . . . , is that the wrongdoer must not be allowed to profit from his wrong by recovering property that he had parted with in order to thwart his creditors. That reason falls out now that [*EM*] has been ousted from control of and beneficial interest in the corporations. The appointment of the receiver removed the wrongdoer from the scene. The corporations were no longer [*EM*'s] evil zombies. Freed from his spell they became entitled to the return of the moneys—for the benefit not of [*EM*] but of innocent investors—that [*EM*] had made the corporations divert to unauthorized purposes. That the return would benefit the limited partners is just to say that anything that helps a corporation helps those who have claims against its assets.[345]

This passage reveals a serious misconception of colliding worlds. Judge Posner imagines that, where *D* conveys a thing to *X* in order to hinder creditors, *D* may not recover the thing from *X*. The reason: *D* must not be allowed to profit from *D*'s wrong against *D*'s creditors.[346]

But this does not explain why *D* cannot avoid *D*'s own fraudulent transfers. The reason is because *D* has no property interest in the thing *D* formerly conveyed to *X*. Rather, *X* has title to the thing in trust for the creditors of *D* and the creditors of *D* have equitable interests in *X*'s thing. *D* has forever alienated the property to *X*.[347]

Suppose some sort of conservator is appointed over *D*'s estate—an assignee of the benefit of creditors, for example. The assignee does not become entitled to *X*'s thing, as *D* voluntarily conveyed the thing away before the assignment.[348] On the other hand, suppose, prior to the assignment, *D* holds a thing in trust for *V* and then gives the thing to *X*. *X* holds legal title for *V*. Although *D* gave the thing to *X* voluntarily, *D* is still a constructive trustee and has the fiduciary duty to act for *V* in getting the thing back from *X*. When the assignee takes over

345. 56 F.3d at 754 (citations omitted).

346. *Accord* Levy v. Braverman, 260 N.Y.S.2d 681, 681 (N.Y. App. Div. 1965)

347. To be distinguished is *Estate of Blanco*, 150 Cal. Rptr. 645 (Cal. Ct. App. 1978). There, *D*, fearing liability for medical malpractice, conveyed to *X* who "would hold title in trust for [*D*] and reconvey the parcels upon request of [*D*]." *Id*. at 646. *D* was acquitted of malpractice and sought to enforce that trust. *Id.* The court decided that *D* had "clean hands" and was entitled to get the land back. *Id*. at 652. The decision is not a fraudulent transfer but is a case forcing a trustee (*X*) to conform to the terms of the trust.

348. GLENN, *supra* note 9, § 102.

from *D*, the assignee becomes the trustee for *V* and is authorized to recover from *X*.[349] That is the case Judge Posner had before him.

Judge Posner's reasoning was followed in *Wiand v. Lee*,[350] where the facts were basically identical. A receiver (*R*) was appointed at the behest of the SEC.[351] *R* sought to recover excess lulling payments[352] from lucky escapees (*X*) of the Ponzi scheme. In the case, *R* was said to represent the transferors of dividends (*T*). Properly, *T* should have been conceived as *D*. *T* = *D* held investor funds in constructive trust for the defrauded investors and used them to make excess lulling payments to *X*. Properly, *R* then succeeds to the fiduciary duty of *T* = *D* to get back trust funds wrongfully given away. Instead, the *Wiand* court insisted that *T* was a *creditor* (*T* = *C*). The debtor was viewed to be the evil mastermind (*EM*). Yet *EM* was neither transferor not transferee. Nor did *EM* owe a debt to *T*. *EM* should have been left out of the analysis altogether.

X objected that it received transfers from *T* = *C*. Yet the Uniform Fraudulent Transfer Act required a transfer by property of *EM* = *D*. Since *EM* = *D*, and since *X* never received *D*'s property, *X* should be off the hook. Here is how the court characterized *X*'s argument:

> But, [*X* argues], the transfers were of [*T*] funds, not [*EM*] funds. In other words, applying [the Florida UFTA] to [*EM*'s] transfers appears to treat [*T* and *EM*] as simultaneously both separate and distinct entities—the [*T*] are considered distinct from [*EM*] in order to establish a creditor and a debtor, but they are treated as one entity in order to establish that [*EM*'s] transferors of [*T*] funds were transfers of [*EM*'s] property.[353]

X hit the nail right on its head. *R*'s theory was contradictory. The court, however, was "not persuaded by these arguments" and instead followed the lead of *Scholes*. *Scholes* taught that the reason *D* has no standing to recover a fraudulent transfer from *X* was *in pari delicto*. But since receivership purges *D* of wrongdoing, *D* has standing to take back his own gifts.

349. *See Scholes*, 56 F.3d at 754. In dictum, Judge Posner suggests that a bankruptcy trustee could recover trust property for *V*, but this overlooks Caplin v. Marine Midland Grace Trust Co. of N.Y., 406 U.S. 416 (1972); Stevenson v. J.C. Bradford & Co. (*In re* Cannon), 277 F.3d 838 (6th Cir. 2002).

350. 753 F.3d 1194 (11th Cir. 2014).

351. Wiand v. Lee, 8:10-CV-210-T-EAK-MAP, 2013 U.S. Dist. LEXIS 8997, at *4 (M.D. Fla. Jan. 23, 2013).

352. In Ponzi argot, "lulling payments" are payments to investors in order to give the appearance that all is normal. McHale v. Boulder Capital LLC (*In re* 1031 Tax Grp., LLC), 439 B.R. 47, 72 (Bankr. S.D.N.Y. 2010).

353. *Wiand*, 753 F.3d at 1202.

Of course, ultimately, *X* should not be off the hook. *R* does have a valid theory in constructive trust, but it is simply wrong to say that *T* is equal to *C* in this case. Not even Judge Posner went this far in *Scholes*. According to Judge Posner, *T* is equal to *D* and *D* (once baptized with receivership, exorcized of zombiism and forgiven all past sins) could avoid his own evil gifts. But this is not so. When *D* conveys to *X*, *D* surrenders all rights in the thing *D* conveys. *X* gets the legal title and the creditors of *D* get the equitable title.

It is far more satisfactory to follow *Cannon*: *D* is the constructive trustee for the investors and has a duty to retrieve transfers of legal title from bad faith purchasers or good faith purchasers for no value.

In *Meoli v. The Huntington National Bank*,[354] the court permitted recoveries of constructive trust funds under the guise of fraudulent transfer theory.[355] A fraudster (*EM*) had incorporated *X Corp*. and *D Corp*. *X Corp*. obtained purchase money financing for computer equipment from secured lenders. *D Corp*. posed as the seller of computer equipment. *X Corp*. represented that *D Corp* was to sell equipment to *X Corp*. Consistent with good practice (but without the due diligence to assure the sale was real), the purchase money lenders would wire funds directly to *D Corp*. to finance *X Corp*.'s apparent purchase of equipment. *X Corp*. purported to grant to the lenders security interests on this non-existent collateral.[356] The case proves that purchase money lending and Ponzi schemes do indeed mix.

From a restitution standpoint, *X Corp*. had borrowed money on false pretenses. It was therefore constructive trustee for the lenders. The borrowed funds were initially wired to *D Corp*., which (consistent with good conscience) restored the funds to *X Corp*. as constructive trustee-in-chief for the lenders.[357] *D Corp*. was never more than a sub-trustee in this case.

X Corp. did indeed make lulling payments to the victims for a while—in Ponzi style.[358] At the end of the day, the fraudster used the loan proceeds to pay *X*'s bank (*X Bank*) for a loan. Excess proceeds were deposited with *X Bank*.

354. 848 F.3d 716 (6th Cir. 2017).

355. Meoli v. Huntington Nat'l Bank (*In re* Teleservices Grp., Inc.), 444 B.R. 767 at 786–87 (Bankr. W.D. Mich. 2011).

356. *Id.* at 784.

357. *Id.* at 785.

358. *Id.* ("[*D Corp.*], of course, did not keep its ill-gotten gains. Rather, it funneled them back to [*X Corp.* and *X Corp.*] in turn used what it received: (1) to perpetuate the fraud by making payments on the many promissory notes and leases [*X Corp.*] had signed in connection with prior nonexistent purchases; and (2) to pay [*X Corp.*]'s other operating expenses, including the handsome salaries and expense accounts of Watson and his fellow cheats. Of course, Watson accomplished this by depositing the transfers from [*D Corp.*] into [*X Corp.*'s deposit accounts with *X Bank*]. . . .").

These proceeds *X Corp*. withdrew and dissipated. *X Bank* was found to be a bad faith purchaser of these trust funds.[359]

Bankruptcy Judge Jeffrey Hughes recognized that *D Corp*. did not own equitable title to the funds. Nevertheless, *D Corp*. has a "sufficient interest in what it had stolen in order to have made a cognizable Section 548(a) transfer of its property when it then used the purloined funds to pay off the remainder of [*X Corp*.'s] debt to [*X Bank*]."[360]

Without more explanation, Judge Hughes was in violation of our definition of a fraudulent transfer—D must convey an equitable title which otherwise the creditors of *D* would have enjoyed. All that happened here is that *D Corp*. conveyed funds to the main constructive trustee.[361] The beneficial interest never changed hands. That interest stayed with the *V*, the defrauded purchase money lenders. These *V* owned the cause of action against *X Bank*—not *D Corp*.'s bankruptcy trustee. Under *Cannon*, *X Corp*.'s bankruptcy trustee (not to mention *D Corp*.'s bankruptcy trustee), has no standing to collect property for third parties.

Eberhard v. Marcu[362] is a case where the two worlds do not actually collide, though it is a near miss. Nevertheless, the Second Circuit Court of Appeals contributed some dubious wisdom on SEC receiverships. In *Eberhard*, the evil mastermind (*EM*) caused *D Corp*. to loot *V*'s property in the customary manner. At the behest of the SEC, *R* was appointed receiver of *EM*'s estate and also the estate of *D Corp*. Soon, *D Corp*. was wrested from *R*'s control in favor of a SIPA proceeding, where the colliding worlds are mediated by sensible legislation.[363] *R* was left with the estate of *EM*.

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359. The Sixth Circuit, on appeal, would rule that, to the extent *X Bank* received payment in bad faith, *X Bank* was liable to the bankruptcy trustee of *D Corp*. for receiving proceeds of a fraudulent transfer. Meoli v. Huntington Nat'l Bank, 848 F.3d 716, 735–36 (6th Cir. 2017). But as to deposits above and beyond the repayment amount, *X Bank* was not a transferee at all! It was a "mere conduit." *Id.* at 736. For a critique of this holding, see generally Carlson, *Conduit*, *supra* note 1, at 555–64.

360. *In re Teleservices Grp., Inc.*, 444 B.R. at 787. The court in *Jobin v. Lalan (In re M&L Bus. Mach. Co.)*, 160 B.R. 851, 857 (Bankr. D. Colo. 1993), also assumes that mere possession suffices to sustain a fraudulent transfer theory.

361. Judge Hughes used his *Erie* privilege to ignore *Alliance Bancorp v. Select Mortgage, LLC*, No. 274853, 2008 Mich. App. LEXIS 554 (Mich App. Mar. 18, 2008), as being the incorrect pronouncement of a court subordinate to the Michigan Supreme Court. *See* Meoli v. Huntington Nat'l Bank (*In re* Teleservices Group, Inc.), 469 B.R. 713, 763 (Bankr. W.D. Mich. 2012) (Hughes, J.). In *Alliance*, D "defrauded" funds from *V* and transferred them to *X*. 2008 Mich. App. LEXIS 554, at *1. *V* pleaded a fraudulent transfer theory against *X* and was dismissed. *Id.* Somehow the *Alliance* court found itself talking about stolen funds, not trust funds, though clearly the case was about trust funds. *Id.* at *3–6. Presumably *V* in *Alliance* could sue *X* under a restitutionary theory.

362. 530 F.3d 122 (2d Cir. 2008).

363. *Id.* at 126; *see supra* text accompanying notes 300–304.

EM, it appears, invested stolen funds in a separate wholly owned corporation (*S Corp*.).[364] *EM* then conveyed the *S Corp*. shares to *X*. *R* claimed that *EM* fraudulently transferred these shares to *X*. *X* demurred that *R* had no standing to assert this cause of action against *X*; only creditors could do so, and *R* was not (nor did he represent) a creditor of *EM*. The court agreed, thus putting the Second Circuit at odds with the Seventh[365] and Eleventh[366] Circuits.[367]

Properly, the SIPC trustee should have pursued the proceeds of stolen funds into the hands of *S Corp*., thereby denuding *S Corp*. of assets. Had this strategy been pursued, the shares in *S Corp*. conveyed to *X* would have been valueless and not worth pursuing. Nevertheless, this point was overlooked by all the parties, not to mention the SIPA trustee.

Be that as it may, *R* certainly could have been bestowed with the power to recover fraudulent transfers on behalf of the creditors of *EM*. The creditors of *EM* presumably had no money judgments against *EM*. As such, under New York Debtor and Creditor Law § 279, these creditors were creditors "whose claim has not matured." Such creditors are entitled to "a receiver to take charge of the property . . . ."[368] Certainly, the court could have appointed *R* to represent the creditors—unless the court meant to rule that the SEC was incapable of representing the creditors of *EM*. If so, *Eberhard* stands for the fact that a receiver merely succeeds to the choses in action that the receivership entity actually happens to own. Translated back to the corporate looting environment, such a restriction is no impediment to receivers because, under *Cannon*, a constructive trustee can recover the very property that the trustee transferred to *X*. *Eberhard* becomes an impediment only when fraudulent transfers are confounded with constructive trust theory.

In *Eberhard*, the Second Circuit erroneously thought it was in accord with the Seventh Circuit in *Scholes*, but this was not so. *Eberhart* quotes *Scholes* as holding that *R*'s "object was 'to maximize the value of the corporations for the benefit of their investors *and any creditors*.'"[369] If *R* represented *creditors*, it

364. 530 F.3d 122 at 128.

365. Scholes v. Lehmann, 56 F.3d 750 (7th Cir. 1995).

366. Wiand v. Lee, 753 F.3d 1194 (11th Cir. 2014).

367. *See also* Evans v. Armenta, 134 F. Supp. 3d 1052, 1062 (E.D. Ky. 2015) (receiver had standing to pursue fraudulent transfers in the context of a Ponzi scheme); Bartholomew v. Avalon Capital Grp., Inc., 828 F. Supp. 2d 1019, 1026–27 (D. Minn. 2009) (same). *But see* Aaron v. Rosepink (*In re* Global Grounds Greenery, LLC), 405 B.R. 659, 663–64 (Bankr. D. Ariz. 2009) (holding that Arizona law does not countenance authorizing a receiver to avoid fraudulent transfers).

368. N.Y. DEBT. & CRED. LAW § 279 (Consol. 2009).

369. 530 F.3d at 132 (emphasis added) (quoting *Scholes*, 56 F.3d at 755).

stands to reason that *R* could collect the fraudulent transfers *D Corp*. actually made.[370]

An old Supreme Court case can be cited against *Eberhard* and in favor of *R*'s standing to pursue *D*'s fraudulent transfers. In *Texas & Pacific Railway Co. v. Pottorff*,[371] a bank pledged securities to a depositor and subsequently failed. *R* was appointed receiver for purpose of liquidating bank assets. The depositor made a claim against *R* as a secured creditor. *R* claimed that the pledge was ultra vires—not within the power of the bank to give. *R* tendered mere pro rata dividends to the depositor as if the depositor were unsecured. The depositor responded by seeking to replevy the securities.

Justice Brandeis agreed that the pledge was ultra vires and held that the depositor was not entitled to possession of the collateral. Strictly speaking, this is not a fraudulent transfer. If it were, the bank could not deny the pledge. Only a creditor could avoid it. But, with regard to an ultra vires act:

> The bank itself could have set aside this transaction. It is the settled doctrine of this Court that no rights arise on an ultra vires contract, even though the contract has been performed; and that this conclusion cannot be circumvented by erecting an estoppel which would prevent challenging the legality of a power exercised.[372]

This clearly shows the claim of ultra vires is not the same as a fraudulent transfer. What comes next, however, contradicts the *Eberhard* conclusion that *R* has no standing to pursue *D*'s fraudulent transfers:

> But even if the bank would have been estopped from asserting lack of power, its receiver would be free to challenge the validity of the pledge. The unauthorized pledge reduced the assets available to the general creditors. It is the duty of the

370. The *Eberhard* court cites and purports to follow *Troelstrup v. Index Futures Grp., Inc.*, 130 F.3d 1274 (7th Cir. 1997), another opinion by Judge Posner. 530 F.3d at 132. In *Troelstrup*, a receiver brought a negligence action against a third party on behalf of creditors of *D*. 130 F.3d at 1275–76. Judge Posner ruled that *R* was not subrogated to these negligence claims. *Id.* at 1277–78. The Eberhard court analogized *R*'s fraudulent transfer claim against *X* to the negligence claim against the third party in *Troelstrup*. 530 F.3d at 133–35. It therefore followed that *R* in Eberhard had no standing. *Id.* at 135.

This use of *Troelstrup* must be questioned. If I may indulge in an SAT-style simile, *Troelstrup* is to Caplin v. Marine Midland Grace Trust Co. of N.Y., 406 U.S. 416 (1972), what *Eberhard* is to Bankruptcy Code § 544(b)(1). The first two cases are not appropriate to subrogation, but the latter two cases are. The distinction is that the creditors in the first two cases owned purely in personam rights against a nontransferee third party. In *Eberhard* and any given bankruptcy case, the creditors have in rem rights against *X*, a transferee of *D*.

371. 291 U.S. 245, 251–53 (1934).

372. *Id.* at 260.

> receiver of an insolvent corporation to take steps to set aside transactions which fraudulently or illegally reduce the assets available for the general creditors, even though the corporation itself was not in a position to do so.[373]

This "even if" point certainly encompasses standing to pursue fraudulent transfer theories.

To summarize, we have *Cannon*, which stands for the proposition that *D*'s conveyance of trust property can never be a fraudulent transfer. Then we have *Boston Trading*, which holds that a conveyance of trust property can never be intentional fraudulent transfers, but it can be a constructive fraudulent transfer. And finally, we have *Scholes* and *Meoli*, which hold that a conveyance of trust property is always a fraudulent transfer.

The *Scholes–Meoli* position is the one that is needed if bankruptcy courts are to have jurisdiction over Ponzi liquidations. But how can this position be sustained? Asserting that constructive trust cases sound in fraudulent transfer strips *V* of an asset and awards it to creditors of *D*.

If one recognizes two separate worlds exist that do not collide—the world of constructive trust and the world of fraudulent transfer—is it possible to administer Ponzi scheme liquidations from within a bankruptcy proceeding? There are two possibilities—a failure of tracing and the principle of *ius tertii*.

A. *Tracing*

First, a trustee might take jurisdiction over constructive trust property because tracing difficulties prevent a particular *V* from connecting her property with that which *D* transferred to *X*.[374] If tracing fails, the constructive trust fails, and *V* is but an unsecured creditor of *D*.[375] The embezzled funds effectively become *D*'s property. If *D* conveys these untraceable funds to *X* and *X* is not a bona fide purchaser, nothing impedes D's bankruptcy trustee from a successful fraudulent transfer theory.

If *V* wishes to recover trust property from bad faith *X*, *V* must necessarily show that the property transferred by *D* was in fact *V*'s property.[376] Suppose *D* fraudulently induces *V* to convey her car to *D*. *V* has an equitable interest in the

373. *Id.* at 260–61.

374. *See* Gowan v. Patriot Grp., LLC (*In re* Dreier LLP), 452 B.R. 391, 415 (Bankr. S.D.N.Y. 2011) (trustee's allegations of untraceability survived motion by *X* to dismiss complaint).

375. Montanile v. Board of Trs. of Nat'l Elevator Indus. Health Benefit Plan, 136 S. Ct. 651, 659 (2016); Jobin v. Youth Benefits Unlimited (*In re* M&L Bus. Mach. Co.), 59 F.3d 1078, 1080–81 (10th Cir. 1995).

376. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 cmt. b (AM. LAW INST. 2011).

car and *D* holds legal title for *V*'s benefit. Coincidentally, *D* also has a truck. *D* then gives the truck to *X*. *V* cannot recover the truck from *X* when *V*'s equitable interest is in the car. *V*'s rights are in the car and not in the truck.

On the other hand, if *D*, with voidable title to the car, trades the car for *X*'s motorcycle, *D* may replevy the motorcycle from *X* because the motorcycle is a proceed of the car.[377]

Tracing rules aid *V* in this identification task. If *D* takes fungible property from *V* and commingles it with *D*'s own property, the famous lowest intermediate balance rule allows *V* to identify her property.

As applied to deposit accounts, the rule works as follows:[378] Imagine that *D* has a deposit account in which *D* deposits trust money obtained from *D*. We may imagine that the deposit account is a barrel of water, and *V*'s funds are "heavy" water that sinks to the bottom of the barrel.

When *D* dips into the barrel to convey water to some creditor of *D*, it is presumed that *D*, in good conscience, uses *D*'s own water to liquidate the debt. Only when *D* dips down so deeply that *D* invades the heavy water will we admit *D* has embezzled *V*'s funds. If *D* has ladled this heavy water to a bad faith *X*. *V* can sue *X* for conversion, to the extent *X* received *V*'s funds.

In a Ponzi scheme, there are multiple *V*. The tracing rule in the case of multiple *V* is supplied by *Clayton's Case*,[379] which institutes a rule of "first in first out."[380] Suppose in sequence *D* defrauds $V_{1\text{-}4}$ each of $100. Then $400 sinks to the bottom of *D*'s commingled account. Under *Clayton*'s first-in-first-out rule, V_4's funds are heaviest. V_3's funds settle just above V_4's funds, V_2's funds are layered above the funds of $V_{4\text{-}3}$. As "first in," V_1 is most vulnerable.

377. SMITH, *Tracing*, *supra* note 55, at 130 ("Whenever there has been a substitution, there are two possibilities: follow or trace. If some steals my car and swaps it for a motorcycle, I can follow my car, or I can trace into the motorcycle.").

378. *See generally* Bruce A. Markell, *From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9*, 74 CHI.-KENT L. REV. 963, 971–72 (1999).

379. (1816) 1 Mer 572. *Clayton's Case* was cited with approval in *Cunningham v. Brown*, 265 U.S. 1, 12 (1924).

380. *See Clayton's Case* (1816) 1 Mer. 572. In *Clayton*, Devaynes was a partner in a bank. 1 Mer. at 572. Devaynes died solvent. *Id.* The surviving partners were soon bankrupt. *Id.* In the bankruptcy, the unsecured creditors received a dividend. *Id.* They sought to recover the deficit from Devaynes' estate. *Id.* at 573. The rule applied was that Devaynes' estate was liable for pre-death deposits with the bank but not liable for post-death deposits. *Id.* at 574. Clayton had £453 due him from pre-death payments. *Id.* at 586. But Clayton had made many post-death deposits and withdrawals. *Id.* The issue was whether a post-death withdrawal counted against a post-death deposit. *Id.* at 607–08. Or, alternatively, a post-death withdrawal counted against a pre-death deposit, on the rule of "first in first out." The chancery applied "first in first out." *Id.* at 610. Accordingly, Clayton had withdrawn the £453 *first* and so Clayton had no claim against Devaynes' estate. *See generally* SMITH, *Tracing*, *supra* note 55, at 185–89.

Suppose D pays bad faith X \$80 out of the deposit account. The \$80 comes from V_1's share. V_1 can sue X for \$80.[381] V_1 was the first in and so is the first out. Suppose further that D decides to pay dividend of \$30 to V_3. D's account is reduced to \$290. The funds D pays to V_3 are deemed to come from V_3's layer.[382] At the end of the day V_4 (last in, last out) can trace \$100 to the bottom of the account. V_3 is next for \$70. V_2 can trace for \$100 and V_1 can trace for \$20.[383] V_1, however, may recover \$80 from X.[384]

The leading (and original) case on Ponzi schemes approved of tracing in general but not on the facts of the case. In *Cunningham v. Brown*,[385] the court cited the standard lowest intermediate balance test, which it said was used in the lower courts, but (the court concluded) that its use is too "fantastic" for Ponzi schemes:

> To make the rule applicable here, we must infer that in the deposit and withdrawal of more than \$3,000,000 between the deposits of the defendants prior to July 28th, and the payment of their checks after August 2d, Ponzi kept the money of defendants on deposit intact and paid out only his subsequent deposits. Considering the fact that all this money was the result of fraud upon all his dupes, it would be running the fiction of [the lowest intermediate balance test] into the ground to apply it here. The rule is useful to work out equity between a wrongdoer and a victim; but, when the fund with which the wrongdoer is dealing is wholly made up of the fruits of the frauds perpetrated against a myriad of victims, the case is different. To say that, as between equally innocent victims, the wrongdoer, having defeasible title to the whole fund, must be presumed to have distinguished in advance between the money of those who were about to rescind and those who were not, would be carrying the fiction to a fantastic conclusion.[386]

What does this case mean? One view is that, where tracing is impossible, no V can identify trust property. All the V are transformed from property owners into unsecured creditors. Any V paid within the preference period must disgorge as a matter of federal preference law. In short there is no constructive

381. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59(2)(a) ("Withdrawals that yield a traceable product and withdrawals that are dissipated are marshaled so far as possible in favor of the claimant.").

382. SMITH, *Tracing*, *supra* note 55, at 209–10.

383. *See Cunningham*, 265 U.S. at 12 (citing *Clayton's Case* (1816) 1 Mer. 572).

384. Loring v. Baker, 106 N.E.2d 434, 436 (Mass. 1952); SMITH, *Tracing*, *supra* note 55, at 205.

385. 265 U.S. at 12.

386. *Id.* at 12–13.

trust. The world of voidable preference and of constructive trust do not collide. Voidable preferences occurred because *D Corp*. conveyed its own property. It did not use *V* property to pay.[387]

Alternatively, the case may mean that, where multiple *V* exist, tracing will not be used to prejudice one victim over another.[388] Tracing, however, may be used for the *V* as a group. On this view, there is a constructive trust. The victims are entitled to a pro rata share of the pool.[389] On such an interpretation, the trustee's standing to assert the property rights of the victims is imperiled.[390]

Caplin[391] restricts the trustee to succession of *D*'s causes of action or to subrogation of avoidance theories of unsecured creditors.[392] It certainly implies that the trustee is not subrogated to or authorized to act for *V*, where the *V* can trace their trust property out of the Ponzi scheme and into the hands of *X*. After all, the *V* (if they can trace) are not even creditors. They are property owners. And *Cannon* stands for the proposition that the bankruptcy trustee is not the successor trustee for a set of trust beneficiaries.

In contrast, suppose there are thousands of *V* and deposit records are unavailable. Then we say that *D* has converted the trust funds, and the *V* are unsecured creditors for claim sounding in conversion.[393] Under this circumstance, *D*'s bankruptcy trustee can recover payment to *X* as a voidable preference or a gratuitous transfer to *X* as a fraudulent transfer. These

387. *See also* Rosenberg v. Collins, 624 F.2d 659, 663 (5th Cir. 1980).

388. Claire Seaton Rosa, Note, *Should Owners Have to Share? An Examination of Forced Sharing in the Name of Fairness in Recent Multiple Fraud Victim Cases*, 90 B.U. L. REV. 1331, 1348 (2010). Other passages in this article suggest that tracing in general failed, leaving the *V* as unsecured creditors. *Id*. at 1349–50.

389. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 cmt. g (AM. LAW INST. 2011) ("The holding of [*Cunningham*] is that the tracing rules summarized in § 59(2) may not be used to create priorities between restitution claimants whose interests in commingled assets are otherwise indistinguishable."). *R3RUE* goes on to opine that *Cunningham* stands for the proposition that tracing "will not be mechanically applied to answer an altogether different question: namely the proportions of a commingled fund and its products to which competing restitution claimants are entitled." *Id*. On the other hand, "[t]he law of unjust enrichment does not impose a rule of contribution or loss-sharing between the victims of common or related injuries . . . ." *Id*. For a case in which individual *V* who could trace were made to share with *V* not able to trace, see United States v. Durham, 86 F.3d 70 (5th Cir. 1996).

390. *See* Andrew Kull, *Ponzi, Property, and Luck*, 100 IOWA L. REV. 291, 304–06 (2014) (deploring such a reading of *Cunningham*). One feature of the case not usually noted is that, if a *V* sought payment of a note, *V* was excluded from a restitutionary remedy. Only if a *V* demanded a refund (not payment of a note) was *V* even entitled to a constructive trust.

391. *See supra* text accompanying note 298.

392. 11 U.S.C. § 544(b)(1) (2012).

393. Cunningham v. Brown, 265 U.S. 1, 12 (1924).

recoveries are then shared pro rata, not just by the *V*, but by all unsecured creditors of *D*. When this occurs the theft that Ponzi began was consummated by Ponzi's bankruptcy trustee. Of course, as creditors the *V* are entitled to share the loot with the non-*V* creditors of Ponzi.

Costliness of tracing is indeed a factor that cannot be ignored. In support of this claim is the leading case on substantive consolidation, *In re Owens Corning*.[394] There, the court barred any substantive consolidation of two bankrupt related entities, where the consolidation would adversely affect distributions to the creditors of one of the subsidiaries.[395] The exception was the case where the accounting expense of retroactively separating the transactions of the subsidiaries was so prohibitively expensive that every creditor would lose value if the work were actually carried out. Extreme cost therefore justifies substantive consolidation.

It should be recognized, however, that the incentives of the trustee to claim tracing is too difficult are seriously misaligned. The trustee is in the position of arguing that tracing is too much work or is supposedly impossible. The labor expended to trace does not benefit the bankruptcy estate. It benefits third party property owners. The expense arguably is not an "actual, necessary cost[] and expense[] of preserving the estate"[396] and so not allowable as an administrative expense. Nor does Bankruptcy Code § 506(c) apply, since the benefited property owners (the *V*) do not hold allowed secured claims.[397] In short, the trustee is being asked to separate (by proper tracing) what belongs to the bankruptcy estate and what does not. Yet rather than expend funds to protect the property rights of the *V*, the trustee proposes to skip the hard, uncompensated work and expropriate the property for the benefit of the unsecured creditors of *D*. In short, the bankruptcy trustee argues that *D*'s theft should be sanctified and the unsecured creditors should benefit because determining the true owners of the loot is costly.

In the modern computer era, amazing achievements in tracing are no doubt possible. But this would have the effect of depriving bankruptcy trustees of the power to recover from payments to third parties. These causes of actions would belong to the *V*, not to the bankruptcy trustee.

There is something wrong with using expense as an excuse to proclaim tracing unfeasible. A better argument for the trustee is the time-honored claim of *ius tertii*.

394. 419 F.3d 195 (3d Cir. 2005).

395. *Id.* at 216.

396. 11 U.S.C. § 503(b)(1)(A).

397. *See supra* text accompanying notes 67–68.

B. *Ius tertii*

The principle that best justifies bankruptcy jurisdiction over Ponzi schemes is the principle of *ius tertii*. Yet it too, like "tracing is impossible," has an unethical component to it.

First year law students typically learn the principle of *ius tertii* from the case of *Armory v. Delamirie*.[398] In that case, a chimney sweep's boy (*B*) found a ring. He brought it into a jeweler's (*J*) shop. *J*'s apprentice offers three pence for it. *B* declined the offer. *J*'s apprentice returned the ring *sans* valuable jewel. *B* sued *J* for the tort of conversion. *J* defended on the ground that some true owner (*TO*) had better title than *B* and that therefore *B* did not deserve the money judgment. The judges of King's Bench found for *B*:

> [T]he finder of the jewel, though he does not by such finding acquire an absolute property or ownership, yet he has such a property as will enable him to keep it against all but the rightful owner, and consequently may maintain trover.[399]

Some ethical notes about this opinion will come in handy later. As has been observed, the tort of conversion (or trover) has a unique feature. Once the money judgment has been entered, *B* is deemed to have conveyed all his title to *J*. Conversion amounts to a forced sale to *J* against *J*'s will.[400] *B*, however, has acted unethically by selling the jewel to *J*. In effect, by suing *J* for conversion, *B* has committed the tort of conversion against *TO*. Thus *B*'s invocation of the *ius tertii* rule against *TO* constitutes a tort against *TO*.

Because *B*'s assertion of conversion against *J* is itself a conversion by *B* of *TO*'s property, *TO*, following *B*'s judgment against *J*, has a right to a money judgment against *B*. Alternatively, *TO* can treat the proceeds of the suit against *J* as held by *B* in constructive trust. If *TO* so elects, *TO* admits that *B*'s conversion action against *J* was rightful. Assertion of constructive trust theory against *B* implies *TO*'s title to the jewel was validly conveyed to *J*.

If *TO* chooses, *TO* can ignore *B* and can replevy the jewel from *J*, or sue *J* a second time in conversion. But if *TO* has already recovered from *B*, *TO* forfeits the right to sue *J* on either theory. The reason for this is that *TO*'s recovery in conversion from *B* constitutes the sale of *TO*'s rights to *B*. Since *B* has already conveyed more than he had to *J*, *B*'s subsequently acquired title reverts to *J* under the doctrine of estoppel by deed.[401] Thus, *TO*'s recovery from

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398. (1722) 1 Strange 505; *see generally* Luke Rostill, *Relative Title and Deemed Ownership in English Personal Property Law*, 35 OXFORD J. LEGAL STUD. 31 (2015).

399. *Armory* (1722) 1 Strange 505 (K.B. 1722).

400. Pierpoint v. Hoyt, 182 N.E. 235, 236 (N.Y. 1932); Cooper v. Shepherd (1846) 136 Eng. Rep. 107, 109; 3 C.B. 265, 269.

401. *See supra* text accompanying notes 97–99.

B implies that *J* has a valid right of possession against *J*. Similarly, if *TO* declares that *B* holds in trust the proceeds of *B*'s action against *J*, *TO*'s right against *J* fails. Constructive trust is based on the idea of ratification. If *TO* claims the proceeds of *B*'s judgment, *TO* is admitting (after the fact) that *B*'s wrong (the action against *J*) was in fact right. Thus, *B* had authority to convey good title to *J*, and *J*'s possessory right becomes superior to that of *TO*.

Applying these principles to Ponzi schemes, suppose, as in *Cunningham v. Brown*,[402] all or nearly all of the funds of *D Corp*. are held in constructive trust for *V*. *D Corp*. pays V_1, using constructive trust funds. *D Corp*. is bankrupt shortly thereafter, V_1 cannot prove (or, per *Cunningham*, is not permitted to prove) that V_1 is receiving the self-same funds *D Corp*. gulled V_1 into investing. Contrary to *Cannon* or *Boston Trading*, *D Corp*.'s bankruptcy trustee brings a voidable preference action against V_1.

Suppose V_1 pleads that *D Corp*. did not convey to V_1 an equitable title. *D Corp*. conveyed only the legal title. V_1's equitable title in fact comes from, say, V_2. Or V_1 pleads that, if the money does not belong to V_2 or any identifiable V_3 or V_4, it belongs to *some* V_i. If this plea is permitted, then the trustee's voidable preference claim falls apart. Meanwhile, if V_1 is a good faith creditor without knowledge of the Ponzi scheme, the cause of action in any V_1 cannot be brought. V_1 walks away free and clear.[403]

V_1's plea, however, is a *ius tertii*—a claim that *D Corp*. was not the true owner of the equitable interest in the funds conveyed—some party not before the court was the owner. Thus, V_1 will not be heard to claim that *D Corp*. was the true owner. Accordingly, the bankruptcy court is obliged to treat the funds transferred as entirely the property of *D Corp*. [404]

The irony of this principle is that *D Corp*.'s bankruptcy trustee is effectively stealing from the V_i when she recovers from V_1. The trustee's voidable preference recovery is tortious against the V_i. Suppose the trustee wins on *ius tertii* grounds. As a result, the trustee takes property that rightfully can be traced to, say, V_2. The trustee is just like *B* in *Armory*: the mere assertion of *ius tertii* is a wrong. As a result, the trustee has converted V_2's property and is liable for it.

The trustee is like *B* in another respect. *B* and the trustee both hope that *TO* will never appear and that they will reap the profit of their thefts. In Ponzi litigation, this is a good, if ethically dubious, bet.

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402. 265 U.S. 1, 12 (1924).

403. Carlson, *Reconceptualization*, *supra* note 295, at 538–39.

404. Rine & Rine Auctioneers, Inc. v. Douglas Cty. Bank & Tr. Co. (*In re* Rine & Rine Auctioneers, Inc.), 74 F.3d 854, 862–63 (8th Cir. 1996).

Ius tertii appears in a classic case under the Bankruptcy Act of 1898. In *Morris Plan Industrial Bank of New York v. Schorn*,[405] *D* embezzled money from her employer and did not surrender the funds to the bankruptcy trustee. The trustee sought to deny the debtor a discharge because the debtor "failed to explain satisfactorily losses of assets or deficiency of assets to meet his liabilities."[406] *D* responded that she did not withhold estate property. The property withheld really belonged to her employer. The court found for the trustee:

> All we need do is to follow the common-law doctrine that possession and asserted dominion is good title "against all the world except the true owner" to reach the result that an explanation is here required, with appropriate penalty when it is not forthcoming.[407]

Within the context of fraudulent transfer litigation, *ius tertii* has a history in various lower court bankruptcy cases. The most prominent of these cases is *Merrill v. Allen (In re Universal Clearing House Co.)*, where a bankruptcy trustee of a defunct pyramid scheme brought fraudulent conveyance actions against salesmen of Ponzi shares seeking a return of their sales commissions.[408] The dollars these salesmen received were fraudulently procured from the investors—though the salesmen were apparently not in on the fraud.[409] The salesmen eventually prevailed because their commissions were in satisfaction of antecedent debt. As such, they were transfers in exchange for reasonably equivalent value and hence not fraudulent transfers in the debtor's bankruptcy.[410]

Relevant here is the salesmen's additional argument: that all funds were held in constructive trust for defrauded investors. Hence, any payment to them was not "debtor" property for purposes of Bankruptcy Code § 548(a). Judge David Winder rejected this theory, reasoning that any given investor might rescind the investment and get back the identifiable dollars contributed. But pending the appearance of an investor to do just that, the funds were the debtor's, insofar as the salesmen were concerned. Although the phrase *ius tertii*

405. 135 F.2d 538 (2d Cir. 1943).

406. *Id.* at 540.

407. *Id.*; *see also id.* at 539 ("[A] bankrupt cannot refuse to turn over to his trustee assets of which he had assumed possession and dominion merely upon a showing that title to them is in a third person."); *see also* Carlson, *Reconceptualization*, *supra* note 295, at 517–20 (theorizing voidable preference law in *ius terti* terms).

408. 60 B.R. 985, 989 (D. Utah 1986).

409. *Id.* at 989 n.3.

410. 11 U.S.C. § 548(d)(1) (2012).

never appears in Judge Winder's opinion, it describes the result reached in *Universal Clearing House*.[411]

Some courts describe the *ius tertii* principle as a matter of "standing."[412] This seems to be an abuse of the notation, as the mathematicians would say. "Standing" is an attribute of plaintiffs.[413] They must have standing to sue or they are out of court. The illicit attempt to assert *ius tertii* is something defendants do. The attempt, if successful, undermines an indispensable part of the plaintiff's cause of action—namely, that *D Corp*. conveyed *D Corp*.'s own property (and not property of another). Nevertheless, no confusion arises by calling the principle in question as one of "standing" to make a claim. "Standing" is just *ius tertii* by a different name.

At least one court allowed its obsession with standing (or *ius tertii*) to obscure another outcome-determinative issue. In *McHale v. Boulder Capital LLC (In re The 1031 Tax Group, L.L.C.)*, *D Corp*. was a fiduciary for a set of clients (*V*).[414] *D Corp*. was controlled by *X*. *X* stole funds from *D Corp*. *and* (necessarily) from *V*. *X* used these funds to pay his creditor *Y* for loans *Y* had made to *X*. *D Corp*. soon went bankrupt, and *D Corp*.'s trustee[415] sued *Y* for having received fraudulent transfers from *D Corp*.

Y attempted to assert the forbidden *ius tertii*—*D Corp*. did not own the funds. Rather (*Y* claimed) the clients *V* did. *Y* did not have "standing" to make this claim,[416] and so client funds were deemed to be *D Corp*. funds. So far so good.

What was overlooked in this case was the fact that *X stole* what we shall agree were *D Corp*. funds. *D Corp*. therefore had a conversion cause of action against *X*. *D Corp*. did not need a fraudulent transfer theory to recover these funds from *X*.

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411. *Universal Clearing House*, 60 B.R. at 994–96*; see also* Cassirer v. Sterling Nat'l Bank & Tr. Co. (*In re* Schick), 246 B.R. 41, 44–47 (Bankr. S.D.N.Y. 2000) (applying the *ius tertii* principle).

412. McHale v. Boulder Capital LLC (*In re* 1031 Tax Grp., LLC), 439 B.R. 47, 62–63 (Bankr. S.D.N.Y. 2010).

413. *Id*. at 59 ("Every party in federal court must demonstrate proper standing to bring a case").

414. *Id.* at 53, 62–63.

415. The trustee in this case was not, strictly speaking, a bankruptcy trustee. Rather, a chapter 11 plan had been confirmed, and all causes of action owned by the bankruptcy trustee, had been conveyed to the 1031 Debtors Liquidation Trust. The plaintiff trustee was in charge of this post-confirmation trust, not the pre-confirmation bankruptcy estate. *Id*. at 55.

416. *Id.* at 63. The court could have evaded the issue of *ius tertii*. The prohibited *ius tertii* defense is *Y*'s statement: any cause of action belongs to *V* not to *D Corp.*'s trustee. A chapter 11 plan had been confirmed under which *V* conveyed their equitable interests to the postconfirmation debtor. *Id.* at 57. Therefore, the trustee owned the right to enforce *V*'s rights against *Y*. *Ius tertii*, even if permitted, was useless.

Ordinarily, a thief such as *X* can convey no title to a good faith purchaser such as *Y*. But since we are dealing with funds, *X* has power to "negotiate" the stolen property to *Y*. Thus, *Y* took *D Corp*.'s funds free and clear of *D Corp*.'s ownership rights.

By characterizing the case as a fraudulent transfer, the trustee got away with something. The trustee was able to characterize *Y* as the initial transferee of *D Corp*.'s fraudulent transfer.[417] *Y*'s defense therefore had to fall within the purview of Bankruptcy Code § 548(c), which provides:

> [A] transferee . . . of such a [fraudulent] transfer . . . that takes for value and in good faith has a lien on or may retain any interest transferred . . . to the extent that such transferee . . . gave value *to the debtor* in exchange for such transfer . . .[418]

Satisfaction of an antecedent debt is considered value,[419] *Y*'s problem was that this was value given to *X*, not "to the debtor."[420] Therefore, transfixed by the *ius tertii* question, the court overlooked the fact that this was no fraudulent transfer case. If it is not a fraudulent transfer case, then Bankruptcy Code § 550(a) did not apply. If § 550(a) did not apply, then *Y*'s receipt of payment on *X*'s debt constituted a good faith purchaser defense.

In effect, by characterizing the case as a fraudulent transfer, the trustee was denying that *X* was a thief. Rather, the trustee implied that *X* was a faithful agent authorized by *D Corp*. to convey *D Corp*. property to *Y*. But this was quite contrary to the facts.[421]

Another case in which *ius tertii* misled the court into an unjust result was *Taylor Associates v. Diamant (In re Advent Management Corp)*,[422] *D Corp*. was

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417. 11 U.S.C. § 550(a)(1) (2012). Actually, *D Corp.* sent the funds to an escrow agent, which then sent the funds to *Y*. *In re 1031 Tax Grp.*, 439 B.R. at 54–55. The court elected to ignore the transfer to the escrow agent as a transfer on the grounds that the escrow agent was a mere conduit. *Id.* at 69. I have argued against the wisdom of using this phrase. Carlson, *Conduit*, *supra* note 1. In fact, the phrase covers a variety of property ideas. Here it would be appropriate to say that *D Corp.* transferred to the escrow agent in exchange for which the escrow agent promised to follow instructions. Later, *D Corp.* instructed the agent to pay *Y*. Properly, what *Y* received was the agent's obligation to pay. The escrow agent *was* an initial transferee of *D Corp.* funds. But what *Y* received was *D Corp.*'s right to be paid by the escrow agent. So analyzed, we can dispense with the fiction that the escrow agent was not a transferee.

418. 11 U.S.C. § 548(c) (emphasis added).

419. *See* 11 U.S.C. § 548(d)(2)(A) ("'[V]alue means . . . satisfaction . . . of . . . antecedent debt.").

420. *In re 1031 Tax Group, LLC*, 439 B.R. at 73.

421. *Id*. at 53 ("it is undisputed that the funds were stolen.").

422. 178 B.R. 480 (B.A.P. 9th Cir. 1995), *aff'd*, 104 F.3d 293 (9th Cir. 1997).

the shareholder of *V Corp*. *D Corp*. managed the affairs of *V Corp*. *D Corp*. "diverted" *V Corp*. funds, commingling those funds with *D Corp*. funds (which also came from *V Corp*. in the form of managerial fees). One of *V Corp*.'s creditors was C. *D Corp*. paid *C*, there by discharging *V Corp*.'s debt. *D Corp*. was soon bankrupt. *D Corp*.'s trustee claimed *C* received *D Corp*. property as a fraudulent transfer. When *C* tried to claim that the cash was from *V Corp*., *ius tertii* enjailed *C*'s tongue, doubly portcullised by his teeth and lips.

Ius tertii misled the court into overlooking an obvious solution in *C*'s favor. Let us concede that *D Corp*. used its own funds to pay *C*. *D Corp*. received something valuable from *C*. Through subrogation, *D Corp*. bought *C*'s right against *V Corp*. If *V Corp*. was solvent, then this subrogation right was a dollar-for-dollar reasonably equivalent value.[423] *C* therefore did not receive a fraudulent transfer of *D*'s property. Later, if *D*'s bankruptcy trustee were to enforce *C*'s claim against *V Corp*., pursuant to Bankruptcy Code § 542(b), *V Corp*. could assert a valid setoff, as *D Corp*. either converted *V Corp*. funds or owed the money for *V Corp*.'s "loan."

Ius tertii is powerful point when worlds collide. But the dazzling brilliance of the point should not be permitted to occlude other decisive factors.

Where *X* is silenced by invocation of *ius* tertii, what if *V* intervenes and tries to assert equitable title? Then *V* is a party before the court and *ius tertii* ceases to apply. Between *D*'s bankruptcy trustee and *V*, the court should award identifiable constructive trust property to *V*.

This obvious principle was recently ignored by the First Circuit Court of Appeals in *Darr v. Dos Santos (In re TelexFree, LLC)*.[424] Simplifying the facts of the case, *D* defrauded funds from *V* and instructed *V* to deposit the funds with *X*, in payment of claims *X* had against *D*. *D* filed for bankruptcy, and the bankruptcy trustee sued *X* for fraudulent transfer and voidable preference. *V* (in the guise of a class action) brought unjust enrichment claims directly against *X*. The bankruptcy trustee responded with an adversary proceeding seeking an injunction (in supplement to the automatic stay) preventing *V* from suing *X*.

Properly, *V* was not in violation of the automatic stay. *D* had neither legal nor equitable title to the funds. *D* (via the agency of *V*) had conveyed legal title to *X* and *V* all the while retained equitable title. True, *D* had conveyed the valueless legal title in the funds to *X*. But being valueless this transfer was not fraudulent.[425] Nor was the transfer a voidable preference. The Supreme Court

423. On subrogation as a routine defense in tripartite fraudulent transfer cases, see Carlson, *Conduit*, *supra* note 1, at 536–40.

424. 941 F.3d 576, 579–82 (1st Cir. 2019).

425. *See supra* text accompanying notes 293–294.

itself has ruled that the use of constructive trust funds to pay a debt is not a voidable preference.[426]

The First Circuit, however, ruled that the automatic stay applied because *D* had an interest in *X*'s funds. But didn't *D transfer* all interest to *X* prior to bankruptcy? Yes, but the *TelexFree* court insinuated that the transfer to *X* was a fraudulent transfer on *ius tertii* grounds. The transfer was voidable, not void.[427] This is a good point to silence *X*, but it is utterly invalid to silence *V* from asserting *V*'s own equitable interest in *X*'s funds.

The Court of Appeals also denied that constructive trust and fraudulent transfer constitutes separate worlds. They are the same world, the court thought. Thus *V*'s claim was held to be "derivative" of the bankruptcy trustee's fraudulent transfer cause of action.

> The bankruptcy court ruled that the unjust enrichment claims brought by [*V*] are derivative of the trustee's Avoidance Actions because they seek to accomplish the same thing as the trustee's actions and to go about it the same way. That is . . . [*V*'s] efforts to prove unjust enrichment will not focus on any supposed wrongdoing by individual [*X*]. Rather, [*V*] seeks to prove its unjust enrichment case through the overall fraudulent scheme created by [*D*]. That is what the trustee seeks to do.
>
> . . .
>
> But for the reasons just discussed, under the framework adopted by the bankruptcy court, the unjust enrichment claims are best understood as avoidance actions in disguise. The bankruptcy estate as a whole was harmed, not any individual [*V*].[428]

Everything in this passage is contestable. A fraudulent transfer is completely distinguishable from an unjust enrichment claim. In a fraudulent transfer case, *D* has both legal and equitable title to a thing. *D* conveys it to *X* in hindrance of the unsecured creditors. The transfer is the fraud. But in an unjust enrichment case, *D*'s acquisition of the thing is the fraud. The later transfer of legal title to *X* is *not* a fraud. *D*'s acquisition of legal title to the thing has no effect on the unsecured creditors. If anything, *D*'s acquisition positively benefited *D*'s unsecured creditors, if the constructive trust principle is negated. If the constructive trust is recognized, the bankruptcy estate was definitely *not*

426. Begier v. Internal Revenue Service, 496 U.S. 53, 67 (1990). The case involved the surrender of trust property to the beneficiary of the trust. *Id.* The case, however, should also govern here, where *D* paid *X* with *V*'s money.

427. 941 F.3d at 584.

428. *Id*. at 588.

harmed because *V*'s equitable interest never would have entered the bankruptcy estate. *V*'s cause of action in no way conflicts with the trustee's fraudulent transfer action, mainly because the trustee's fraudulent transfer action does not even exist.

TelexFree must be counted as a case in which the limits of *ius tertii* were transgressed because *V* was entirely before the court and yet was not permitted to assert *V*'s equitable interest in *X*'s funds. Indeed, the case probably stands (like *Omegas*) for the negation of constructive trust doctrine in bankruptcy cases.[429]

VI. CONCLUSION

This Article has shown that, in the liquidation of Ponzi schemes, two worlds collide—the world of constructive trust and the contradictory world of fraudulent transfer. Ponzi schemes are largely made up of constructive trust funds. When Ponzi debtors have conveyed trust funds to bad faith third parties or to donees, we are in the world of constructive trusts. Yet courts have presumed themselves to be in the world of fraudulent transfers. A fraudulent transfer, however, requires a debtor to convey legal *and* equitable to title to the third party. A Ponzi debtor conveys only legal title. Equitable title stays with the victims of the fraud.

If asked, trustees would respond with a practical observation. If the trustee does not sue the third party, no one will, as the victims of a Ponzi scheme are too disorganized to trace their trust property into the hands of a given third party. On a doctrinal level, bankruptcy trustees may claim that tracing is impossible or too expensive. Since tracing is impossible, the trust disappears, and the Ponzi debtor really is transferring debtor property in a fraudulent transfer.

I have pointed out the self-serving nature of the factual claim that tracing is impossible. Instead, the principle of *ius tertii* better justifies continued bankruptcy court jurisdiction over Ponzi schemes. But even this better rationale involves the expropriation of victim property. Where tracing is indeed possible, the bankruptcy trustee, after recovering, should properly disgorge trust property to its true owners, when and if they intervene.

My final observation is that denying standing to a trustee in Ponzi cases is unwise. But so is denying fraud victims their constructive trust remedy. SIPA[430] avoids the dilemma by giving the SIPC trustee standing to recover embezzlements for the benefit of the class of victims *as if* embezzlements were

429. *See supra* text accompanying notes 139–55.

430. *See supra* text accompanying notes 293–297.

fraudulent transfers. An expansion of bankruptcy trustee standing in a similar fashion makes a lot of common sense.