2003 BNH 025 **Note: This is an unreported opinion. Refer to AO 1050-1 regarding citation.**

UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW HAMPSHIRE

In re: Bk. No. 02-11983-JMD
Chapter 7

Charlie's Quality Carpentry, LLC,
Debtor

John W. Hanley,
Plaintiff

v. Adv. No. 02-1133-JMD

Steven Notinger, Ch. 7 Trustee,
Defendant

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MEMORANDUM OPINION

I. INTRODUCTION

John Hanley ("Hanley") filed the above captioned adversary proceeding on September 23, 2002, seeking a determination whether certain property of Charlie's Quality Carpentry (the "Debtor") is trust fund property belonging to him under section 541(d)[1] or property of the

[1] Unless otherwise indicated, all references to "section" refer to Title 11 of the United States Code.

Debtor's bankruptcy estate pursuant to section 541(a)(1). On March 14, 2003, the Chapter 7 Trustee (the "Trustee") filed a Motion for Summary Judgment (the "Motion") (Doc. No. 13). On May 13, 2003, the Court held a hearing on the Trustee's Motion and took the matter under advisement.

This Court has jurisdiction of the subject matter and the parties pursuant to 28 U.S.C. §§ 1334 and 157(a) and the "Standing Order of Referral of Title 11 Proceedings to the United States Bankruptcy Court for the District of New Hampshire," dated January 18, 1994 (DiClerico, C.J.). This is a core proceeding in accordance with 28 U.S.C. § 157(b).

II. FACTS

Hanley entered into a written contract (the "Contract") with the Debtor on April 26, 2002, for the construction of a single family residence in Barnstead, New Hampshire. The Contract stated that "any monies received during the period of the contract from the purchasers will be used to pay costs of construction, including land costs, before using such money for other purposes." Exhibit 1 to the Trustee's Affidavit (Doc. No. 13). The Contract is a simple one page form document with blanks for dates, amounts and the parties' names. Hanley contends that the Debtor assured him that any funds advanced would be maintained in a separate account and used only for the costs of his construction project. See Hanley's Objection to Motion for Summary Judgment, Exhibit 1 - Affidavit of John Hanley (Doc. No. 19).

On April 29, 2002, Hanley paid the Debtor, by check, $50,000.00 representing the deposit on the construction project. The check was deposited on April 30, 2002, into the Debtor's general operating account at Citizen's Bank (the "Bank Account") and commingled with other funds of the Debtor. The account balance after the deposit was $53,229.00. Trustee's Memorandum of Law

(Doc. No. 13). Almost immediately, the Debtor started to expend the funds, including a $25,000.00 check made payable to Brock's Building Materials on account of an antecedent debt. Over the next two weeks the Debtor paid various business and personal expenses from the Bank Account; none of the funds were used for the construction of Hanley's house.

On May 15, 2002, Hanley sued the Debtor in state court for breach of contract and other legal theories and obtained a pre-judgment attachment against the Debtor's Bank Account on May 16, 2002. At the time of the attachment, the Bank Account had a balance of $16,633.49. On June 26, 2002 (the "Petition Date"), 42 days after the Bank Account was attached, the Debtor filed a petition under Chapter 7 of the Bankruptcy Code.

Hanley's Complaint contains two Counts. In Count I, he alleges that he and the Debtor entered into an express trust relationship and Hanley tendered the $50,000.00 deposit on that basis. Hanley contends that he did not extend credit to the Debtor and by the terms of the Contract, the Debtor was not free to use Hanley's deposit for the Debtor's own benefit. Furthermore, even if the Court does not find that an express trust was formed, Hanley states that a constructive trust should be imposed based on the Debtor's fraud and misrepresentation. Finally, Hanley contends that the Trustee should be compelled to recover the preferential transfer to Brock's Building Materials, among others, for Hanley's sole benefit. In Count II, Hanley is seeking recovery from the bankruptcy estate of the entire $50,000.00 allegedly transferred in trust to the Debtor. Hanley bases his right to recovery on an argument that property obtained by the Debtor through fraudulent misrepresentation is not property of the estate. However, Hanley's argument also appears to claim a right to damages from the bankruptcy estate on account of the Debtor's alleged prepetition fraud.

In his answer to the Complaint, the Trustee brought a counterclaim against Hanley alleging that the prepetition attachment of the Debtor's Bank Account less than 90 days before the Petition

Date is avoidable as a preference (the "Counterclaim"). The Trustee also brought a third-party complaint against Citizens Bank of New Hampshire as trustee defendant seeking an order from this Court compelling the bank to turnover the funds in the attached Bank Account to the Trustee (the "Third-Party Complaint"). The Trustee seeks summary judgment on Counts I and II of the Complaint, the Counterclaim and the Third-Party Complaint.

III. DISCUSSION

A. The Summary Judgment Standard.

The standard for summary judgment is well established.[2] An order granting summary judgment is proper if "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c); see also Barbour v. Dynamics Research Corp., 63 F.3d 32, 36 (1st Cir. 1995). When considering summary judgment, the court should draw all reasonable inferences from the facts in the manner most favorable to the non-movant. See Desmond v. Varrasso (In re Varrasso), 37 F.3d 760, 763 (1st Cir. 1994).

Federal Rule of Civil Procedure 56(e) further provides that "[w]hen a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of the adverse party's pleading, but the adverse party's response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial." Fed. R. Civ. P. 56(e). Consequently, a party opposing summary judgment

[2] Fed. R. Civ. P. 56 ("Federal Rule 56") is made applicable to bankruptcy proceedings pursuant to Fed. R. Bankr. P. 7056.

must "present definite, competent evidence to rebut the motion." Maldonado-Denis, 23 F.3d at 581; see also Torres v. E.I. Dupont de Nemours & Co., 219 F.3d 13 (1st Cir. 2000) (citing Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 252 (1986)) ("[T]he mere existence of a scintilla of evidence is insufficient to defeat a properly supported motion for summary judgment"). Motions for summary judgment must be decided "on the record as it stands, not on litigants' visions of what the facts might some day reveal." Maldonado-Denis, 23 F.3d at 581. "[B]rash conjecture, coupled with earnest hope that something concrete will eventually materialize, is insufficient to block summary judgment." Id. Thus, the non-movant bears the burden of placing at least one material fact into dispute once the moving party offers evidence of the absence of a genuine issue. See Crawford v. Lamantia, 34 F.3d 28, 31 (1st Cir. 1994).

> A "genuine" issue is one "that properly can be resolved only by a finder of fact because [it] may reasonably be resolved in favor or either party." Put another way, a "genuine" issue exists if there is "sufficient evidence supporting the claimed factual dispute" to require a choice between "the parties' differing versions of the truth at trial." A "material" issue is one that "affect[s] the outcome of the suit," that is, an issue which, perforce, "need[s] to be resolved before the related legal issues can be decided."

Maldonado-Denis, 23 F.3d at 581 (citations omitted).

Although the evidence presented is to be viewed in the light most favorable to the nonmoving party, "[a]s to any essential factual element of its claim on which the non-movant would bear the burden of proof at trial, its failure to come forward with sufficient evidence to generate a trial worthy issue warrants summary judgment to the moving party." McCrory v. Spigel (In re Spigel), 260 F.3d 27, 31 (1st Cir. 2001). "[A]t the summary judgment stage the judge's function is not himself to weigh the evidence and determine the truth of the matter but to determine whether there is a genuine issue for trial." 10 Lawrence P. King, Collier on Bankruptcy ¶ 7056.05

(15th ed. rev. 2002) (citing Anderson, 477 U.S. at 249). Therefore, an inadequate opposition to a motion for summary judgment can eliminate the objecting party's ability to raise factual issues warranting trial. See Adam Coop. Bank v. Greenberg (In re Greenberg), 229 B.R. 544, 546 (B.A.P. 1st Cir. 1999).

B. Count I of the Complaint: Trust Funds belonging to Hanley

Under the Bankruptcy Code, a bankruptcy trustee is charged to collect and liquidate all property of the estate and distribute the proceeds to creditors. See 11 U.S.C. §§ 704, 725 and 726. The Bankruptcy Code broadly defines property of the estate as "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). Expressly excluded from the estate is any "[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . ." 11 U.S.C. § 541(d). The purpose of section 541(d)'s exclusion is to ensure that the trustee takes no greater rights in the property than the debtor himself had. Mid-Atlantic Supply, Inc. v. Three Rivers Aluminum Co., 790 F.2d 1121, 1124 (4th Cir. 1986) quoting S. Rep. No. 989, 95th Cong., 2d Sess. 82. Therefore, when a debtor does not own an equitable interest in the property he holds in trust for another, that interest is not property of the estate for purposes of the Bankruptcy Code. Begier v. IRS, 496 U.S. 53, 59 (1990).

Whether the funds in the Bank Account are subject to a trust is a matter involving the property rights of the Debtor and Hanley on the Petition Date. In the absence of an overarching federal interest, those property rights are determined under applicable state law. Butner v. United States, 440 U.S. 48, 54 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."). In this case there is no overarching federal interest in determining whether property held by the

Debtor is subject to a trust. Therefore, New Hampshire law shall be used to determine the property rights of the Debtor and Hanley on the Petition Date. See In re Dameron, 155 F.3d 718, 722 (4th Cir. 1998) ("Our consideration of what constitutes an 'equitable interest' subject to exclusion from the bankruptcy estate under section 541(d) is a question of state law."); Connecticut Gen. Life Ins. Co. v. Universal Ins. Co., 838 F.2d 612 (1st Cir. 1988); In re B.I. Fin. Serv. Group, Inc., 854 F.2d 351 (9th Cir. 1988); In re General Coffee Corp., 828 F.2d 699 (11th Cir. 1987); In re N.S. Garrott & Sons, 772 F.2d 462 (8th Cir. 1985).

On the Petition Date, if the Debtor held property impressed by a trust, express or constructive, the bankrupt estate would hold such property subject to the outstanding interest of the beneficiaries. Connecticut, 838 F.2d at 618; American Serv. Co. v. Henderson, 120 F.2d 525, 531 (4th Cir. 1941); 4 Lawrence King, Collier on Bankruptcy ¶ 541.13 at 541-76 (15th ed. 1994). In order to establish such a right as trust beneficiary, a claimant must make two showings: *first*, the claimant must prove the existence and legal source of a trust relationship; *second*, the claimant must identify the trust fund or property and, where the trust fund has been commingled with general property of a debtor, sufficiently trace the property or funds, the res. Connecticut, 838 F.2d at 618 (emphasis added). See Pare v. Campopiano (In re Campopiano), No. 92-11669, 1994 WL 675317, at *3, 1994 Bankr. LEXIS 1849, at *9 (Bankr. D.R.I. Nov. 23, 1994); In re Mill Concepts, 123 B.R. 938, 944-45 (Bankr. D. Mass. 1991). Whereas the first showing is generally a question of state law, the second showing is exclusively a question of federal law because it pertains to distribution of assets from an entity in a federal bankruptcy proceeding. Connecticut, 838 F.2d at 618.

1. Express Trusts

A trust is a fiduciary relationship in which one person, the trustee, holds the legal title to property subject to a fiduciary duty to deal with or use the property for the benefit of another, the beneficiary. See Restatement (Third) of Trusts § 2 (2003). The trust arises as a result of a manifestation of an intention to bring it into existence by its creator, the "settlor." Id. Accordingly, every express trust has a settlor, a trustee and a beneficiary. Id. In addition, every trust must have trust property, or a trust res, which is held by the trustee for the beneficiary. Id.

Technical language or formalities are not necessary in order to create an express trust in New Hampshire. See Trustees of Pembroke Acad. v. Epsom Sch. Dis., 75 N.H. 408 (1910). The intention of the parties is the key. Id. There only needs to be an agreement between the parties expressed either in writing, orally or by the conduct of the parties. Woburn Nat'l Bank v. Woods, 77 N.H. 172, 174 (1914). Unless the trust res consists in whole or in part of real estate, an express trust need not be in writing and can be proven by parole evidence. Barrett v, Cody, 78 N.H. 60, 66 (1915).

It is clear to the Court that in order to create an express trust in New Hampshire there must be a proper manifestation of the intention to do so, either by the settlor or in communications between the settlor and the intended trustee. The settlor must make a transfer of the trust property to the trustee. For the purposes of summary judgment the parties have stipulated that an express trust was created; however, the Trustee disputes that a proper transfer of trust property was made. The Trustee contends that since the Debtor did not deposit the check into a specially labeled "trust account" or a segregated account, but into his general operating account, the trust was never "funded." See Trustee's Memorandum of Law (Doc. No. 13).

The Third Restatement of Trusts (the "Restatement") § 10 lists five methods of creating a trust. The method applicable to the facts of this case is "a transfer inter vivos by a property owner to another person as trustee for one or more persons." Restatement (Third) of Trusts § 10 (2003). Section 16 of the Restatement, Comment b, states that, "subsequent actions of the property owner, considered together with the initial manifestation of trust intention, may constitute delivery, thereby completing the transfer and bringing the trust into being." The Court finds that the physical act of tendering a bank check for $50,000.00 is a valid inter vivos transfer would be sufficient to fund an express trust. The Debtor may have subsequently breached his fiduciary duty by depositing that check into his general operating account and utilizing the proceeds for his own benefit. However, any such breaches do not impact the creation or funding of a trust through an inter vivos transfer.

2. Constructive Trusts

The Trustee's claim that a constructive trust is a remedy and therefore is not enforceable against a bankruptcy trustee is without merit in this Circuit. The First Circuit Court of Appeals in Connecticut Gen. Life Ins. v. Universal Ins. Co., explicitly stated that, "[w]hen a debtor is in possession of property impressed by a trust, express or *constructive*, the bankrupt estate holds the property subject to the outstanding interest of the beneficiaries." 838 F.2d at 618 (emphasis added); see also In re Reider, 177 B.R. 412, 415 (Bankr. D. Me. 1994) (finding that the First Circuit recognizes that constructive trusts provides a beneficiary rights superior to those of the bankruptcy estate); In re Mill Concepts, 123 B.R. 938, 944-45 (Bankr. D. Mass. 1991) (recognizing that a constructive trust beneficiary has rights superior to that of a bankruptcy trustee). For purposes of summary judgment the Court need not decide if a constructive trust was formed, but only that if formed, the rights of the beneficiary of a constructive trust would be superior to those of the Trustee's.

3. Commingling of Funds

If Hanley is able to establish that an express or constructive trust exists and that funds were transferred in trust to the Debtor, he must be able to trace such funds in the hands of the Debtor. See, e.g., Connecticut, 838 F.2d at 618. The mere commingling of trust property with other property is not sufficient to defeat tracing. Id. In such cases, courts use the "lowest intermediate balance test." See, e.g., id. at 619; Schyluer v. Littlefield, 232 U.S. 707 (1914); Dameron, 155 F.3d at 724. The lowest intermediate balance test is grounded in the fiction that if a trustee makes a withdrawal from a mixed account for personal purposes, such withdrawal will be charged to the non-trust funds first, thus maintaining as much of the trust's funds as possible. Dameron, 155 F.3d at 724. This result is usually said to be based on the general presumption that one is presumed to do his duty, and that when an act could have been done with honest intent or with dishonest the court will interpret it as intended to be a lawful act. Bogert's Trusts and Trustees (Rev. 2d ed.) § 926 (2002). Pursuant to the lowest intermediate balance test, if the amount on deposit in the commingled fund has at all times equaled or exceeded the amount of the trust, the trust's funds will be returned in their full amount. See Connecticut, 838 F.2d at 619. However, if the commingled fund has been completely withdrawn, the trust is considered lost. Id. "Should the amount on deposit be reduced below the amount of the trust but not depleted, the claimant is entitled to the lowest intermediate balance in the account. This is based on the fiction that the trustee would withdraw non-trust funds first, retaining as much as possible of the trust fund in the account." Id. In no case is the trust permitted to be replenished by deposits made subsequent to the lowest intermediate balance. Id.

In the instant case, at the time of the bankruptcy filing, the balance of the Debtor's account was $16,633.49. Hanley claims entitlement to a trust in the amount of $50,000.00. Because the

Bank Account has been reduced below that amount but not depleted entirely, if Hanley is successful in establishing the existence of an express or constructive trust at trial, he would then need to present evidence on the lowest intermediate balance of any account where such funds were deposited, without the benefit of any deposits made after such balance was reached.

4. Trust funds traceable to the Debtor's Estate

Hanley contends that certain payments made by the Debtor prepetition[3] are directly traceable to his trust funds and to the extent that they come into the estate's possession they should be returned to him. Hanley argues that either the Trustee should be compelled to recover these prepetition transfers under section 548 or that he be allowed to step into the shoes of the Trustee and use section 548 to recover the transfers.

If these prepetition transfers are truly trust fund property then the Debtor never had any interest in the money, it was never the Debtor's "property," and the Trustee could not avoid the transfers pursuant to section 548. So, if Hanley retained title to the property even after the transfer, then that transfer is beyond the reach of the Trustee. However, if the Debtor was able to divest title from Hanley by transferring the property, then the Trustee would have standing to pursue recovery or avoidance of those transfers for the benefit of the estate.

The circumstances surrounding the Debtor's prepetition transfer of property which may have been held in trust will determine the Trustee's interest in the proceeds and the recovery of such transfers.

> . . . [O]ne cannot transfer better title to a chattel than he possesses. See R. Brown, The Law of Personal Property § 67. One who steals property cannot pass good title to it, even to a bona fide purchaser. See Western Sur. Co. v. Redding, 626 P.2d 437, 439 (Utah 1981);

[3] Specifically a $25,000.00 payment to Brock's Building Materials and a $740.50 payment to National Grange Mutual, both made within 90 days of the Debtor's bankruptcy petition.

> Gurley v. Phoenix Ins. Co., 101 So.2d 101 (Miss. 1958); Allstate Ins. Co. v. Estes, 345 So.2d 265 (Miss.1977). *Cf.* Butler v. Farmers Ins. Co., 616 P.2d 46, 47 (1980) (bona fide purchaser of stolen property has a title defeasible only by the rightful owner). On the other hand, under modern law, a person who obtains property by fraud can transfer good title to a bona fide purchaser. See U.C.C. § 2-403; Paschal v. Hamilton, 363 So.2d 1360 (Miss.1978). Contra Hewitt v. Malone, 124 S.E.2d 501 (Ga.1962); Wyatt v. Singley, 118 S.E.2d 841 (Ga.1961). A person who obtains property by fraud must therefore have title to the property, or at least some legally recognized interest in the property. Thus, although it may be true that one who steals or embezzles property obtains no title to it, one who obtains property by fraud obtains some interest in it, namely, a defeasible title.

In re Universal Clearing House Co., 60 B.R. 985, 997 (D. Utah 1986). Therefore, if the transferees were bona fide purchasers with no knowledge of the Debtor's fraud, Hanley's title would pass to the transferees. Hanley's burden at trial would be to show that either the transferees knew or should have known that the Debtor was improperly using trust fund property. Absent such a showing, the Trustee would be entitled to seek recovery of such transfers solely for the benefit of the estate.

For the reasons discussed above, the Trustee's motion for summary judgment on Count I shall be denied.

C. Count II of the Complaint: Fraud and Misrepresentation

To the extent that Hanley can establish the necessary elements under Count I of his Complaint, he may recover from the Trustee property that is not property of the estate. Any claim by Hanley for damages arising from any prepetition fraud, misrepresentation or breach of contract by the Debtor would constitute a claim against the estate. Under the Bankruptcy Code a "claim" means a:

> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, . . . disputed, 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, . . .

11 U.S.C. § 101(5). A creditor holding a claim may file a proof of claim. 11 U.S.C. § 501. A proof of claim is subject to objection by a party in interest and is ultimately allowable under section 502 of the Bankruptcy Code.

Hanley's claims for fraud and misrepresentation under Count II of the Complaint amount to the commencement of a judicial action which could have been commenced against the Debtor to recover on a claim that arose before the commencement of the bankruptcy proceeding. Such actions are stayed under the provisions of section 362(a)(1) of the Bankruptcy Code. The sole method for Hanley to recover from the bankruptcy estate on account of the claims raised in Count II is to file a proof of claim. Accordingly, the Trustee's motion for summary judgment under Count II shall be granted.

D. The Counterclaim

It is undisputed that Hanley perfected an attachment of the Debtor's Bank Account at Citizen's Bank on May 16, 2002, less than 90 days prior to the Petition Date. The Trustee has alleged that the attachment is avoidable as a preferential transfer under section 547(b) of the Bankruptcy Code. Hanley has not disputed the Trustee's allegations. Instead Hanley argues that because the funds in the Bank Account are traceable to an express or constructive trust, the attachment is not avoidable as a preference since it did not effectuate a transfer of property of the estate.

Hanley's argument on the Trustee's Counterclaim is unavailing. It is undisputed that the Debtor held legal title to the Bank Account on the Petition Date and that legal title passed to the Trustee. 11 U.S.C. § 541(d). To the extent that Hanley prevails under Count I of his Complaint, he will establish equitable title to some or all of the funds in the account. Hanley may not establish a

right to the funds in the Bank Account superior to the Trustee via a transfer (i.e., the attachment) which is otherwise preferential. His sole remedy is to establish an equitable interest that is superior to the Trustee's interest. Accordingly, the Trustee's motion for summary judgment on the Counterclaim shall be granted.

E. The Third-Party Complaint

For the same reasons that the Court is granting the Trustee's motion for summary judgment on the Counterclaim, the Trustee is entitled to summary judgment on the Third-Party Complaint.

IV. CONCLUSION

Accordingly, for the reasons stated above, the Court by separate order shall deny summary judgment on Count I of the Complaint and grant summary judgment in favor of the Trustee on Count II of the Complaint, the Counterclaim and the Third-Party Complaint. This opinion constitutes the Court's findings of fact and conclusions of law in accordance with Federal Rule of Bankruptcy Procedure 7052. The Court will issue a separate order consistent with this opinion.

Entered at Manchester, New Hampshire.

Dated: August 25, 2003

/s/ J. Michael Deasy
J. Michael Deasy
Bankruptcy Judge