st. john's UNIVERSITY
SCHOOL OF LAW

St. John's Bankruptcy Research Library
A project of St. John's School of Law and the American Bankruptcy Institute Law Review

2014 Volume VI No. 19

Whether Funds Transferred From Trust Account Can Be "Property of the Debtor" That Is Subject to a Fraudulent Transfer Claim

Adam C.B. Lanza, J.D. Candidate 2015

Cite as: *Whether Funds Transferred From Trust Account Can be "Property of the Debtor" That is Subject to a Fraudulent Transfer Claim*, 6 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 19 (2014).

Introduction

One of the main purposes of bankruptcy is to maximize the value of the bankruptcy estate for the benefit of creditors. Consistent with this goal of maximizing the value of a bankrupt estate, a bankruptcy trustee has certain "avoidance powers" that are codified in chapter 5 of the Bankruptcy Code. These broad powers allow the trustee to file adversary proceedings to avoid certain pre- and post-petition transfers of property of the debtor.[1] After a trustee avoids a transfer, the "transferred property is returned to the estate for the benefit of all persons who have presented valid claims."[2]

One common avoidance power is the trustee's power to avoid certain pre-petition transfers of property by the debtor to a third party as a fraudulent transfers.[3] Fraudulent transfers may be avoided under federal law, section 548 of the Bankruptcy Code, or under state law according to section 544(b) of the Bankruptcy Code.[4] Under section 548, the trustee may avoid

---

[1] *In re Manhattan Inv. Fund Ltd.*, 359 B.R. 510, 516 (Bankr. S.D.N.Y. 2007) aff'd in part, rev'd in part, 397 B.R. 1 (S.D.N.Y. 2007).
[2] *See* Christy v. Alexander & Alexander of NY, Inc. (*In re* Finley), 130 F.3d 52, 55 (2d. Cir. 1997) (discussing the broad powers of a trustee of a bankrupt estate.)
[3] 11 U.S.C. §548
[4] *Id.*; 11 U.S.C. §544(b)

both an actually fraudulent transfer (i.e., a transfer of property of the debtor made with the actual intent to hinder, delay, or defraud creditors) and a constructively fraudulent transfer (i.e., a transfer of property made by an insolvent company in exchange for less than reasonably equivalent value).[5] Under section 544(b), the trustee may avoid any transfer that an actual unsecured creditor could have avoided under applicable state law, which in most states is the Uniform Fraudulent Transfer Act (the "UFTA") (though in some states it is Uniform Fraudulent Conveyances Act (the "UFCA")).[6] As a result, the trustee may also be able avoid both types of fraudulent transfers under section 544(b) because the UFTA permits (1) any creditor that was in existence at the time of the subject transfer to avoid a constructively fraudulent transfer and (2) any existing or future creditor to avoid an actually fraudulent transfer.[7]

An essential element in a trustee's avoidance powers is ability to avoid a "transfer of property made by the debtor."[8] If there is not a transfer of property from the debtor, but from a different source, then a trustee may not be able to avoid a particular transfer. For this reason, a transfer of property being held in trust cannot constitute a fraudulent transfer because when property is being held in trust, it is for the benefit of another – never entering the holder of the trust's bankrupt estate.[9]

Recently, in *In re Dayton Title Agency, Inc.*, a trustee sued a paid-off lender to avoid the payment made to the lender on behalf of the debtor's client as a fraudulent transfer.[10] The Sixth Circuit Court of Appeals held in that a transfer of funds from a trust account to the lender was

[5] DOUGLAS G. BAIRD, THOMAS H. JACKSON & BARRY E. ADLER, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 310 (4th ed. 2007).
[6] "Although there are small differences among state fraudulent conveyance laws, and between state laws and the provisions of §548, the substantive law in each instance is essentially the same." *Id.*
[7] *Id.*
[8] *Id.* at 311
[9] *In re Cannon*, 277 F.3d 838, 842, 850 (6th Cir. 2002).
[10] *The While Family Co. v. Sloan* (*In re Dayton Title Agency, Inc.*), 724 F.3d 678 (6th Cir. 2013).

constructively fraudulent because the elements of the UFTA were met.[11] This Article will examine whether a trustee can avoid a transfer from a debtor's trust account as a fraudulent transfer and is separated into four parts. Part 1 discusses the basic tenets of fraudulent conveyance law under sections 544(b) and 548 of the Bankruptcy Code, while Part I(a) analyzes why funds held in trust are not subject to fraudulent transfer law. Part II discusses the holdings by the *Dayton Title* court in Ohio, and the *Cannon* court in Tennessee. Part III illustrates why *Dayton* and *Cannon* are distinguishable cases, and the Conclusion discusses implications of the *Dayton* court's holding.

I. Fraudulent Conveyance Law

The Bankruptcy Code provides for the appointment of a trustee and grants the trustee with numerous powers, including the power to avoid fraudulent transfers.[12] When a bankruptcy case is commenced, the Code enables the trustee to maximize the value of the bankrupt estate for the benefit of the creditors. Two sections of the Bankruptcy Code permits the trustee to avoid fraudulent transfers: first, Section 548 provides an independent basis for a trustee to avoid a fraudulent conveyance made within two years before the debtor's bankruptcy petition - regardless of the rights any unsecured creditor may have.[13] The elements of section 548 are met when: (1) the debtor had an interest in the property transferred, (2) that was made within two years of before the date of the filing of the petition; and (a) had actual intent to hinder, delay or defraud, or; (b) was constructively fraudulent.[14]

[11] *Id*. at
[12] 11 U.S.C. §544.
[13] *See supra* note 1 at 309.
[14] 11 U.S.C. §548.

Second, section 544 "equips a trustee with all of the rights and powers of an unsecured creditor under applicable nonbankruptcy law (the so-called "strong-arm powers"). [15] Using section 544(b)'s strong-arm powers, a trustee can assert state-law fraudulent transfer claims and "avoid any transfer that an unsecured creditor could have avoided under applicable nonbankruptcy law, but for the automatic stay."[16] The Uniform Fraudulent Transfer Act, which codifies these claims of actions in most states,[17] provides that a transfer may be avoided as constructively fraudulent if: (1) it is "[a] transfer made . . . by the debtor"; (2) "the debtor made the transfer . . . [w]ithout receiving a reasonably equivalent value in exchange for the transfers"; and (3) "either of the following applies: (a) The debtor was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; (b) The debtor intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due."[18]

a. Funds Held In Trust Are Not Subject to Fraudulent Conveyance Law

One caveat to fraudulent transfer statutes, however, is that transfers of funds held in trust are not subject to fraudulent transfer law because the holder of a trust has only legal title, and no equitable interest – "holding it for the benefit of the beneficiary who owns the equitable title."[19] According to the UFTA, a "transfer" is defined as "disposing of or parting with an asset."[20] However, it is important to examine whether the property transferred actually came from the debtor. Under the "mere conduit theory," derived from Judge Cardozo's opinion in *Carson v.*

[15] Michael F. Holbein, Esq., and Sean C. Kulka, Esq, *Defending Fraudulent-Transfer Avoidance Actions in Ponzi-Scheme Cases*, Winter 2014, http://www.willamette.com/insights_journal/14/winter_2014_11.pdf; *Id*.
[16] *Supra* note 5 at 311.
[17] *Id*.
[18] *Id.;* OHIO REV. CODE § 1336.04(A)(2); Uniform Fraudulent Transfer Act ("UFTA"); 11 U.S.C. §548.
[19] *In re Cannon*, 277 F.3d 838, 842, 850 (6th Cir. 2002);
[20] *In re Dayton Title Agency, Inc*., 724 F.3d at 680.

Federal Reserve Bank of New York,[21] "a debtor that has mere possession of the funds, without more, does not necessarily possess sufficient control so as to warrant a finding that the funds were the debtor's property." Thus, if transferred funds were never property of the debtor's estate, and the transfer did not deplete funds that otherwise would have been available for creditor distribution - fraudulent transfer law does not apply. Similarly, funds held in trust are not property of a debtor's estate because the holder of a trust owns only legal title.

The determination of whether a trust relationship exists between the debtor and a third party, with respect to the transferred property, will be governed by state law.[22] A trust is created when there is: (1) "an explicit declaration of trust, or circumstances which show beyond reasonable doubt that a trust was intended to be created, (2) accompanied with an intention to create a trust, (3) followed by an actual conveyance or transfer of lawful, definite property or estate or interest, made by a person capable of making a transfer thereof, for a definite term, (4) vesting the legal title presently in a person capable of holding it."[23]

II. Example of a Trust Relationship, or Lack Thereof, in *In re Dayton Title Agency* and *In re Cannon*

In both *Dayton Title* and *In re Cannon*, the court was faced with similar questions of law regarding whether fraudulent conveyance law was applicable. While both cases were presented with similar facts, the courts came out with different answers. The holdings in both cases hinged on whether a trust relationship had been created.

In *Dayton Title*, the client gave the debtor a check to deposit in the debtor's client trust account. Before the check cleared, the bank issued a provisional credit,[24] allowing the debtor to

---

[21] 254 N.Y. 218, 235-36 (1930).
[22] Angelle v. Reed (*Matter of Angelle*), 610 F.2d 1335, 1341 (5th Cir. 1980); *In re* Librandi, 183 B.R. 379, 382 (M.D. pa. 1995).
[23] Ulmer v. Fulton, 195 N.E. 557, 564 (Ohio 1935).
[24] *Id.*; Extending provisional credit was a routine practice of the Bank. *Id.*

access those funds. The debtor then used those funds to pay the client's lender on behalf of the client. Shortly thereafter, the client's check, which was forged, bounced – causing the debtor to file for bankruptcy. In the bankruptcy case, the trustee brought an action to avoid the payment as a constructively fraudulent transfer.

In response to the fraudulent transfer action, the lender argued, among other things, that the transfer was not constructively fraudulent because the funds that the lender received was not property of the title agency, as the money was being held in trust for the benefit of a third party (i.e., the client).[25]

The bankruptcy court entered summary judgment in favor of the trustee, holding that majority of the payment could be avoided as constructively fraudulent.[26] On appeal, the district court, reversed the bankruptcy court and held that only a small portion of the payment was fraudulent.[27] However, the Sixth Circuit Court of Appeals held that the chapter 7 trustee could avoid, as constructively fraudulent, a payment to a client's lender that had been made for the benefit of the client – affirming the bankruptcy court. While the funds were paid out of the debtor's client-trust account, the court determined that such funds constituted property of the debtor at the time of transfer.[28]

Since it was undisputed that the second and third elements of the constructive fraud claim were present, the issue on appeal in *Dayton Title* was whether the transaction was a "transfer" under the Ohio fraudulent transfer statute.[29] This question turned on the court's determination of whether the funds used to make the payment were being held in trust for the benefit of the creditor.

---

[25] *Id.* at 680.
[26] *Id.* at 678
[27] *Id.*
[28] *Id.* at 678.
[29] *Id.* at 679.

The *Dayton Title* court determined that the funds were not being held in trust for the debtor's client under Ohio law. Notwithstanding the fact that the funds were being held in a "trust account," indicating the parties seemingly intended to create a trust relationship, the debtor's bank - and not its client - transferred the funds into the account (the bank had advanced the funds to the debtor by way of provisional credit).[30] Accordingly, no trust relationship was created between the debtor and its client. Under Ohio law, a trust is created when there is "an explicit declaration of trust, accompanied with an intention to create a trust, followed by an actual conveyance, vesting legal title.[31] Accordingly, the funds were property of the debtor because the debtor had both equitable and legal title to the funds at the time of the transfer.[32] Therefore, Sixth Circuit concluded the transaction at issue qualified as a "transfer" under Ohio law.[33] Since the trustee established all three elements of a constructive fraud claim under Ohio law, he was able to avoid the payments.[34]

a. Trust relationship in *Cannon* grounds for disallowing trustee's avoiding power

However, as discussed above, when a court finds that at the time of the transfer, the transferred property at issue was being held in a trust for the benefit of a third party, the transfer may not be avoided under state or federal fraudulent transfer law.[35] For example, in *In re Cannon*, while the court was presented with a similar set of facts as in *Dayton Title*, and the Sixth Circuit came to a different conclusion, the two cases were ultimately distinguishable.[36]

Cannon involved a lawyer who used comingled funds from his escrow account to invest

[30] *Dayton Title*, 724 F.3d at 679.
[31] Ulmer*,* 195 N.E. at 564.
[32] *Id.*
[33] *Id.*
[34] *Id.* at 680–81.
[35] *In re* Cannon, 277 F.3d at 842.
[36] *Id.*

in the commodities market.[37] After the lawyer's risky gamble did not work, in addition to facing criminal charges, the deficiencies in the escrow account forced him to file for bankruptcy under chapter 7 of the Bankruptcy Code.[38] The chapter 7 trustee sought to avoid the transfers of the co-mingled funds to the commodities brokers, arguing that such transfers were actually fraudulent.[39] However, the Sixth Circuit held that the bankruptcy trustee could not use his avoidance power to recover money; concluding that the funds were being held in trust at the time of the transfer.[40]

In deciding whether a trust relationship existed, the court turned to Tennessee law to determine whether the requirements of the following elements were met: "(1) a trustee who holds trust property and who is subject to the equitable duties to deal with it for the benefit of another, (2) a beneficiary to whom the trustee owes the equitable duties to deal with the trust property for his benefit, and (3) identifiable trust property."[41] The Sixth Circuit determined that all the requisite elements were met and therefore, concluded that the comingled funds in the debtor's accounts were not property of the debtor at the time of the transfer.[42] Therefore, because the property was being held in trust, no fraudulent transfer claim could be brought.

III. Distinguishing *Dayton Title* and *Cannon*

When looking at cases that deal with trustee's attempting to use section 548, it is important to scrutinize over the details of particular transactions. A trustee's ability to avoid certain transfers will depend on the source of funds transferred.

The issue in *Dayton Title* was whether the payments made from Dayton Title Agency to the transferees qualified as a "transfer made . . . by the debtor." A "transfer" is defined as a

[37] *Id.*
[38] *Id.* at 845.
[39] *Id.* at 847.
[40] *Id.* at 850.
[41] *Id.*
[42] Noting that while the bankruptcy code does not define "property of the debtor," "property of the estate" is broadly defined and applied. *Id.*

means of disposing of an "asset."[43] An "asset" is defined as "property of a debtor."[44] Because the debtor's bank, and not his client transferred the funds, a trust relationship was not created – thereby giving the debtor both legal and equitable title.

Although a trust account was established, evidencing an intention to create a trust, no actual conveyance took place between Dayton and its client.[45] Rather, the funds came from the bank by way of provisional credit. While assets held in trust are not subject to fraudulent transfer claims, the court's finding of the absence of a trust relationship rendered Dayton's fraudulent transfer claim valid.

The *Cannon* court found that "property of the estate" included only "property that would have been part of the estate had it not been transferred before the commencement of the bankruptcy proceedings. . . .'[B]ecause the debtor does not own an equitable interest in property he holds in trust for another, that interest is not property of the estate.'"[46]

Essentially, the distinguishing feature between these two cases was the source of the funds. While *Dayton* came close to establishing all the elements of a trust, because the bank, and not the client, transferred the funds – the third element of "actual conveyance" was not met. Conversely, in *Cannon*, the funds were transferred directly from the attorney's clients who intended to create a trust – establishing a trust, and therefore placing the funds outside the bankrupt estate.

Conclusion: Why *Dayton Title* is relevant

---

[43] See Ohio Rev. Code § 1336.01(L).
[44] See Ohio Rev. Code § 1336.01(B); However, the definition of an "asset" excludes the following: (1) "Property to the extent it is encumbered by a valid lien; (2) Property to the extent it generally is exempt under non-bankruptcy law, including, but not limited to, section 2329.66 of the [Ohio] Revised Code; (3) An interest in property held in the form of a tenancy by the entireties created under section 5302.17 of the [Ohio] Revised Code prior to April 4, 1985, to the extent it is not subject to process by a creditor holding a claim against only one tenant." *Dayton Title*, 724 F.3d at 679.
[45] *Id*. at 677.
[46] *In re Cannon,* 277 F.3d at 849 (quoting Begier v. IRS*,* 496 U.S. 53, 58–59 (1990)).

Dayton Title has significant implications for bankruptcy trustees because a trustee may be able to avoid a transfer of funds transferred from a debtor's "client trust" account. As such, a bankruptcy trustee should carefully scrutinize transactions from a debtor's "trust account" and not assume that the funds were being held in trust. For example, if the trustee discovers that the debtor transferred funds that were advanced by a third party, such as the debtor's bank, the trustee may be able to avoid the transfer.

In sum, cases like *Dayton* illustrates the importance of scrutinizing transactions from a debtor's "trust account." Depending on the source of the funds, a trust may or may not be created – having implications on the bankrupt estate, and the trustee's avoiding powers.

With respect to the first element of establishing a trust relationship, *Dayton Title* demonstrates that funds held in a debtor's client trust account can be property of the debtor, despite the parties' intention that funds would be held in trust, in the trust account, and deposited by a third party (such as the debtor's bank).[47] As to the second element, the debtor will likely not have received reasonably equivalent value in exchange for a transfer from his trust account because such a transfer will typically have been made for the benefit of the debtor's client, instead of the debtor itself. While the viability of such a constructive fraud claim will depend on whether the trustee can establish the third element of the claim, a trustee should remember *Dayton Title* in cases in which the debtor has a client trust account.

---

[47] *Id.* at 680.