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Dean A. Dulchinos

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BANKRUPTCY LAW—DETERMINING PROPERTY INTERESTS IN FUNDS RECOVERED PURSUANT TO THE SETTLEMENT OF A SECTION 547 PREFERENCE ACTION

INTRODUCTION

A debtor in financial distress often makes transfers of its property that have the effect of preferring some creditors over others. If the debtor subsequently enters bankruptcy, section 547(b) of the Bankruptcy Code¹ authorizes the trustee² of the bankruptcy estate³ to avoid certain of these prepetition transfers, thereby recovering property for the benefit of the estate.⁴ The property recovered for the benefit of the estate becomes available either for general distribution to the debtor's creditors in a liquidation proceeding or for use by the estate in a reorganization.⁵

However, the trustee's section 547(b) preference avoidance powers only apply to transfers "of an *interest of the debtor* in property."⁶ Often, a debtor will be in possession of property in which others also have an interest. Such situations include escrow and trust arrangements. The language of section 547(b) seems to indicate that property held in this fashion would not be subject to a preference action.⁷ In this regard, courts have ruled that property held in trust by the debtor and money held in escrow by the debtor do not become part of the bankruptcy estate.⁸

1. 11 U.S.C. § 547(b) (1988). The Bankruptcy Code is the name commonly used when referring to the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1988)).

2. See *infra* note 12 for an explanation of the term "bankruptcy trustee."

3. See *infra* notes 11-13 and accompanying text for an explanation of the term "bankruptcy estate."

4. These prior transfers are termed "preferences" by § 547. See *infra* notes 14-20 and accompanying text for an explanation of "preferences."

5. See *infra* note 29 for an explanation of liquidation and reorganization proceedings.

6. 11 U.S.C. § 547(b) (1988) (emphasis added).

7. See *id.*

8. See, e.g., *Turley v. Mahan & Rowsey, Inc.* (*In re Mahan & Rowsey, Inc.*), 817 F.2d 682, 684 (10th Cir. 1987) (stating that money held in constructive trust by the debtor did not become part of the bankruptcy estate); *Gulf Petroleum, S.A. v. Collazo*, 316 F.2d 257, 261 (1st Cir. 1963) (concluding that money held in escrow by the debtor did not become property of the bankruptcy estate); *Stickney v. General Elec. Co.* (*In re Spear Eng'rs, Inc.*), 44 F.2d 362, 365-66 (4th Cir. 1930) (holding that money held in escrow by a debtor may constitute a trust fund for those entitled to it).

However, a complication arises when the debtor has misappropriated trust or escrow funds prior to bankruptcy, and the trustee in bankruptcy later comes into possession of the misappropriated funds. In this instance, the trustee in bankruptcy may be inclined to regard such funds as recovered for the benefit of the estate under section 547(b), while the beneficiary or depositor of the funds may claim ownership of them. In *Research-Planning, Inc. v. Segal (In re First Capital Mortgage Loan Corp.)*,⁹ the Court of Appeals for the Tenth Circuit addressed this problem for the first time. The Tenth Circuit held in favor of the trustee, thus allowing all creditors of the estate to share in the funds.¹⁰

This Note considers the dilemma that arises when the bankruptcy trustee comes into possession of misappropriated escrow funds pursuant to the settlement of a section 547 preference action. It focuses on the interpretation of section 547 regarding the type of property interest subject to the trustee's section 547 avoidance powers. Section I discusses the mechanics of a section 547 preference action and explores the primary purpose of section 547. Section II sets out the facts of *First Capital* and the reasoning of the bankruptcy court, district court and the court of appeals. Section III then analyzes the decision of the United States Court of Appeals' for the Tenth Circuit in *First Capital*, which permitted the trustee to recover misappropriated escrow funds for the benefit of the estate, and suggests that the decision is in conflict with the basic tenets of both property and bankruptcy law as applied to misappropriated trust funds.

I. BACKGROUND

When a bankruptcy petition is filed, a bankruptcy estate is immediately created under section 541(a) of the Bankruptcy Code.¹¹ The bankruptcy estate includes all property in which the debtor has a legal or equitable interest and all property recovered by the bankruptcy trustee¹² for the benefit of the estate.¹³ In certain situations, the Bankruptcy Code, under section 547(b), allows the trustee in bankruptcy to

9. 917 F.2d 424 (10th Cir. 1990) (en banc).

10. *Id.* at 429.

11. 11 U.S.C. § 541(a) (1988).

12. The "bankruptcy trustee" is a person appointed by the bankruptcy court to take charge of the estate. Under 11 U.S.C. § 323 (1988), "[t]he trustee . . . is the representative of the estate" and "has capacity to sue and be sued." *Id.*

13. 11 U.S.C. § 541(a) (1988). Section 541(a) provides in pertinent part as follows:

The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

recover a transfer made by the debtor prior to the commencement of the bankruptcy case.¹⁴ If the conditions of section 547(b) are met, the recovered preference becomes part of the bankruptcy estate under section 550¹⁵ and is available for distribution to creditors in a liquidation proceeding or for use by the estate in reorganization.¹⁶

The legislative history defines a section 547 preference as “a transfer that enables a creditor to receive payment of a greater percentage of his claim against the debtor than he would have received if the transfer had not been made and he had participated in the distribu-

(1) [A]ll legal or equitable interests of the debtor in property as of the commencement of the case.

....

(3) Any interest in property that the trustee recovers under section . . . 550 . . . of this title.

....

(7) Any interest in property that the estate acquires after the commencement of the case.

Id.

14. Section 547(b) provides in pertinent part as follows:

[T]he trustee may avoid any transfer of an interest of the debtor in property—

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made—
 - (A) on or within 90 days before the date of the filing of the petition; or
 - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
- (5) that enables such creditor to receive 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.

11 U.S.C. § 547(b) (1988).

For an in-depth discussion of the mechanics of § 547, see Beverly J. Hall, Note, *Preferences and Setoffs: Sections 547 and 553*, 2 BANKR. DEV. J. 49, 50-75 (1985). See also Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3 (1986) (history of preference law); Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713 (1985) (development of preference law).

15. Section 550(a) provides as follows: “[T]o the extent that a transfer is avoided under section . . . 547 . . . of this title, the trustee may recover, for the benefit of the estate, the property transferred” 11 U.S.C. § 550(a) (1988).

See *supra* note 13 for the text of § 541(a), which includes within the estate property recovered under § 550.

16. See *infra* note 29 for an explanation of liquidation and reorganization proceedings.

tion of the assets of the bankrupt estate."¹⁷ The congressional purpose in allowing the recovery of preferences for the benefit of the bankruptcy estate is twofold. First, by allowing the bankruptcy trustee to avoid prebankruptcy transfers, creditors are discouraged from "racing to the courthouse to dismember the debtor during his slide into bankruptcy."¹⁸ Often, this protection will enable the debtor to work its way out of a difficult financial situation by cooperating with creditors.¹⁹ Second, and of greater importance, "the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor."²⁰

However, the power of the trustee to recover property for the benefit of the estate under section 547 is subject to the requirement that the debtor have an interest in such property.²¹ Additionally, in its discussion of property of the estate in the Senate Report²² on the Bankruptcy Reform Act of 1978,²³ Congress clearly manifests an intent to limit section 541 so that only property in which the debtor has an interest may become property of the estate.²⁴ Consequently, sections 541 and 547, as well as the Senate Report, indicate that the bankruptcy trustee does not have the power to include any property in the estate which does not belong to the debtor.

17. H.R. REP. NO. 595, 95th Cong., 1st Sess. 177 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138.

18. *Id.*

19. *Id.*

20. *Id.* See Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 735-39, 780-87 (1991) for a comparison of two suggested rationales underlying bankruptcy law and their explication of the equality of distribution principle.

21. 11 U.S.C. § 547(b) (1988).

22. S. REP. NO. 989, 95th Cong., 2d Sess. 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5868.

23. *See supra* note 1.

24. S. REP. NO. 989, *supra* note 22, at 82, *reprinted in* 1978 U.S.C.C.A.N. at 5868. The Senate Report states as follows:

Though [§ 541] will include choses in action and claims by the debtor against others, it is not intended to expand the debtor's rights against others more than they exist at the commencement of the case. . . .

. . . .

Situations occasionally arise where property ostensibly belonging to the debtor will actually not be property of the debtor, but will be held in trust for another. For example, if the debtor has incurred medical bills that were covered by insurance, and the insurance company had sent the payment of the bills to the debtor before the debtor had paid the bill for which the payment was reimbursement, the payment would actually be held in a constructive trust for the person to whom the bill was owed.

Id.

II. RESEARCH-PLANNING, INC. V. SEGAL (IN RE FIRST CAPITAL MORTGAGE LOAN CORP.)²⁵

A. Facts

The plaintiff, Research-Planning, Inc. ("Research-Planning") contracted to loan \$260,000 to a third party who intended to invest the funds in real property. Research-Planning deposited the funds in escrow with First Capital Mortgage Loan Corp. ("First Capital"), which placed the escrow funds in its general account. During the following week, First Security Bank of Utah ("First Security") drew two checks on First Capital's general account in the amounts of \$66,000 and \$2,489.66²⁶ in satisfaction of debts owed to it by First Capital.²⁷ The escrow agreement with Research-Planning did not permit First Capital to release the funds to First Security. Consequently, the payment of these funds to First Security constituted a breach of the escrow agreement. First Security was not aware of the misappropriation of the funds it received.²⁸

After the misappropriation of the escrow funds, First Capital became the object of an involuntary bankruptcy proceeding under Chapter 7²⁹ of the Bankruptcy Code.³⁰ The trustee in bankruptcy brought two actions against First Security to recover, as avoidable preferences under section 547,³¹ the funds paid to it by First Capital. First Security settled these actions by voluntarily paying the disputed funds to the trustee.³² Research-Planning then brought suit against the trustee, claiming that the funds recovered from First Security were subject to a

25. 917 F.2d 424 (10th Cir. 1990) (en banc).

26. *Id.* at 425. The remainder of the escrow funds were disbursed by the debtor, First Capital, and were not at issue in this case. The Tenth Circuit Court of Appeals assumed that Research-Planning never recovered these funds. *Id.* at 426 n.2.

27. First Capital's bank had refused to honor these checks prior to the deposit of the escrow funds due to insufficient funds in First Capital's general account. *Id.* at 426. This fact indicates that the funds paid to First Security were the same escrow funds that Research-Planning deposited with First Capital.

28. *Id.*

29. 11 U.S.C. §§ 701-766 (1988). Section 726 provides for the pro rata distribution of the debtor's assets among creditors where a Chapter 7 liquidation proceeding has been instituted. *Id.* A Chapter 7 proceeding is designed to liquidate the debtor's assets, pay off the debtor's creditors and discharge the debtor from his other debts. BLACK'S LAW DICTIONARY 148 (6th ed. 1990). A Chapter 7 proceeding differs in this respect from rehabilitative proceedings (e.g., Chapter 11 and Chapter 13), which attempt to reorganize the debtor's affairs and allow it to repay creditors pursuant to a plan that avoids liquidation. *Id.*

30. *First Capital*, 917 F.2d at 425.

31. *Id.* at 426. See *supra* note 14 for the elements of a § 547 preference action.

32. *Id.*

trust in Research-Planning's favor and, therefore, were not available for distribution to First Capital's general creditors.³³

B. *United States Bankruptcy Court for the District of Utah*³⁴

Research-Planning argued that the settlement funds were trust property traceable to the escrow deposit and, thus, these funds were not subject to the trustee's section 547 powers.³⁵ Research-Planning further contended that if the other creditors were allowed to share in these funds, they would be unjustly enriched since the trustee had no power under the Bankruptcy Code to recover the funds for the benefit of the estate.³⁶ The bankruptcy court agreed that if an express trust³⁷ existed or if a constructive trust³⁸ should be imposed, Research-Planning would be entitled to the funds. However, the court found the facts inappropriate for the imposition of either type of trust.³⁹

The court concluded that an express trust did not exist because the funds were not traceable beyond the transfer to First Security.⁴⁰ Additionally, the court declined to impose a constructive trust on the funds because this would defeat the fundamental bankruptcy policy of creditor equality.⁴¹ The court reasoned that since the bankruptcy trustee represents all creditors, it would be inequitable to allow his avoidance powers to benefit only Research-Planning.⁴² Consequently, the court dismissed Research-Planning's complaint.⁴³ Research-Planning appealed to the United States District Court for the District of Utah.

33. *Id.*

34. *Research-Planning, Inc. v. Segal (In re First Capital Mortgage Loan Corp.)*, 60 B.R. 915 (Bankr. D. Utah 1986).

35. *Id.* at 916.

36. *Id.* at 916-17.

37. An "express trust" is defined as "[a] trust directly created for specific purposes in contrast to a constructive . . . trust which arises by implication of law or the demands of equity." BLACK'S LAW DICTIONARY 1511 (6th ed. 1990).

38. A "constructive trust" is an equitable remedy which requires proof of three elements: (1) a wrongful act; (2) specific property acquired by the wrongdoer which is traceable to the wrongful behavior; and (3) an equitable reason why the party holding the property should not be allowed to keep it. *Merrill v. Abbott (In re Independent Clearing House Co.)*, 41 B.R. 985 (Bankr. D. Utah 1984).

39. *First Capital*, 60 B.R. at 917-18.

40. The court relied on the *Restatement of Restitution* which provides that "where a person wrongfully disposes of the property of another but the property cannot be traced into any product, the other has merely a personal claim against the wrongdoer." RESTATEMENT OF RESTITUTION § 215(1) (1937). *See infra* note 70.

41. *First Capital*, 60 B.R. at 919-20.

42. *Id.* at 919.

43. *Id.* at 920.

C. *United States District Court for the District of Utah*⁴⁴

The district court began its analysis by accepting, *arguendo*, that First Capital held the escrow funds in trust for Research-Planning.⁴⁵ The court reasoned, however, that when First Capital wrongfully transferred the funds to First Security, both legal and equitable title vested in First Security by virtue of its status as a bona fide purchaser.⁴⁶ As a result, the court held that Research-Planning had no claim to the funds in the hands of First Security. Instead, Research-Planning's claim was against First Capital, which made Research-Planning only an unsecured creditor of First Capital.⁴⁷

Research-Planning argued that the trustee's recovery of the funds put the parties in the position they occupied prior to the transfers.⁴⁸ Research-Planning thus asserted that the reacquisition of the funds by the trustee, as agent for the debtor, revived the trust in favor of Research-Planning.⁴⁹ On the basis of this reasoning, Research-Planning concluded that the bankruptcy trustee, as escrow agent, succeeded to First Capital's interest in the funds, and Research-Planning, as escrow depositor, had an interest in the funds superior to that of the trustee.⁵⁰

The court refused to adopt Research-Planning's logic and held that a trustee succeeds to the rights of the transferee in an avoided transfer.⁵¹ The court rejected Research-Planning's argument that a

44. *Research-Planning, Inc. v. Segal (In re First Capital Mortgage Loan Corp.)*, 99 B.R. 462 (D. Utah 1987).

45. *Id.* at 465 n.4. Strictly speaking, an escrow agent is not a trustee because he does not hold legal title to the escrow property. The depositor retains legal title until the escrow conditions are either accomplished or abandoned. *Id.* See *Tucker v. Dr. P. Phillips Co.*, 139 F.2d 601, 603 (5th Cir. 1943).

However, at least one court has ruled that escrow funds are held subject to a trust in favor of the depositor. See *Parker State Bank v. Pennington*, 9 F.2d 966 (8th Cir. 1925).

46. *First Capital*, 99 B.R. at 465-66 (relying on RESTATEMENT OF RESTITUTION § 172 (1936)). A "bona fide purchaser" is defined as "[o]ne who has purchased property for value without any notice of any defects in the title of the seller." BLACK'S LAW DICTIONARY 177 (6th ed. 1990).

47. *First Capital*, 99 B.R. at 464. The court did not explain this conclusion, but it apparently rests on the assumption that the claim for breach of fiduciary duty, which Research-Planning had against First Capital for misappropriating the escrow funds, was an unsecured claim.

48. *Id.* at 466.

49. *Id.* (relying on *Turner v. Kirkwood*, 49 F.2d 590, 596 (10th Cir.), *cert. denied*, 284 U.S. 635 (1931)); see also *Angeles Real Estate Co. v. Kerxton (In re Construction General, Inc.)*, 737 F.2d 416, 418 (4th Cir. 1984) (contending that the bankruptcy trustee stands in the shoes of the debtor).

50. *First Capital*, 99 B.R. at 466. Research-Planning relied on *Gulf Petroleum S.A. v. Collazo*, 316 F.2d 257, 261 (1st Cir. 1963) (holding that a bankruptcy trustee has a duty to return escrow funds to the depositor upon failure of the escrow condition).

51. *First Capital*, 99 B.R. at 466 (relying on *In re Vermont Fiberglass, Inc.*, 44 B.R.

revival of the trust had occurred on two grounds. First, since the filing of a bankruptcy petition creates a bankruptcy estate under section 541 of the Bankruptcy Code,⁵² the estate and the debtor are separate entities. Under section 323 the trustee is a "representative of the estate," and not a representative of the debtor.⁵³ Thus, the trustee and the debtor cannot be equated, and the trustee cannot be an agent of the debtor for purposes of reviving the trust in the hands of the trustee.⁵⁴ Consequently, the court found that the trustee could not have succeeded to First Capital's interest as escrow agent in the funds. Second, the court noted that the language of section 550 clearly states that avoided transfers are recovered for the benefit of the estate.⁵⁵ Thus, the court held that section 550 requires the inclusion of the funds in the estate.

After concluding that the recovered escrow funds were property of the bankruptcy estate, the court proceeded to consider whether a constructive trust should be imposed on the funds in favor of Research-Planning.⁵⁶ The court held that a constructive trust should not be imposed on the funds. The court reasoned that if it were not for First Capital's bankruptcy and the assertion of the trustee's avoidance powers, First Security would have been able to retain the funds as a bona fide purchaser.⁵⁷ Therefore, it would be inequitable to give Research-Planning priority over First Capital's other unsecured creditors because this would place Research-Planning in a better position than it was in prior to the bankruptcy.⁵⁸ Consequently, the court affirmed the bankruptcy court's dismissal of Research-Planning's complaint. Research-Planning appealed to the United States Court of Appeals for the Tenth Circuit.

505, 511 (Bankr. D. Vt. 1984) and *Staats v. Barry* (*In re Barry*), 31 B.R. 683 (Bankr. S.D. Ohio 1983)).

52. See *supra* note 13 for the text of § 541(a).

53. 11 U.S.C. § 323 (1988).

54. *First Capital*, 99 B.R. at 467; see also *Merrill v. Abbott* (*In re Independent Clearing House Co.*), 41 B.R. 985, 999 (Bankr. D. Utah 1984), *aff'd in part and rev'd in part on other grounds sub nom. Merrill v. Dietz* (*In re Universal Clearing House Co.*), 62 B.R. 118 (Bankr. D. Utah 1986).

55. See 11 U.S.C. § 550 (1988).

56. *First Capital*, 99 B.R. at 467. See *supra* note 38 for the elements required to impose a constructive trust.

57. *Id.* at 468.

58. *Id.*

D. *United States Court of Appeals for the Tenth Circuit—
Panel Decision*⁵⁹

1. Majority⁶⁰

On appeal, a panel of the Court of Appeals for the Tenth Circuit reversed the district court decision⁶¹ and held that the funds should be returned to Research-Planning.⁶² The court focused on the language of section 547(b), which grants the trustee the power to avoid transfers of property in which the debtor had an interest.⁶³ The court reasoned that since First Capital had no title to the escrow funds in its possession, those funds could not be recovered for the bankruptcy estate under section 547.⁶⁴ The fact that the trustee asserted his avoidance powers and First Security relented by settling did not, in itself, change the ownership of the funds.⁶⁵ In reality, the trustee came into possession of the funds by a mere fortuity.

Additionally, the court determined that First Security's temporary status as a bona fide purchaser did not divest Research-Planning of the ownership of the funds.⁶⁶ The court reasoned that First Security was shielded from a claim for the funds during the time it held them due to its status as a bona fide purchaser. As soon as the funds came into the possession of the bankruptcy trustee, however, First Security's bona fide purchaser status became irrelevant with respect to the relationship between the trustee and Research-Planning. On this basis, the court reversed the bankruptcy and district court decisions and held in favor of Research-Planning.⁶⁷

2. Dissent⁶⁸

Judge Seymour, in a dissenting opinion, relied on the tracing ar-

59. *Research-Planning, Inc. v. Segal (In re First Capital Mortgage Loan Corp.)*, 872 F.2d 335 (10th Cir. 1989) (per curiam) (2-1 decision with Judge Seth joined by a district court judge comprising the majority).

60. *Id.*

61. For a discussion of the district court decision see *supra* notes 44-58 and accompanying text.

62. *First Capital*, 872 F.2d at 335.

63. See *supra* note 14 for the text of 11 U.S.C. § 547(b) (1988).

64. *First Capital*, 872 F.2d at 336 (relying on the district court's determination that First Capital, as escrow agent, had no title to, and therefore no interest in, the escrow funds).

65. *Id.* at 336-37.

66. *Id.* at 337.

67. *Id.*

68. One member of the three-judge panel, Judge Seymour, dissented in a separate opinion. *Id.*

gument made previously by the bankruptcy court.⁶⁹ Judge Seymour urged that since the funds were transferred to a bona fide purchaser, Research-Planning's only recourse became a general claim for damages against First Capital.⁷⁰ When the bankruptcy petition was filed, Research-Planning remained a general unsecured creditor of First Capital, and the recovery of the funds by the trustee did not change this status. Thus, Judge Seymour asserted that Research-Planning should take its place in line with all other general unsecured creditors of First Capital.⁷¹ The trustee in bankruptcy appealed the panel decision.

E. *United States Court of Appeals for the Tenth Circuit—En Banc*⁷²

1. Majority⁷³

On appeal, the Tenth Circuit, sitting en banc, vacated the panel decision⁷⁴ and affirmed the district court's decision⁷⁵ that the funds were property of First Capital's bankruptcy estate.⁷⁶ The court relied on "the unambiguous language of the Code" in sections 541(a)⁷⁷ and 550⁷⁸ for the conclusion that avoided transfers, by definition, are recovered for the benefit of the estate and become property of the estate.⁷⁹ In order to apply this conclusion to the facts of the case, the court made the assumption that "property recovered in a court-approved settlement of a preference action is treated similarly to property recovered after judgment on the same action."⁸⁰

69. *First Capital*, 872 F.2d at 337 (Seymour, J., dissenting). See *supra* note 40 and accompanying text for a discussion of this argument.

70. Judge Seymour relied on 4 COLLIER ON BANKRUPTCY ¶ 541.13 at 541-76 to 541-77 (L. King ed., 15th ed. 1988) which states that the beneficiary of a trust must be able to trace its funds into some assets held by the debtor *at the time the bankruptcy petition is filed* in order to recover them.

In this case, the funds were not in First Capital's possession at the time of bankruptcy nor were any assets to which the funds could be traced. *First Capital*, 872 F.2d at 337-38.

71. *First Capital*, 872 F.2d at 338.

72. *Research-Planning, Inc. v. Segal (In re First Capital Mortgage Loan Corp.)*, 917 F.2d 424 (10th Cir. 1990).

73. Judge Seymour authored the majority opinion in which Chief Judge Holloway, and Circuit Judges McKay, Logan, Moore, Anderson, Tacha, Baldock, Brorby, and Ebel joined.

74. See *supra* notes 59-71 and accompanying text.

75. See *supra* notes 44-58 and accompanying text.

76. *First Capital*, 917 F.2d at 429.

77. See *supra* note 13 for the text of § 541(a).

78. See *supra* note 15 for the text of § 550(a).

79. *First Capital*, 917 F.2d at 427.

80. *Id.* This assumption is necessary to the court's analysis because the court relied on the language of §§ 541(a) and 550 for the premise that all recovered preferences auto-

In a separate equity argument, the court bolstered its decision by citing the "prime bankruptcy policy of equality of distribution among creditors of the debtor."⁸¹ The court reasoned that if First Capital had not been involuntarily placed in bankruptcy, and if the trustee had not asserted his avoidance powers, neither Research-Planning nor First Capital would have had any claim for the funds against the bona fide purchaser, First Security. Therefore, to allow Research-Planning to be made whole by the exercise of the trustee's avoidance powers would frustrate Congress' purpose in granting the power, namely, equality of distribution among creditors.⁸²

2. Dissent⁸³

Judge Seth's key point of dissension was with the majority's assumption that the settlement of a preference action has the same effect as a judgment allowing the avoidance of the preference.⁸⁴ Judge Seth argued that since the funds were not the debtor's property, the trustee, under section 547, had no power to recover them as a preference. In the absence of any statutory power, mere possession by the trustee does not make the funds part of the bankruptcy estate.⁸⁵ Judge Seth asserted that, "the bare fact that suit was filed and that the funds were paid cannot be enough in these circumstances to launder the trust out of the funds in the hands of the Trustee in Bankruptcy."⁸⁶

Additionally, Judge Seth, citing section 541(d),⁸⁷ argued that to allow the trustee to recover trust funds to the exclusion of the beneficiary's interest would be contrary to the intent of Congress in granting the avoidance power.⁸⁸ He noted that section 541(d) indicates that the trustee only receives the property interest that the debtor had and

matically become part of the bankruptcy estate regardless of any prior property interest held in them by third parties. *Id.* See *supra* notes 13 and 15 respectively for the text of §§ 541(a) and 550(a).

81. *Id.* at 428 (quoting H.R. REP. NO. 595, 95th Cong., 1st Sess. 177 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6138).

82. *Id.*

83. Judge Seth was the sole dissenter.

84. *First Capital*, 917 F.2d at 429 (Seth, J., dissenting).

85. *Id.* at 430.

86. *Id.*

87. 11 U.S.C. § 541(d) (1988), in relevant part, states as follows:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate under subsection (a)(1) . . . 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.

Id.

88. *First Capital*, 917 F.2d at 431.

nothing more.⁸⁹ Under this reading of the language, the trustee in this case received no title to the escrow funds since the debtor, as escrow agent, had no title to the funds.⁹⁰

III. ANALYSIS

The majority's analysis in *First Capital* creates an anomaly in bankruptcy law that should not exist. Simply stated, the Court of Appeals for the Tenth Circuit allowed the bankruptcy trustee to appropriate escrow funds that he would not have had any claim to had the debtor been in possession of those funds at the commencement of the bankruptcy proceeding. The determinative factor in the Tenth Circuit Court of Appeals' decision was that the funds were temporarily in the possession of a third party bona fide purchaser.⁹¹ As the district court conceded, "Admittedly, this result is not wholly satisfactory."⁹² That court continued, "By its actions, First Capital has precluded the court from doing complete justice among all the parties."⁹³ However, a more complete consideration of the relevant facts and statutory language results in a conclusion favoring the interest of Research-Planning in its escrow funds and maintaining the consistency of bankruptcy law.

A. *The Statutory Language and Legislative History of the Bankruptcy Code Do Not Manifest an Intent to Include Escrow Funds in the Bankruptcy Estate*

Section 541, which defines property of the estate, specifically limits the interest acquired by the estate to the same interest held by the debtor.⁹⁴ In *First Capital*, the debtor, as an escrow agent, technically had neither a legal nor an equitable interest in the trust funds it held.⁹⁵ Under section 541, it appears that Congress never intended the bankruptcy estate to include property in which the debtor does not hold some kind of interest.

Section 547, which governs the avoidance of preferences, clearly states that "the trustee may avoid any transfer of *an interest of the*

89. *Id.*

90. *Id.*

91. *Id.* at 427.

92. *Research-Planning, Inc. v. Segal (In re First Capital Mortgage Loan Corp.)*, 99 B.R. 462, 469 (D. Utah 1987).

93. *Id.*

94. 11 U.S.C. § 541(d) (1988). See *supra* note 87 for the text of this provision.

95. See *supra* note 45 and *infra* notes 117-19 and accompanying text.

debtor in property.”⁹⁶ This language appears to limit the trustee’s avoidance power to those interests in property that are held by the debtor. Certainly, Congress did not intend to confer upon the trustee the authority to recover property interests that do not belong to the debtor. It would have been irrational for Congress to define the bankruptcy estate to include only property in which the debtor has an interest and then to allow the trustee to augment the estate with other property in which the debtor has no interest.

Moreover, section 550 provides that an avoided transfer may be recovered “for the benefit of the estate.”⁹⁷ In order for this language to become operative with respect to section 547, a preference must be avoided under section 547.⁹⁸ However, as discussed above, sections 547 and 541 strictly limit the trustee’s power to avoid preferences to situations where the debtor held an interest in the property that was transferred.⁹⁹ Thus, it does not appear that section 550 authorizes the recovery of property not belonging to the debtor.¹⁰⁰

In addition to the statutory language, Congress has revealed its intent to limit the bankruptcy estate to property in which the debtor has an interest. In the Senate Report discussing section 541, the section which defines property of the estate, the Senate stated that this section “is not intended to expand the debtor’s rights against others more than they exist at the commencement of the case.”¹⁰¹ It is evi-

96. 11 U.S.C. § 547(b) (1988) (emphasis added).

97. 11 U.S.C. § 550(a) (1988).

98. See *supra* note 15.

99. See Douglass G. Boshkoff, *Bankruptcy in the Seventh Circuit: 1989-1990*, 24 IND. L. REV. 551, 552-54 (1991) (arguing that a trustee’s § 547 powers are limited by the operation of § 541 and § 550 which permit only property of the debtor to be included in the bankruptcy estate).

100. See John C. McCoid, II, *Preservation of Avoided Transfers and Liens*, 77 VA. L. REV. 1091, 1124-26 (1991) for the conclusion that the Tenth Circuit Court of Appeals was correct in allowing the trustee in the *First Capital* case to use the recovered escrow funds for the benefit of all creditors. This conclusion is based on an assumption that 11 U.S.C. § 551 applied in that case. Section 551 provides that any transfer avoided under § 547, among others, “is preserved for the benefit of the estate but only with respect to property of the estate.” 11 U.S.C. § 551 (1988). This analysis, however, fails to consider the implication of the fact that, under Utah law, *First Capital* had no property interest in the escrow funds in its possession. See *infra* notes 113-19 and accompanying text. Section 547 only gives a trustee power to avoid transfers “of an interest of the debtor in property.” 11 U.S.C. § 547 (1988). Since the escrow funds were not the property of *First Capital*, the trustee had no power to recover them under § 547. Without a valid § 547 recovery, § 551 of the Bankruptcy Code is not implicated and cannot be applied to validate the Tenth Circuit Court of Appeals’ decision in *First Capital*. See Boshkoff, *supra* note 99, at 552-54.

101. S. REP. NO. 989, *supra* note 22, at 82, reprinted in 1978 U.S.C.C.A.N. at 5868. The report continues, “For example, if the debtor has a claim that is barred at the time of the commencement of the case by the statute of limitations, then the trustee would not be

dent, on this basis, that to allow the trustee to include escrow funds in the estate would do violence to the congressional intent that the debtor's rights not be expanded by section 541. Such an inclusion would expand the debtor's rights in escrow funds, in which the debtor previously had only a possessory interest, to the point of full ownership.

Likewise, further comment on section 541(d) states that this section "reiterates the general principle that where the debtor holds bare legal title without any equitable interest, . . . the estate acquires bare legal title without any equitable interest in the property."¹⁰² This language seems to indicate that the bankruptcy estate's interest in property is limited by the debtor's interest.

Unlike the legislative history of section 541(d), the legislative history of section 547 does not specifically indicate an intent to limit the trustee's avoidance powers to property interests held by the debtor. However, the language of the section itself clearly defines this boundary.¹⁰³ Moreover, it would be illogical for Congress to limit the bankruptcy estate to property interests of the debtor¹⁰⁴ and then to sanction the trustee's recovery, under section 547, of property in which the debtor has no interest. Thus, it appears that both the plain language of the Bankruptcy Code and the legislative history do not reveal any intent to include in the estate property not belonging to the debtor.

B. *Case Law Does Not Support the Inclusion in the Estate of Property in Which the Debtor Has No Interest*

Case law is in accordance with the general proposition that the bankruptcy estate cannot include any property in which the debtor does not have an interest.¹⁰⁵ In *Pearlman v. Reliance Insurance*

able to pursue that claim, because he too would be barred. He could take no greater rights than the debtor himself had." *Id.* See *supra* note 24.

102. 124 CONG. REC. 33,999 (1978) (remarks of Sen. DeConcini).

103. Section 547 specifically states, "the trustee may avoid any transfer of an *interest of the debtor* in property." 11 U.S.C. § 547(b) (1988) (emphasis added). See *supra* note 14 for the full text of § 547(b).

104. See *supra* notes 13 and 14 for the text of 11 U.S.C. §§ 541(a) and 547(b) (1988), which limit the bankruptcy estate to property interests of the debtor.

105. It should be noted that First Capital did have a possessory interest in the funds it held in escrow. However, since the legislative history seems to indicate that the trustee can only acquire the interest of the debtor, the most the trustee in this case could become is a second escrow agent with respect to Research-Planning's funds. In the position of an escrow agent, the trustee would be bound by the escrow agreement to deliver the funds to the borrower if the transaction were completed or to Research-Planning if the transaction were abandoned. See Geoffrey Orlandi, Note, *Property of the Estate: Section 541*, 3

Co.,¹⁰⁶ the United States Supreme Court faced the issue of whether a fund, not in possession of the debtor, became property of the estate in a bankruptcy proceeding.¹⁰⁷ The Court noted, with regard to the debtor's interest in the fund, that "[p]roperty interests in a fund not owned by a bankrupt at the time of adjudication, whether complete or partial, legal or equitable . . . are of course not a part of the bankrupt's property and do not vest in the trustee."¹⁰⁸ The Court continued, "The Bankruptcy Act simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors."¹⁰⁹

Similarly, where the debtor has a limited interest in property, the estate may only succeed to that interest and no more. In *Cross Electric Co. v. United States (In re Cross Electric Co.)*,¹¹⁰ the United States Court of Appeals for the Fourth Circuit, after quoting the House Report,¹¹¹ made clear that section 541 "simply transfer[s] to the [trustee] the debtor's interests in property as it [sic] existed at the time of the commencement of the bankruptcy proceedings and if those interests were limited at that time, the trustee's rights to possession are similarly limited."¹¹² Additionally, in two cases dealing with the bankruptcy trustee's rights to escrow accounts opened pursuant to mortgage agreements, the courts held that the accounts became property of the estate, subject to the same limitations that the mortgage agreements placed on the debtor.¹¹³

BANKR. DEV. J. 341, 353-56 (1986), for a discussion of whether a debtor's possessory interest is sufficient to render property part of the bankruptcy estate.

106. 371 U.S. 132 (1962).

107. *Id.* at 134. In *Pearlman*, the United States government was in possession of a payment fund that had been withheld pending satisfactory completion of a construction project by the debtor. The debtor failed to satisfy his contract, and subsequently entered bankruptcy. *Id.* The government turned the fund over to the trustee in bankruptcy after a surety company paid for the completion of the project by another contractor. *Id.* The surety company then made a claim for the fund in the hands of the trustee, since by paying for the completion of the project it had acquired the rights to the withheld payment fund. *Id.* The Supreme Court held that the money belonged to the surety company because property interests which do not belong to the debtor cannot become part of the bankruptcy estate. *Id.* at 141-42.

108. *Id.* at 135.

109. *Id.* at 135-36.

110. 664 F.2d 1218 (4th Cir. 1981).

111. *See supra* note 17.

112. *Cross*, 664 F.2d at 1220.

113. *Wilson v. United Savings (In re Missionary Baptist Found. of America)*, 792 F.2d 502 (5th Cir. 1986); *N.S. Garrott & Sons v. Union Planters Nat'l Bank (In re N.S. Garrott & Sons)*, 772 F.2d 462 (8th Cir. 1985). *See* Susan C. Gieser, Note, *Property of the Estate: Section 541(a)(1)*, 4 BANKR. DEV. J. 123, 135-39 (1986) for a discussion of these two cases. *See also* *Vineyard v. McKenzie (In re Quality Holstein Leasing Inc.)*, 752 F.2d 1009, 1013 (5th Cir. 1985) (stating, in reference to § 541(d), that "Congress did not mean

Therefore, it seems that there is a firm judicial stance supporting the proposition that a bankruptcy trustee can only receive an interest in property equal to that held by the debtor. This concept, reasonably extended, indicates that where the debtor holds no interest in property, the Bankruptcy Code does not grant the trustee any interest in this property either.

C. *Property Rights Must Be Determined By State Law*

The initial inquiry in determining which property becomes part of the estate must be one of state law, since the Bankruptcy Code does not provide rules for determining whether a debtor has an interest in particular property.¹¹⁴ Thus, to determine a debtor's interest in property, the court must look to state law.¹¹⁵ Once this determination is made, the Bankruptcy Code defines the extent to which that interest is property of the estate.¹¹⁶

However, there do not appear to be any Utah decisions specifically defining the interest of an escrow agent in escrowed property. Yet, the Supreme Court of Utah has held that when a depositor executes an escrow agreement and deposits the subject matter into escrow, the depositor retains title to the subject matter until all the conditions of the escrow agreement have been satisfied, at which point title passes to the depositor's grantee.¹¹⁷ Utah courts also generally

to authorize a bankruptcy estate to benefit from property that the debtor did not own" (footnote omitted); *Angeles Real Estate Co. v. Kerxton (In re Construction General, Inc.)*, 737 F.2d 416 (4th Cir. 1984) (refusing to include in the bankruptcy estate the proceeds of a note previously assigned by the debtor to the plaintiff. The proceeds of the note had been misappropriated by the debtor and recovered as a preference by the trustee). *But see In re Vermont Fiberglass, Inc.*, 44 B.R. 505, 511 (Bankr. D. Vt. 1984) (stating that "the trustee succeeds to such rights as he may defeat in the hands of the transferee of an avoided transfer"); *Staats v. Barry (In re Barry)*, 31 B.R. 683, 686 (Bankr. S.D. Ohio 1983) (holding that the bankruptcy trustee succeeds "to the rights of the transferee in the avoided transfer").

114. *Butner v. United States*, 440 U.S. 48 (1979) (holding that property rights under the Bankruptcy Code are defined by state law); *Garrott*, 772 F.2d at 466 (relying on 4 COLLIER ON BANKRUPTCY ¶ 541.02[1] (L. King 15th ed. 1985) for the same proposition).

115. *Garrott*, 772 F.2d at 466.

116. *Id.*

117. *Foxley v. Rich*, 99 P. 666, 669 (Utah 1909). *See also* 30A C.J.S. *Escrows* § 11 (1992) ("Until the performance of the condition, or the happening of the event, on which delivery is to be made by the depositary, the legal title to land to be conveyed by the instrument, or to other matter placed in escrow, remains in the grantor or depositor . . ."). Other jurisdictions follow this analytical pattern. *See, e.g., Press v. Marvalan Industries, Inc.*, 422 F. Supp. 346, 349 (S.D.N.Y. 1976) ("[T]he incidents of ownership remain in the person depositing the property into escrow until the conditions of the escrow agreement are fulfilled."); *Pagan v. Spencer*, 232 P.2d 323, 326 (Cal. Dist. Ct. App. 1951) ("The title to money deposited in escrow to be paid to the vendor of property does not pass until all the conditions of the escrow have been fulfilled."); *Beren Corp. v. Spader*, 255 N.W.2d 247, 254

hold that an escrow agent is the mere agent of the parties to the transaction.¹¹⁸ By implication, then, the escrow agent appears never to actually hold title to the escrowed property. Title remains in the escrow depositor until it passes directly to the grantee under the escrow transaction.

Therefore, First Capital, as escrow agent, arguably had no interest in the funds deposited with it other than to see that they were transferred to their rightful owner upon completion of the escrow condition. Under Utah law,¹¹⁹ First Capital was merely the agent of the contracting parties and was nothing more than a conduit through which the escrowed funds passed from one party to the other. Under section 547, the trustee in bankruptcy is only empowered to avoid transfers "of an interest of the debtor in property."¹²⁰ Thus, since the escrow funds were not the property of First Capital, the trustee did not have the power to recover them under section 547.

Nor does it seem reasonable to assume that the requirement of section 547, that the debtor have an interest in the property recovered, was satisfied simply because the trustee came into possession of the escrow funds pursuant to the settlement of a preference action. It should be noted that there was never any judicial determination that section 547 applied to this case.¹²¹ First Security, the bank to which the funds were improperly paid by First Capital, voluntarily surrendered the funds to the trustee in the absence of any judicial mandate to that effect.¹²² This circumstance does not change the fact that First Capital was merely an escrow agent in possession of funds belonging to another party.

Assuming that the Bankruptcy Code did not authorize the trustee to recover the escrowed funds, a determination must now be made as to who is entitled to the funds.¹²³ As would be expected, the true

(Neb. 1977) (stating that in land sale contract where deed is placed in escrow, seller retains legal title while buyer receives equitable title); *Rushmore State Bank v. Kurylas, Inc.*, 424 N.W.2d 649, 661 (S.D. 1988) (holding that escrow depositor retains legal and equitable title to deposited funds until escrow conditions are met).

118. *Freegard v. First Western Nat'l Bank*, 738 P.2d 614, 616 (Utah 1987); *Morris v. Clark*, 112 P.2d 153, 155 (Utah 1941), *cert. denied*, 314 U.S. 584 (1941); *Nelson v. Ashton-Jenkins Co.*, 242 P. 408, 410 (Utah 1925); *Gammon v. Bunnell*, 64 P. 958, 959 (Utah 1900).

119. *See supra* notes 117-18.

120. 11 U.S.C. § 547(b) (1988).

121. *Research-Planning, Inc. v. Segal (In re First Capital Mortgage Loan Corp.)*, 917 F.2d 424, 429 (10th Cir. 1990) (en banc) (Seth, J., dissenting).

122. *Id.* *See supra* notes 31-32 and accompanying text.

123. *See Nancy L. Sanborn, Note, Avoidance Recoveries in Bankruptcy: For the Benefit of the Estate or the Secured Creditor?*, 90 COLUM. L. REV. 1376, 1384-86 (1990) (commenting that "although bankruptcy courts have long held that avoidance recoveries are

owner of stolen property can recover it from a thief.¹²⁴ If First Capital had merely stolen Research-Planning's funds, Research-Planning could have recovered them from First Capital.¹²⁵ Here, however, as a result of First Capital's misappropriation of the escrow money, the funds were placed in the hands of a third party, the trustee, who is not a representative of First Capital.¹²⁶ Therefore, the rule allowing recovery from a thief does not apply since the funds are not in the hands of the thief, First Capital.

In general, the true owner of property may recover it from a transferee of a thief as long as the transferee is not a bona fide purchaser.¹²⁷ In this case, however, First Security, the party to which the escrow funds were improperly transferred, was a bona fide purchaser.¹²⁸ The trustee, now in possession, however, received the funds from First Security with knowledge of the misappropriation by First Capital.¹²⁹ It seems that to allow a transferee with knowledge, who gave no value, to gain full title to stolen property simply because the property was washed by passing it through a bona fide purchaser, does violence to the owner's state law rights in the property that has been stolen from him.¹³⁰

Since the escrow funds are not property of the debtor, the bankruptcy trustee is not empowered to use them to benefit the estate. A

available for all creditors of the estate, the recognition of a creditor's entitlement to recovered property pursuant to nonbankruptcy law is not precluded by the language of the [Bankruptcy] Code, its legislative history or Supreme Court interpretations of the bankruptcy statutes.").

124. See *Corporation of the President of the Church of Jesus Christ of Latter-Day Saints v. Jolley*, 467 P.2d 984, 985 (Utah 1970) (holding that "[w]here one has stolen or embezzled the money or property of another, he obtains no title whatsoever").

125. *Id.*

126. See *Merrill v. Abbott (In re Independent Clearing House Co.)*, 41 B.R. 985, 999 (Bankr. D. Utah 1984), *aff'd in part and rev'd in part on other grounds sub nom. Merrill v. Dietz (In re Universal Clearing House Co.)*, 62 B.R. 118 (Bankr. D. Utah 1986) (stating that the trustee acts "in a representative capacity on behalf of all the creditors" and therefore cannot be the representative of the debtor); *cf.* 11 U.S.C. § 323 (1988) (stating that "[t]he trustee . . . is the representative of the estate").

127. *Jolley*, 467 P.2d at 985.

128. *Research-Planning, Inc. v. Segal (In re First Capital Mortgage Loan Corp.)*, 917 F.2d 424, 426 (10th Cir. 1990) (en banc).

129. The trustee must have had knowledge of the misappropriation, since he traced the funds to First Security and was aware of their source. *Id.* at 429 (Seth, J., dissenting). See *Research-Planning, Inc. v. Segal (In re First Capital Mortgage Loan Corp.)*, 872 F.2d 335, 336 (10th Cir. 1989) (panel decision) (stating that "[t]he trustee had been able to demonstrate that the money came from the debtor originally, and there seems to be no question as to this source of the funds. The funds were held by the debtor who had control of them only pursuant to the escrow agreement with Research-Planning").

130. See *supra* note 124 and accompanying text.

key motivation in the Tenth Circuit Court of Appeals' decision that the funds should become property of the estate was the fundamental bankruptcy policy of equality of distribution among creditors.¹³¹ However, where, as here, the Bankruptcy Code is not implicated,¹³² this motivation is not valid. Therefore, the court should have placed title to the escrow funds in the hands of their owner, Research-Planning.

CONCLUSION

Courts deciding cases similar to *First Capital* must be careful not to send the wrong message to bankruptcy trustees. The Bankruptcy Code and its legislative history indicate that Congress only intended the bankruptcy estate to include the debtor's property. A decision such as *First Capital*, on the other hand, may encourage trustees to pursue questionable claims under the Bankruptcy Code in the hopes of augmenting the bankruptcy estate. Furthermore, allowing the bankruptcy trustee's treatment of an escrow depositor's funds to depend on the prepetition conduct of the debtor complicates bankruptcy proceedings with needless litigation and violates basic principles of property law. Congress clearly did not intend to espouse this sort of anomalous treatment when it enacted the Bankruptcy Code.

Dean A. Dulchinos

131. See *supra* notes 81-82 and accompanying text.

132. The Bankruptcy Code is not implicated here because the trustee was not empowered by § 547 to include the misappropriated escrow funds in the estate since the debtor had no interest in the funds.