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Consumer Track

Trusts and Other Interests

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ISSUES IN TREATMENT OF TRUSTS IN CONSUMER BANKRUPTCY CASES

MATERIALS OUTLINE:

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I. The Bankruptcy Basics: Property of the Estate Under Section 541 and Schedule A/B

Section 541(a)(1) of the Bankruptcy Code broadly sweeps into the bankruptcy estate a debtor's "legal or equitable" interests in property at the date of filing of the bankruptcy petition. That certainly includes various debtor interests or rights in a trust. Beneficial interests in trusts are "equitable" interests in property, even though legal title is in a trustee. *Kloos v. Dias (In re Dias),* 37 Bankr. 584, 586-87 (Bankr. D. Idaho 1984)("a beneficial interest in a trust is an equitable interest under § 541(a)(1)"); *see Colish v. United States (In re Colish)*, 289 B.R. 523 (Bankr. E.D.N.Y. 2002). And § 541(a)(5) and (7) bring certain property interests into the bankruptcy estate based on post-petition events. Of particular relevance to testamentary trusts, property that a debtor acquires or becomes entitled to acquire by, among other events, a bequest, devise or inheritance within 180 days after commencement of the case is brought into the bankruptcy estate by § 541(a)(5).

§ 541. Property of the Estate

> (a) The commencement of a case under section 301, 302 or 303 of this title creates an estate. Such estate is comprised of all of the following property, wherever located and by whomever held:
>
> (1) **Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case**.
>
> ***
>
> (5) Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date–
>
> > (A) by bequest, devise, or inheritance
> >
> > ***
> >
> > (C) as a beneficiary of a life insurance policy or of a death benefit plan.
> >
> > ***
>
> (7) Any interest in property that the estate acquires after the commencement of the case.

Sections 541(b)(1), (c)(2) and (d) then limit the broad sweep of § 541(a)(1).

Section 541(b)(1) clarifies that any power, such as a power of appointment under a will or trust, for example, that the debtor may exercise *solely* (emphasis added) for the benefit of an entity other than the debtor is excluded as property of the estate.

Likewise subsection 541(d) clarifies that where a debtor holds bare legal title to property, and not any equitable interest in it, such as where the debtor is acting as a trustee in certain situations, the equitable interest in property is not otherwise swept into the bankruptcy estate for administration.

> (b) Property of the estate does not include–
> **(1) any power that the debtor may exercise solely for the benefit of an entity other than the debtor;**
>
> ***
>
> (d) 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) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

Subsection 541(c)(1) reinforces § 541(a) by invalidating provisions in contracts and applicable non-bankruptcy law, often referred to as ipso facto clauses, that would otherwise have the effect of excluding various property interests from the broad sweep of the estate under § 541(a). In other words, parties cannot contract and legislatures cannot legislate their way out of bankruptcy. *But cf. In re Town Center Flats*, Case No. 16-1812, 2017 U.S. App. LEXIS 7733 (6th Cir., May 2, 2017)(holding under Michigan law that a perfected assignment of rents in a mortgage effects a transfer preventing any interest in tenant rents from becoming property of the bankruptcy estate, while recognizing as a result the reality that "single-asset real estate entities may have limited options under Chapter 11 in this situation").

Section 541(c)(2) sets forth an important exception to § 541(c)(1) by providing that a restriction on transfer of a debtor's beneficial interest in a trust is nevertheless still equally enforceable in a bankruptcy case as it is under applicable non-bankruptcy law. Note that subsection (c)(2) is also expressly included in the preamble to § 541(a)(1) as an exception (as is subsection (b)). The legislative history supporting (c)(2) reinforces the statutory language and purpose of preserving state spendthrift trusts. The House Report states: "Paragraph (2) of subsection (c) . . . preserves restrictions on transfer of a spendthrift trust to the extent that the restriction is enforceable under applicable nonbankruptcy law." H. R. Rep. No. 95-595, p. 369 (1977); *see also* S. Rep. No. 95-989, p. 83 (1978) (§ 541(c)(2) "preserves restrictions on a transfer of a spendthrift trust"). A general introductory section to the House Report contains the additional statement that the new law "continues over the exclusion from property of the estate of the debtor's interest in a spendthrift trust to the extent the trust is protected from creditors under applicable State law." H. R. Rep. No. 95-595, p. 176.

While it has been clear since enactment that the § 541(c)(2) exception applies to spendthrift trust provisions under state law, it was unclear until 1992 whether the reach of "applicable nonbankruptcy law" is broader than to spendthrift trust provisions under state law. The Supreme Court solved that debate in *Patterson v. Shumate*, 504 U.S. 753 (1992), holding that the phrase "applicable nonbankruptcy law" equally includes transfer restrictions on trust interests under federal law, such as the anti-alienation provisions in qualified pensions plan trusts under ERISA.

> (c)(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection(a)(1)(a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument or applicable nonbankruptcy law-
>
> > (A) that restricts or conditions transfer of such interest by the debtor; or
> >
> > (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.
>
> **(2) A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.**

(Emphasis added).

Section 541(a) is implemented at the commencement of a bankruptcy case as to equitable interests in property generally and interests in trusts specifically through the following questions designed to obtain relevant information from debtors on Schedule A/B, which is Official Form B 106A/B:

Part 1: Describe Each Residence, Building, Land or Other Real Estate You Own or Have an Interest In	
1. Do you own or have any legal or equitable interest in any residence, building, land, or similar property?	
☐ No. Go to Part 2 ☐ Yes. Where is the property Questions 1.1-2	
Part 2: Describe Your Vehicles	
Do you own, lease or have any legal or equitable interest in any vehicles, whether they are registered or not? Include any vehicles you own that someone else drives. If you lease a vehicle, also report it on *Schedule G: Executory Contracts and Unexpired Leases.*	
3. Cars, vans, trucks, sport utility vehicles, motorcycles ☐ No ☐ Yes Questions 3.1-5	
Part 3: Describe Your Personal and Household Items	
Do you own or have any legal or equitable interest in any of the following items? Questions 6-15	Current Value of the Portion You Own ? Do not deduct secured claims or exemptions

Part 4: Describe Your Financial Assets	
Do you own or have any legal or equitable interest in any of the following? Questions 16-24	Current Value of the Portion You Own ? Do not deduct secured claims or exemptions
25. Trusts, equitable or future interests in property (other than anything listed in line 1) and rights or powers exercisable for your benefit ☐ No ☐Yes. Give specific information about them. Questions 25-31	$__________________

32. Any interest in property that is due you from someone who has died If you are the beneficiary of a living trust, expect proceeds from a life insurance policy, or are currently entitled to receive property because someone has died. ☐ No ☐ Yes. Give specific information $__________________ Questions 32-34
35. Any financial assets you did not already list ☐ No ☐ Yes. Give specific information $__________________
Question 36.
Part 5: Describe Any Business-Related Property You Own or Have an Interest In. List any real estate in Part 1.
37. Do you own or have any legal or equitable interest in any business-related property? ☐ No. Go to Part 6. ☐ Yes. Go to line 38.
Questions 38-45
Part 6: Describe Any Farm and Commercial Fishing Related Property You Own or Have an Interest In. If you own or have an interest in farmland, list it in Part 1.
46. Do you have any legal or equitable interest in any farm or commercial fishing-related property? ☐ No. Go to Part 7. ☐ Yes. Go to line 47.
Questions 47-52
Part 7: Describe All Property You Own or Have an Interest in That you Did Not List Above
53. Do you have other property of any kind you did not already list? Examples: Season tickets, country club membership ☐ No. ☐ Yes. Give specific information.

II. When Can the Trustee Reach a Debtor's Beneficial Interest in an Express Trust?

Against the background of the applicable Bankruptcy Code provisions and the basic case information source as a starting point, the Sixth Circuit set forth the general framework of inquiry for deciding whether the § 541(c)(2) exception applies to exclude a debtor's purported equitable interest in property from the bankruptcy estate in *Taunt v. General Retirement System of the City of Detroit (In re Wilcox)*, 233 F.3d 899, 904 (6th Cir. 2000) : "An inquiry under § 541(c)(2) normally has three parts: First, does the debtor have a beneficial interest in a trust? Second, is there a restriction on the transfer of that interest? Third, is the restriction enforceable under nonbankruptcy law?"

While it is usually a trustee seeking a determination whether a debtor's interest in a trust is property of the estate, creditors also have standing to do so in some instances. *See Strong v. Page (In re Page)*, 239 B.R. 755, 758, n.3 (Bankr. W.D. Mich. 1999)(Chapter 11 case). There is unclear authority on who bears the burden of proof. One court stated in the context of a bankruptcy trustee's demand for turnover of a distribution payment from a living trust that "[a] bankruptcy trustee has the burden in turnover proceedings to prove by a preponderance of the evidence that the property sought is in fact property of the bankruptcy estate and that the debtor has possession of it." *Resop v. McCoy (In re McCoy)*, 464 B.R. 832, 835 (Bankr. W.D. Wis. 2011)(citing *In re Smith*, 2011 Bankr. LEXIS 390, 2011 WL 345865, *1 (Bankr. S.D. Ind. Feb. 2, 2011)). On the other hand, another court states that a debtor arguing that the § 541(c)(2) exception applies has the burden of proof that all of its requirements have been met. *Rhiel v. Adams (In re Adams)*, 302 B.R. 535, 540 (B.A.P. 6th Cir. Dec. 10, 2003). These cases can be reconciled by treating the trustee's burden in the first instance as proving the application of § 541(a)(1) (or (a)(5) as the case may be), while treating the § 541(c)(2) exception as an affirmative defense upon which the debtor bears the burden of proof.

The following discussion addresses some of the most important issues raised by the decisional framework for the § 541(c)(2) exception. But three important limitations on this discussion must be noted.

First, the case law involving trusts and their intersection with § 541(a) and (c)(2) tends to be very fact intensive. The actual terms of the trusts at issue (and sometimes wills, as well) are usually critical to resolving trustee attempts to reach assets, and are rarely the same as the terms of documents you might be dealing with, either on behalf of a debtor or as a trustee. The timing of events preceding the bankruptcy filing, such as the death of a testator or life beneficiary and the timing of creation of a trust, can make a critical difference in the outcome of whether trust assets are determined to be property of the bankruptcy estate. The activities involved in administration of the trust and trust assets are also often important.

Second, almost all of these issues turn on specific state law, often common law but also statutory law. Whether a property interest of a debtor is "property of the estate" is a federal question to be decided as a matter of federal law. *Matter of Yonikus*, 996 F.2d 866, 869 (7th Cir. 1993). But state law determines whether and to what extent the debtor has any legal or equitable interest in property as of the commencement of the case. *Butner v. United States*, 440 U.S. 48, 55 (1979). So while there are many common relevant principals within the law of the various states, there are sometimes important differences even though many states have adopted a version of the Uniform Trust Code. Indeed the choice of law to apply in a given case can sometimes be a key issue. *See, e,g, In re Newman,* 903 F.2d 1150, 1153 (7th Cir. 1990)(applying Missouri law to Illinois debtor's trust interest); *Safanda v. Castellano*, 2015 U.S. Dist. LEXIS 54458, 2015 WL 1911130 (N.D. Ill. Apr. 27, 2015), sustaining objection to report and recommendation at *Safanda v. Castellano (In re Castellano),* 514 B.R. 555 (Bankr. N.D. Ill. 2014)(court construes Illinois, South Carolina and Wisconsin spendthrift trust law, all as potentially applicable and all as finally predicting the same outcome, without deciding which actually controls).

Third, there are many different types of trusts with varying degrees of reserved interests and discretionary authority vested in the trustee. A full discussion of the varying types of trusts as they might specifically be impacted in bankruptcy is also beyond the scope of this program.

For these reasons, the value of any particular case discussed below as persuasive or even binding precedent in your situation, even one from your jurisdiction, might be limited. *Diamond v. Trawick (In re Trawick)*, 497 B.R. 572, 580 (Bankr. C.D. Cal. 2013)("The court is not so sure that Trustee's reliance on case law interpreting the law of other states to interpret North Carolina trust law is a good idea or appropriate."). And because of these characteristics, this discussion is intended to be general and not a comprehensive review of the law on a given point within any of the states from which the ABI Central States Workshop typically draws attendees, even where a case from a specific state is highlighted. Rather the purpose of this program and these materials is to provide a general grounding in the basic issues that arise at the intersection of trust law and bankruptcy and how courts address them.

A. Does debtor have a beneficial interest in a trust ?

Issues around the preliminary question whether a debtor has a beneficial interest in a trust tend to raise three inquiries: Is there a trust relationship in the first place? Is the Debtor's interest too remote to be included in the bankruptcy estate? Has the trust terminated either by its terms or by some action of the trustee or the beneficiaries?

1. Is there a trust?

In a traditional trust, the trustee holds legal title to the corpus and the beneficiaries hold the equitable interest. The term "trust" is a term of art and has a specific legal meaning. A trust is created by "an explicit declaration of trust, or circumstances which show beyond reasonable doubt that a trust was intended to be created, accompanied with an intention to create a trust, followed by an actual conveyance . . . of definite property . . . vesting the legal title presently in a person capable of holding it, to hold as trustee for the benefit of a cestui que trust." *Ulmer v. Fulton*, 129 Ohio St. 323, 2 Ohio Op. 326, 195 N.E. 557, 564 (Ohio 1935) (quoting 65 C.J. § 21); *accord*, *Booth v. Vaughan (In re Booth)*, 260 B.R. 281, 290-91 (B.A.P. 6th Cir. 2001); *Equitable Trust Co. v. Milton Realty Co.*, 261 Mich. 571, 577, 246 N.W. 500 (1933)(to create a trust, there must be an assignment of designated property to a trustee with the intention of passing title thereto, to hold for the benefit of others). The Restatement defines a trust in similar terms as:

> [a] fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee.

Restatement (Third) of Trusts § 2 (2003). With or without a writing, issues on the existence or creation of a trust in the first instance may arise either defensively, where a debtor argues that she does not own property or only holds a legal interest in trust for a third party who has the beneficial interest, or offensively, where a trustee argues that the beneficial interest in property in the possession or control of a third party is actually the debtor's and thus subject to administration as property of the estate.

2. Is debtor's interest too remote to be property of the estate?

In many situations involving a trust, such as an interest in a revocable intervivos trust established by a family member, distributions of principal or income are wholly discretionary and/or contingent on the death of the settlor or another beneficiary. Sometimes a debtor will be entitled to distribution of an interest in a trust at a specified future date, such as at a specific age. Debtors often argue that such contingent interests are generally too remote to constitute property of the estate under § 541(a)(1). These arguments are generally rejected by courts.

Absent a restriction under § 541(c)(2), a debtor's beneficial interest in a trust becomes property of the estate even if the debtor has no present rights and her future rights are conditional since property of the estate includes contingent interest in future income or distributions. *See In re Neuton*, 922 F.2d 1379, 1382-83 (9th Cir. 1990) (collecting cases); *In re Prochnow*, 467 B.R. 656, 663 (C.D. Ill. 2012); *In re Taylor*, 2006 Bankr. LEXIS 755, 2006 WL 1275400 (Bankr. C.D. Ill. May 9, 2006)(debtor's interest in inter vivos trust is property of the estate and the fact that she is not eligible to receive any distribution until one year after the death of her aunt does not defeat the bankruptcy estate's interest in the trust); *In re Knight*, 164 B.R. 372 (Bankr. S.D.Fla. 1994) (debtor's contingent one-half interest in corpus of the trust of which his mother was life beneficiary was property of the estate, even though debtor could be divested of his interest if he predeceased his mother and principal could be invaded and dissipated during mother's life in order to provide for her needs); *Magill v. Newman (In re Newman*), 88 B.R. 191 (Bankr. C.D.Ill. 1987)(debtor trust beneficiary's interest where he was not entitled to distribution until age 50 still property of the estate), rev'd on other grounds *In re Newman*, 903 F.2d 1150 (7th Cir. 1990)(valid Missouri spendthrift clause takes it out of the bankruptcy estate); *In re Kreiss*, 72 B.R. 933 (Bankr. E.D.N.Y. 1987)(debtor's contingent remainder interest-- a 50% remainder interest in a trust subject to a life tenancy–determined to be an interest that is alienable and subject to seizure under applicable New York law and thus property of the bankruptcy estate); *In re Dias,* 37 B.R. 584, 586-87 (Bankr. D.Idaho 1984)(interest in corpus of a trust, payable to debtor when she reached 25 years of age, was subject to levy by creditors and was property of the estate under petition filed when she was 23). *Cf.* Restatement (2d) of Trusts § 162 ("The mere fact that the interest of the beneficiary is contingent and not vested does not preclude creditors of the beneficiary from reaching it"). *But see In re Hicks*, 22 B.R. 243 (Bankr. N.D.Ga. 1982)(Trust instrument gave debtor's mother a power of appointment and absolute discretion in determining whether debtor would receive any portion of the trust corpus. As of the bankruptcy filing, the debtor's mother had not exercised the power of appointment. The court found that it could not compel the exercise of a discretionary power of appointment and held that the debtor had no interest that passed to the bankruptcy trustee.).

Rather, the contingent nature of a debtor's interests instead affects the value includible in the estate; it does not prevent the property from becoming property of the estate in the first instance. *Dias*, 37 B.R. at 587; In *Knight*, debtor argued that he had no vested right to any portion of the principal of the so-called Dorothy Trust unless three contingencies occurred: (1) debtor survives

Dorothy; (2) Dorothy does not amend the trust interest so as to exclude debtor as a beneficiary; and (3) the trustees do not consume the entire principal by paying it to Dorothy or other beneficiaries as they may in their discretion do under the trust instrument. *Knight*, 164 B.R. at 374. These contingencies did not prevent the Debtor's beneficial interest from becoming property of the estate. But the court recognized the impairment these contingencies place on the *value* of debtor's interest, as follows:

> The possibility of divestment does not render the trust interests without value as of the filing date. The possibility of divestment by virtue of the Debtor predeceasing Dorothy and the possibility of reduction in the trust corpora, by virtue of distributions prior to her death, do affect the value of the interests. Thus, the estate is not entitled to simply receive one half of the principal of each trust as of the filing date. Instead, the value which passes to the estate is the hypothetical value of the trust interests if they had been seized by creditors or sold by the Debtor as of the date of his Chapter 7 petition. *See In re Dias, supra*, 37 Bankr. at 587. If the parties are unable to agree on the value of the trust interests, the Court will conduct a further evidentiary hearing.

Id. at 376.

2a. Are distributions from a spendthrift trust to a debtor received within 180 days of commencement of the bankruptcy case treated as property of the estate?

This answer to this question turns on the nature of the trust. A beneficiary of a spendthrift trust generally "[does] not acquire or become entitled to any distribution until the trustees actually [make] a distribution." *Heidkamp v. Galliher (In re Hunger)*, 272 B.R. 792, 796 (Bankr. M.D. Fla. 2002).

If the trust is a testamentary trust and a distribution is made to the debtor within 180 days after commencement of the case, the distribution is generally treated as a "bequest" brought within the bankruptcy estate by § 541(a)(5).[1] *E.g. Smith v. Moody (In re Moody)*, 837 F.2d 719 (5th Cir. 1988) (payments which are bequests from a spendthrift testamentary trust to which the beneficiary is entitled or received within the 180 day period after the filing of the bankruptcy petition are

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An inter vivos trust is one where the settlor creates a trust and transfers property, thereby creating a present interest on behalf of the beneficiaries. The beneficiaries' interests vest immediately, despite the fact that the beneficiaries' use and enjoyment of the property is delayed until some future date (*e.g.* death of the settlor). This differs from a testamentary disposition of property where the beneficiary's interest does not vest until the settlor's death. *See Matter of Walz*, 423 N.E.2d 729, 732 (Ind. Ct. App. 1981).

property of the bankruptcy estate); *Richardson v. McCullough (In re McCullough)*, 259 B.R. 509, 521 (Bankr. D.R.I. 2001)(trust is testamentary in nature and distributions of $321,377.67 to debtor within 180 days after commencement of the Chapter 7 case were bequests under Rhode Island law and property of the bankruptcy estate under § 541(a)(5)(A)).

If the trust is not a testamentary trust, *e.g. In re Newman*, 903 F.2d 1150 (7th Cir. 1990)(property received as the beneficiary of a non-testamentary inter vivos trust is not a bequest under § 541(a)(5)(A)); *In re Rowand*, Case No. 11-81717, 2012 Bankr. LEXIS 3501, *20-*24, 2012 WL 3070215, *4-*5 (Bankr. C.D. Ill. July 30. 2012)(reconciling § 541(a)(5) and collecting cases), or the distribution from a testamentary trust is made more than 180 days after commencement of the case, *e.g. Massillon v. Riley (In re Massillon)*, BAP No. MB 10-024, 2011 Bankr. LEXIS 83, * 21-* 23, 2011 WL 1496101,*4-*6 (B.A.P. 1st Cir. Jan. 11, 2011), the distribution likely will not be treated as property of the estate.

3. Has the trust terminated?

If the trust is no longer in effect by its terms or has otherwise terminated, there is no trust and § 541(c)(2) will not be operative to exclude a debtor's former trust interest from the bankruptcy estate.

A trust cannot be a valid spendthrift trust "'[i]f the beneficiary is entitled to have the principal conveyed to him immediately' . . . ."). *In re McCoy*, 274 B.R. at 763 (quoting Restatement (Second) of Trusts § 153(2)). A bankruptcy estate is entitled to take debtor's interest in that portion of a trust, spendthrift or otherwise, that the debtor has an absolute right to receive. *See In re Rolfe*, 34 B.R. 159, 161 (Bankr. N.D. Ill. 1983).

An example of application of this principal is *McCord v. Borko (In re Borko)*, Case No. 12-44373 (NHL), Adv. Pro. No. 12-1268 (NHL), 2013 Bankr. LEXIS 4083, 2013 WL 5442264 (Bankr. E.D.N.Y. Sept. 29, 2013). Debtor argued that the trustee could not sell the family home because it was property of a spendthrift trust still in existence when she filed her bankruptcy case, specifically her:

> "50% interest in Testamentary Trust of Abraham Borko, which owns the property at 73-44 195th Street. My mother, as Executor, conveyed the property under the terms of the will of my father in 1998. She retained a life estate. There is no power to sell the property without the consent of the trustees. My parents owned the house since the 1950s."

The value of the property at issue as of the date of the debtor's bankruptcy filing was approximately

$709,000, unencumbered by any liens. Debtor and her sister were the co-trustees. Both parents had died before the commencement of the bankruptcy case. Debtor and her sister, as surviving trustees, did not subsequently transfer the deed to the home, and thus did not made any distribution of the principal of the testamentary trust. The trust did not have any specific termination language or date and debtor and her sister argued that the trust was still in effect. Construing testator Abraham Borko's intent as expressed through his will, the bankruptcy court disagreed and decided that Abraham Borko intended that the beneficiaries, including debtor, possess the real estate in their individual capacities after their mother's death. Accordingly the trust had terminated and debtor's half interest in the real estate vested before she filed for bankruptcy. As a result debtor's interest in the home became property of the bankruptcy estate.

In *Strong v. Page (In re Page)*, 239 B.R. 755 (Bankr. W.D. Mich. 1999), plaintiff creditors filed an adversary complaint against a Chapter 11 debtor, seeking a declaratory judgment that his interest in a trust was property of the bankruptcy estate. By the terms of the original trust, the corpus was distributed to the defendant, free and discharged of the trust, upon his mother's death. Thereafter, debtor's own trust was created. The bankruptcy court found that debtor's own trust was invalid and terminated based upon the doctrine of merger, because defendant had become sole trustee and sole beneficiary after his mother died. The bankruptcy court explained the doctrine as follows:

> In a traditional trust, the trustee holds legal title to the corpus and the beneficiaries hold the equitable interest. *See Equitable Trust Co. v. Milton Realty Co.*, 261 Mich. 571, 577, 246 N.W. 500 (1933)(to create a trust, there must be an assignment of designated property to a trustee with the intention of passing title thereto, to hold for the benefit of others; there must be a separation of the legal estate from the beneficial enjoyment). *See also* Mich. Comp. Laws Ann. § 555.16 (valid express trust shall vest the whole estate in the trustees, in law and in equity, subject only to the execution of the trust; the beneficiary shall take no estate or interest in the lands, but may enforce the performance of the trust in equity). However, when the same person holds both the legal title and the equitable interest, the trust terminates, as a matter of law. This result is known as merger.
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> The RESTATEMENT (SECOND) TRUSTS describes the merger doctrine: "Except as stated in Subsection (2) 16, if the legal title of the trust property and the entire beneficial interest become united in one person who is not under an incapacity, the trust terminates." RESTATEMENT (SECOND) TRUSTS, § 341(1) (1959). "If by operation of law the legal title to the trust property passes to the beneficiary who has the entire beneficial interest, the trust terminates and the beneficiary holds the property free of trust." Id. at Comment b. "The sole beneficiary of a trust cannot be the sole trustee of the trust." Id. § 99(5).

Id., 239 B.R. at 763-64. As the operative facts effecting the merger and termination of the trust interest occurred before commencement of the case, the property at issue became property of the bankruptcy estate.

In contrast to the foregoing cases where a court found that a trust had terminated pre-petition, either through its terms or the actions of a trustee or debtor, the district court in *Safanda v. Castellano*, 2015 U.S. Dist. LEXIS 54458, 2015 WL 1911130 (N.D. Ill. Apr. 27, 2015), sustaining objection to report and recommendation at *Safanda v. Castellano (In re Castellano),* 514 B.R. 555 (Bankr. N.D. Ill. 2014), determined that a trust with a valid spendthrift provision *had not* terminated prior to the debtor's bankruptcy filing. The bankruptcy court transmitted a report and recommendation to the district court in *Castellano* in which it found that debtor's interest in a living trust containing a spendthrift clause had been terminated after the settlor had died pre-petition and the would-be debtor sent a letter to the trustee of the living trust (a relative) informing him of her financial problems and impending bankruptcy. Indeed one section of the living trust stated that "[u]pon the death of Faith F. Campbell and upon settlement of her estate, this Trust shall terminate." The letter prompted the trustee to take debtor's share of the trust assets and open up a separate brokerage account named the "Faith F. Campbell Spendthrift Trust f/b/o Linda Castellano." The bankruptcy trustee argued that this action terminated debtor's interest in the living trust with the valid spendthrift clause. The debtor argued that she transferred nothing and that the assets were still under the umbrella of the living trust's spendthrift provision when she filed for bankruptcy. The district court ultimately agreed with the debtor and held that, consistent with the reading that best reflects settlor Campbell's overall intent, the living trust was still in effect and Castellano had a beneficial interest in it when she filed for bankruptcy. The *Castellano* case nevertheless illustrates another way in which the termination argument might surface in the context of a § 541(c)(2) analysis.

B. Section 541(c)(2) and spendthrift clauses: Is there a restriction on transfer of the debtor's interest in the trust?

A spendthrift trust is one in which, by direction of the settlor, the right of the beneficiary to the assets in or distributions from the trust is not transferable by him (voluntarily) nor liable to be taken from him for satisfaction of his debts (involuntarily). *Industrial Nat. Bank v. Budlong*, 106 R.I. 780, 786, 264 A.2d 18 (1970) (citing Bogert, *Trusts and Trustees* (2d Ed.), § 221, at 623. "The purpose of a spendthrift trust is to protect the beneficiary from himself and his creditors." *In re*

Cattafi, 237 B.R. 853, 856 (Bankr. M.D. Fla. 1999)(citing *Croom v. Ocala Plumbing & Elec. Co.*, 62 Fla. 460, 466, 57 So. 243, 244-45 (1911)).The restraint on voluntary alienation prevents a beneficiary from voluntarily transferring rights to future payment of income or principal. The restraint on involuntary alienation prevents creditors of a beneficiary from attaching the beneficial interest to satisfy claims.

"No particular form of language is necessary to create a spendthrift trust, but the settlor must manifest her intention in language which is clear and unequivocal." *In re Baldwin*, 142 B.R. 210, 213 (Bankr. S.D. Ohio 1992); *McCoy v. Johnson (In re McCoy)*, Case No. 02C 3258, 2002 U.S. Dist. LEXIS 13239 (N.D. Ill. July 22, 2002)(under Illinois law, no special language is required to create a spendthrift trust, therefore, a trust containing an anti-alienation or spendthrift provisions does not automatically qualify as spendthrift trust).

The following are examples from case law of restrictive spendthrift clause language, some short and to the point and some more extensive. Courts generally seem to take these provisions as they find them and do not tend to delve into or analyze the language or its sufficiency. They key is that both voluntary and involuntary alienation of the beneficial interest be prohibited by the language. *See Geiger v. Geer*, 395 Ill. 367, 376, 69 N.E.2d 848 (1946)(directions against alienation by the voluntary act of the beneficiary or through legal process by creditors are the "usual incidents" of spendthrift trusts).

- "No money or property payable or distributable under this trust shall be pledged, assigned, transferred, sold or in any matter whatsoever anticipated, charged, or encumbered by the beneficiary hereunder or in any matter liable in the possession of the Trustee for the debts, contracts, obligations, or engagements of such claims, legal or equitable against any such beneficiary. The Trust property shall not be subject to attachment." *Richardson v. McCullough (In re McCullough)*, 259 B.R. 509, 517 n.5 (Bankr. D.R.I. 2001)(characterized as boilerplate spendthrift language).

- "The interests of beneficiaries in principal or income shall not be subject to the claims of any creditor, any spouse for alimony or support, or others, or to legal process, and may not be voluntarily or involuntarily alienated or encumbered." *Lunkes v. Gecker*, 427 B.R. 425, 430 (N.D. Ill. 2010).

- "C. Protective Trust Provisions. No beneficiary of any trust created under this instrument shall have the power to anticipate, encumber, or transfer any interest in the trust estate in any manner. No part of any trust estate shall be liable for or charged with any debts, contracts, liabilities, or torts of a beneficiary or be subject to seizure or other process by any creditor of a beneficiary. Notwithstanding the foregoing, if any beneficiary of any trust created under this instrument (except a surviving Grantor to the extent he or she is a beneficiary of any such trust whose value absent this provision would be allowable as a marital deduction in the estate tax proceeding relating to Grantor's death) shall attempt to anticipate, pledge, assign, sell, transfer, alienate or encumber his or her interest in the income or principal of such trust; or if any creditor or claimant shall attempt to subject such interest to the payment of any debt, liability or obligation of any such [**16] beneficiary; or if such beneficiary shall be subject to bankruptcy, insolvency or receivership proceedings, thereupon any absolute right of such beneficiary to income or principal from such trust shall cease. Thereafter, and until such time as the Trustee is able to distribute such property to such beneficiary, the Trustee may accumulate trust income, if any, to which such beneficiary would otherwise be entitled or the Trustee may distribute the same to the other beneficiaries, if any, of the trust entitled to receive such income and shall be held harmless in making such discretionary distributions. In no event shall the Trustee be required or compelled to pay any income or principal to or for the benefit of such beneficiary, and, upon the death of such beneficiary, any property held or accumulated in his or her trust shall be distributed in accordance with the provisions provided for principal dispositions at his or her death" *Diamond v. Trawick (In re Trawick)*, 497 B.R. 572, 579 (Bankr. C.D. Cal. 2013)(described as "maximum spendthrift provision" under North Carolina trust statute, which is a version of the Uniform Trust Code).

● "Neither the principal nor the income from this trust shall be liable for the debts of any beneficiary hereunder. Nor shall any part thereof be subject to seizure by any creditor of any beneficiary under any return or proceeding in law or in equity or otherwise, and no disposition, charge, encumbrance, sale or assignment of the income or of the principal of this trust or any part hereof by any beneficiary hereunder shall be of any validity or legal effect or in any way recognized by said TRUSTEE." *In re Roth*, 289 B.R. 161, 165 (Bankr. D. Kan. 2003)(described as "classic spendthrift clause").

●"If any beneficiary should attempt to alienate, encumber, or dispose of all or any part of the income or principal of this [Living] Trust before it has been delivered by the [Spendthrift] Trustee, or if by reason of bankruptcy or insolvency or any attempted execution, levy, attachment, or seizure of any assets remaining in the hands of the [Spendthrift] Trustee under claims of creditors or otherwise, all or any part of the income or principal might fail to be enjoyed by any beneficiary or might vest in or be enjoyed by some other person, then the interest of that beneficiary shall immediately terminate Thereafter, the [Spendthrift] Trustee shall pay to or for the benefit of that beneficiary only those amounts that the [Spendthrift] Trustee, in its sole and absolute discretion, deems advisable for the education and support of that beneficiary until the death of the beneficiary or the maximum period permissible under the South Carolina rule against perpetuities, whichever first occurs." *Safanda v. Castellano (In re Castellano)*, 514 B.R. 555, 558 (Bankr. N.D. Ill. 2014).

C. Is the restriction on transfer valid and enforceable under state law?

1. General rule of enforceability

Restrictions on alienation of a beneficial interest in a trust, in their common guise as "spendthrift provisions," are generally valid and enforceable under state law, either by common law, statute, or both, and including, as follows, in Illinois, Michigan, Ohio, Indiana, and Wisconsin. As one court emphasizes, the precise inquiry under the third prong of the § 541(c)(2) framework is not more generally whether a trust is or is not a "spendthrift trust." Rather, “the question is whether a specific provision was valid as to a specific person's interest at a specific point in time.” *Safanda v. Castellano*, 2015 U.S. Dist. LEXIS 54458, 2015 WL 1911130 (N.D. Ill. Apr. 27, 2015), sustaining objection to report and recommendation at *Safanda v. Castellano (In re Castellano),* 514 B.R. 555 (Bankr. N.D. Ill. 2014).

Illinois law:

Spendthrift trusts are valid in Illinois. *Geiger v. Geer*, 395 Ill. 367, 69 N.E.2d 848 (1946). The policy purpose of allowing spendthrift trusts in Illinois is to provide a fund for the support of another while protecting the fund against the beneficiary's incapacity or financial imprudence. *In re Di Piazza*, 29 B.R. 916, 918-19 (Bankr. N.D.Ill. 1983).

No Illinois statute specifically addresses spendthrift provisions. Instead, the state's rules are based partly on the common law, *see Rush University Medical Center v. Sessions*, 2012 IL 112906 ¶ 20, 980 N.E.2d 45, 366 Ill. Dec. 245, and partly on its Code of Civil Procedure, *see* 735 ILCS 5/2-1403. Section 2-1403, entitled "Judgment debtor as beneficiary of trust" and which states that "No court . . . shall order the satisfaction of a judgment out of any property held in trust for the judgment debtor if such trust has, in good faith, been created by, or the fund so held in trust has proceeded from, a person other than the judgment debtor. . . .".. To qualify as a spendthrift trust, the trust, by its terms, must restrict the beneficiary from accessing or voluntarily alienating the trust assets and must preclude the beneficiary's creditors from reaching the assets by execution, levy, garnishment or otherwise.

Michigan law*:*

Michigan common law has long recognized the validity of spendthrift ’restrictions on the transfer of beneficial interests in trusts. *In re Estate of Edgar*, 137 Mich. App. 419, 357 N.W. 2d 867 (1984); *see Kohut v. Lewiston (In re Lewiston)*, 532 B.R. 36, 42-46 (Bankr. E.D. Mich. 2015(recounting background of spendthrift trusts under Michigan law). A spendthrift trust is: “one created to provide a fund for the maintenance of the beneficiary at the same time to secure it against his improvidence or incapacity. In a narrower and more technical sense, a spendthrift trust is one that restrains either the voluntary or involuntary alienation by a beneficiary of his interest in the trust, or which, in other words, bars such interest from seizure in satisfaction of his debts.'" *In re Benton,* 237 B.R. 353, 357-58 (Bankr. E.D. Mich. 1999) (quoting *Fornell v. Fornell Equip., Inc*., 390 Mich. 540, 548, 213 N.W.2d 172 (1973)). In addition to the common law, there are statutory provisions in the Michigan Trust Code, enacted in 2010, recognizing the validity of spendthrift provisions. Mich. Comp Laws Ann. §§ 700.7103(j)(definition of spendthrift provision); 700.7502(1)(recognizing validity of provision); and 700.7502(3)(limitation on creditor ability to reach assets in spendthrift trust).

Wisconsin law:

Wisconsin statutes support certain spendthrift protections for trust beneficiaries. The Wisconsin Legislature permits protection of income distributions through anti-alienation clauses in Wisconsin Stat. § 701.06(1), as follows:

> **Spendthrift provisions and rights of creditors or beneficiaries.**
>
> (1) A settlor may expressly provide in the creating instrument that the interest in income of a beneficiary other than the settlor is not subject to voluntary or involuntary alienation. The income interest of such beneficiary cannot be assigned and is exempt from claims against the beneficiary until paid over to the beneficiary pursuant to the terms of the trust.

Wisconsin Stat. § 701.06(2) provides that:

> A settlor may expressly provide in the creating instrument that the interest in principal of a beneficiary other than the settlor is not subject to voluntary or involuntary alienation. The interest in principal of such a beneficiary cannot be assigned and is exempt from claims against the beneficiary, but a judgment creditor, after any payments of principal have become due or payable to the beneficiary pursuant to the terms of the trust, may apply to the court for an order directing the trustee to satisfy the judgment out of any such payments and the court in its discretion may issue an order for payment of part or all of the judgment.

In *Resop v. McCoy (In re McCoy)*, 464 B.R. 832, 836 (Bankr. W.D. Wis. 2011), the bankruptcy court decided that "the phrase 'due or payable' [in Wisconsin Stat. § 701.06(2)] was intended to mean mandatory payments under the terms of the trust," i.e., "those that a beneficiary is entitled to receive, or payments that have been declared by a trustee with discretion to do so." 464 B.R. 832, 839 (Bankr. W.D. Wis. 2011). The court arrived at this construction by comparing § 701.06(2) to a nearby provision on self-settled trusts, under which judgment creditors could reach "payments of income or principal as they are due, presently or in the future, or which are payable in the trustee's discretion . . . ." Wisc. Stat. § 701.06(6)(a). According to the court, this slight contrast in language, coupled with the larger statute's "apparent purpose . . . to include different treatments for interest payments, distributions of principal, and protection of self-settled trusts," "suggests that the legislature intended relatively more spendthrift protection for principal distributions" than for self-settled trusts. *McCoy*, 464 B.R. at 839.

The court concluded in *McCoy* that the debtor's interest in the trust principal was excluded from the bankruptcy estate because the spendthrift clause is "enforceable under applicable nonbankruptcy law" and “[w]hile Wisconsin law allows judgment creditors to apply for payments of principal notwithstanding a spendthrift clause, no such payments are ‘due or payable’" in this case. *McCoy*, 464 B.R. at 839. As a result the bankruptcy trustee was not entitled to turnover of the payments that the trustee chose in his discretion to withhold from the debtor.

Ohio law:

Spendthrift trusts, generally described as trusts that impose "a restraint on the voluntary and involuntary transfer of the beneficiary's interest in the trust property," are valid and enforceable in Ohio. *Scott v. Bank One Trust Co., N.A.*, 62 Ohio St. 3d 39, 577 N.E.2d 1077, 1081 (Ohio 1991)(overruling *Sherrow v. Brookover*, 174 Ohio St. 310, 189 N.E.2d 90 (Ohio 1963), which had rendered spendthrift trusts invalid in Ohio); *Domo v. McCarthy*, 66 Ohio St. 3d 312, 612 N.E.2d 706 (Ohio 1993)(syllabus 2: In Ohio, a spendthrift provision of a trust, when applicable, will be given full force and effect). With some exceptions, such trusts are effective to bar the beneficiary's creditors or a trustee in bankruptcy from reaching the trust corpus or distributions.

Indiana law:

In Indiana, a grantor's power to create a spendthrift provision is codified at Indiana Code § 30-4-3-2, as follows:

> Power to restrain transfer of a beneficiary's interest.
>
> (a) The settlor may provide in the terms of the trust that the interest of a beneficiary may not be either voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee.
> (b) Except as otherwise provided in subsection (c), if the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of his beneficial interest will not prevent his creditors from satisfying claims from his interest in the trust estate.
> (c) Subsection (a) applies to a trust that meets both of the following requirements, regardless of whether or not the settlor is also a beneficiary of the trust:
> (1) The trust is a qualified trust under 26 U.S.C. 401(a).
> (2) The limitations on each beneficiary's control over the beneficiary's interest in the trust complies with 29 U.S.C. 1056(d).
> (d) A trust containing terms authorized under subsection (a) may be referred to wherever appropriate as a trust with protective provisions.

Ind. Code § 30-4-3-2. *See Sisters of Mercy Health Corp. v. First Bank of Whiting*, 624 N.E.2d

520, 522 (Ind. App. 1993).

Against this statutory background, spendthrift trusts are valid under Indiana law as long as three requirements are met. *In re Weiser*, Case No. 10-1076-AJM-7A, 2011 Bankr. LEXIS 1615, *5-*6, 2011 WL 1637945,*2 n.3 (Bankr. S.D. Ind. Apr. 29, 2011). The three requirements for a trust to be a spendthrift trust under Indiana law are (1) the settlor may not be a beneficiary of the trust; (2) the beneficiary must not have any present dominion or control over the plan corpus; and (3) the trust must contain an anti-alienation clause which prevents the beneficiary from voluntarily or involuntarily transferring his interest in the trust. *Id.* (citing *United States v. Grimm,* 865 F. Supp. 1303, 1311 (N. D. Ind. 1994)); *Brosamer v Mark*, 540 N.E.2d 652, (Ind. Ct. App. 1989) and Ind. Code § 30-4-3-2); *see also In re Armstrong*, Case No. 12-30175 HCD, 2012 Bankr. LEXIS 5552, 9-10 (Bankr. N.D. Ind. Nov. 15, 2012).

2. Some exceptions to the general rule of state law enforceability of anti-alienation restrictions

(a) Self-settled trusts

At its most basic, a self-settled trust is one in which the settlor transfers assets into a trust and names herself as a beneficiary. *See* 1 *Restatement (Second) of Trusts* 156 (1959). As a matter of either common law or statute, courts throughout the United States will generally not enforce a spendthrift trust against the voluntary and involuntary creditors of a beneficiary if the trust is self-settled. *See In re Salahi*, Case No. 11-16621-BFK, 2012 Bankr. LEXIS 1813, *10-*11, 2012 WL 1438213, *4 (Bankr. E.D. Va. Apr. 25, 2012)(citing cases and authorities for proposition that the "great weight of authority from other jurisdictions" is that a restraint on alienation in a self-settled trust is invalid). In other words, a trust where the person creating the trust and the beneficiary are one and the same is void against present and future creditors, even if it contains an anti-alienation restriction. The public policy against recognizing self-settled trusts as against creditors was described by the Michigan Supreme Court as follows:

> A person cannot, however, create a true spendthrift trust for himself. Public policy does not permit a man to place his own assets beyond the reach of his creditors. But a settlor is not precluded from transferring his own property in trust to protect himself against his own improvidence.
>
> "Such a trust is binding on him except in so far as it is still within his power to alien or encumber it with debts[.]"

Fornell v. Fornell Equipment, Inc., 213 N.W.2d 172 , 176 (Mich. 1973) (quoting 54 *Am. Jur., Trusts*, § 166, p. 135). Thus, if a bankruptcy court finds that a trust containing an otherwise valid restriction on alienation is self-settled, the restriction will not be enforceable under applicable nonbankruptcy law and will therefore not be excluded from the bankruptcy estate by § 541(c)(2).

(b) Debtor exercise of dominion and control over trust assets

The primary concern with creditor protections regarding spendthrift trusts is with self-settled trusts, but some jurisdictions will not recognize a spendthrift trust, even if the trust is not directly or indirectly self-settled, where a beneficiary has or exercises too much control over trust property. *See* Spero, Asset Protection: Legal Planning, Strategies and Forms, ¶ 6.11 (Loss of Protection Because of Beneficiary's Control) (2011), citing *inter alia, Waterbury v. Munn*, 159 Fla. 754, 32 So.2d 603, 606 (1947). Even if a debtor is not the settlor of a trust, the exercise of dominion and control over the assets incompatible with the purpose of the trust may invalidate and make unenforceable the spendthrift restriction in the trust. *Schwen v. Ramette (In re Schwen)*, 240 B.R. 754, 757 (Bankr. D. Minn. 1999)("It is clear that if the beneficiary has absolute and sole discretion to compel distribution of the trust assets, the spendthrift provision must fail."); *In re Silldorff*, 96 B.R. 859, 864 (C.D.Ill. 1989); *In re Balay*, 113 B.R. 429, 437 (Bankr.N.D.Ill. 1990). It is "well-settled" that a beneficiary's right to access trust property overrides and nullifies the protective effect of an otherwise enforceable spendthrift provision. *In re Marriage of Sharp*, 369 Ill.App.3d 271, 281, 860 N.E.2d 539, 307 Ill. Dec. 885 (Ill.App. 2 Dist. 2006).

This tends to be a fact intensive inquiry because "[t]he Court must analyze the terms of the Trust not only for the actual exercise of dominion and control by the debtor but also for the ability of the debtor to exercise dominion and control." *In re Baldwin*, 142 B.R.210, 215 (Bankr. S.D. Ohio 1992)(citing *In re Swanson*, 873 F.2d 1121, 1124 (8th Cir. 1989)). Indeed, "something less than absolute control may also destroy the spendthrift character of a trust." *In re Schwen*, 240 B.R. at 757 (citing *McCauley v. Hersloff (In re Hersloff)*, 147 B.R. 262, 266 (Bankr. M.D. Fla. 1992)). The question is on which side of the line a particular debtor's actions and conduct fall in consideration of the provisions of the trust documents at issue.

The *Schwen* case is an example of examination of debtor dominion and control over trust assets in which the court concluded that the debtor's rights under the trust documents did not invalidate the spendthrift restriction. In *Schwen*, debtor was one of two trustees and a beneficiary of a trust established by her late mother. Both trustees were required to consent jointly to any withdrawal from the trust, which was being used to support their incapacitated father who was still living when the bankruptcy case was filed. In *Schwen*, in the absence of any showing of use of the trust assets for personal benefit, the court decided that the joint role of co-trustee and beneficiary did not afford debtor dominion and control over the assets such that she could compel a distribution to herself, without the consent of her sister who also had fiduciary duties to their father and the debtor. As a result, the court upheld the enforceability of the trust spendthrift provision under Florida law for purposes of § 541(c)(2). In doing so, it distinguished another case in which a co-trustee and beneficiary could unilaterally compel a distribution to himself without the consent of the other trustee.

On the other hand, the *Lewiston* case is a good example of a case where a debtor/ beneficiary/ co-trustee's actions amounted to sufficient dominion and control over the trust assets to invalidate the spendthrift clause under Michigan law and bring the trust assets into the bankruptcy estate. *Lewiston,* 532 B.R. 36, affirmed at *Lewiston v. Kohut (In re Lewiston),* 539 B.R. 154 (E.D. Mich. 2015). The trust was an irrevocable living trust entered into years before the bankruptcy filing. Debtor and his spouse were co-trustees and the sole beneficiaries of the trust during their lifetimes. Debtor's spouse also contributed assets to the trust, which could be amended or revoked only by the joint action of both spouses. Debtor argued that these facts supported his argument that the spendthrift provision was enforceable against the bankruptcy trustee.

But debtor's actions undercut these arguments. Debtor repeatedly over time withdrew funds from the trust and deposited them into his own bank accounts at his whim. He took loans from the trust, but did not execute any loan documents or list it as a creditor in the bankruptcy case. He paid personal taxes and bills for a Florida vacation home and country club dues out of the trust assets. He never obtained nor sought his wife's consent for his actions and by exercising complete and unfettered use and enjoyment of all of the trust assets treated them as his own. As a result, so did the court. Succinctly summarizing the application of the law to the facts, the court concluded:

> The spendthrift provision that restricts [debtor] as a beneficiary of the Trust from transferring his right to receive any distributions from the Trust is not enforceable under applicable Michigan law. Because the restriction is unenforceable under applicable Michigan law, Richard's beneficial interest in the Trust is not excluded from his bankruptcy estate under § 541(c)(2) of the Bankruptcy Code. It became property of his bankruptcy estate under § 541(a)(1) of the Bankruptcy Code when he filed Chapter 7. For these reasons, the Court will enter an order granting the Plaintiff's motion for summary judgment, holding that Richard's beneficial interest in the Trust is property of his bankruptcy estate.

Lewiston, 532 B.R. at 53.[2]

Another example of a finding of dominion and control over trust assets defeating a spendthrift provision is *Casey v. Schneider (In re Behan)*, 506 B.R. 8 (Bankr. D. Mass. 2014). Unlike in *Schwen*, the bankruptcy court in *Behan* found dominion and control over the trust assets based only on the terms of the trust document and even absent any debtor actions inconsistent with the spendthrift provision as in *Lewiston*.

In *Behan*, debtor's father, deceased long before the Chapter 7 filing, placed his home in a trust for the benefit of his five children, including debtor. Debtor and two sisters were co-trustees. The trust contained a spendthrift provision. However, the trust also provided that upon the father's death "the Trustees shall pay to or for the benefit of such child all or so much of the principal and accrued income of such share as such child may specifically demand in writing from the Trustees so long as such child is not incapacitated at time of demand." *Behan*, 506 B.R. at 12. The court held that this unexercised power of appointment conferred on debtor the unfettered right to demand his 1/5 share of the principal and income of the trust at any time and that the dominion and control it afforded debtor over his interest in the assets defeated the spendthrift provision under Massachsetts law. The trustee was thus authorized to exercise debtor's power of appointment over his interest in the trust as property of the bankruptcy estate. *Cf.* 11 U.S.C. § 541(d).

3. Exceptions to the exceptions

There are exceptions to the general principle that a spendthrift provision in a self-settled trust will not be enforceable under applicable nonbankruptcy law.

Most prominently, by statute, 17 states, starting with Alaska and now including Ohio and

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[2] On appeal, the district court addressed another argument of debtor's that the bankruptcy court had also later rejected, namely that debtor's and his wife's conveyance of the assets into the trust created a Michigan statutory tenancy by the entireties exempt from garnishment by creditors. Debtor relied on the case *Zavradinos v. JTRB, Inc.*, 482 Mich. 858, 753 N.W.2d 60 (2008), for the proposition that the strong Michigan statutory presumption in favor of tenancies by the entirety should apply to the trust and/or to debtor's beneficial interest in the trust. Both courts rejected this argument, distinguishing *Zavradimos* and finding that the fact that debtor and his wife were co-beneficiaries of the trust did not transform the beneficial interest of each into an asset held by the entireties. This result might be different now with respect to a self-settled spendthrift trust created under the new Michigan domestic asset protection trust act. Mich. Comp. Laws Ann. 700.1041 *et seq.*

most recently Michigan, have authorized domestic (as opposed to offshore and foreign jurisdiction) asset protection trusts ("DAPTs"). A DAPT is a species of self-settled trust in which the settlor is permitted to retain certain property interests in the trust while still limiting the ability of creditors to reach those interests. The policy around and the specific requirements of DAPTs or any specific statute are beyond the scope of this presentation. The statutory schemes vary in their details by state, but share some common characteristics. Generally DAPT statutes override common law or statutory prohibitions on enforcing transfer restrictions in self-settled trusts against creditors; specify the interests in trust assets a settlor may validly retain; set the parameters for qualified trustees; permit certain classes of creditors (such as domestic creditors) to reach trust assets; establish requirements and limitations for creation of a valid DAPT; and limit creditor remedies if the assets are reachable, including revision of the state's fraudulent (or voidable in states such as Michigan that that have adopted the new Uniform Voidable Transaction Act) transfer law and the limitations and reachback period therein, which are generally shortened.

There has not yet been extensive litigation and published case law involving DAPTs under § 541(c)(2). As the number of states adopting them increases, so will litigation.

One issue that will arise will be choice of law. For example, if a debtor in Illinois sets up a Michigan DAPT, what law will the bankruptcy court apply to determine enforceability of the spendthrift provision in the DAPT? Is it enough that the trust restriction on alienation is enforceable in Michigan or will the court apply Illinois law? In the case *Waldron v. Huber (In re Huber)*, 493 B.R. 798 (Bankr. W.D. Wash. 2013), debtor created an Alaska DAPT and transferred virtually all of his assets to it. The trust specified that it was governed by Alaska law. But the bankruptcy court applied Washington law instead of Alaska law and decided that the trust was an invalid self-settled trust under Washington law. *See also TrustCo Bank v. Mathews*, Del. Ch 8374-VCP, 2015 WL 295373 (Jan. 22, 2015)(Delaware state court declined to apply New York statute of limitations in challenge to trusts created by New York resident, instead looking to Florida or Delaware law). Assets located outside of the DAPT state, as in *Huber*, are likely to complicate choice of law issues.

The DAPT statutes are detailed in their requirements. A DAPT will not be cheap to set up or administer properly. If the DAPT statute is not adhered to and the debtor swings and misses in its creation or administration, the safe harbor it provides for enforceability of the restriction on transfer under § 541(c)(2) will not protect the assets from becoming property of the estate as just another self-settled spendthrift trust under applicable nonbankruptcy law. *E.g. In re Erskine*, 550

B.R. 362 (Bankr. W.D. Tenn. 2016)(living trust for which debtor served as trustee not a valid Tennessee APT as it failed to satisfy most of the statutory requirements, with the result being that there was no enforceable applicable nonbankruptcy law that restricted transfer of debtor's beneficial interest in the trust); *In re Bertran*, Case No. F12-0050-HAR, 2016 Bankr. LEXIS 2439, 2016 WL 3411931 (Bankr. D. Alaska June 8, 2016)(same with respect to noncompliance with requirements to establish valid Alaska APT).

Beyond DAPTs, other types of trusts that might otherwise be considered self-settled may nevertheless enjoy statutory protection under specifically applicable nonbankruptcy law. They include:

- qualified terminable interest trusts ("QTIP"), which can be revocable (*see, e.g.*, Mich. Comp. Laws Ann 700.7506(4)[creditors of the first to die donor spouse cannot reach the assets in the QTIP trust after the death of the donee spouse]);

- qualified personal residence trusts ("QPRT"), which are a form of grantor retained income trust where transferor transfers primary residence while retaining right to live there and with automatic transfer to beneficiaries on trust termination;

- special or supplemental needs trusts ("SNT"), which may be revocable (some state statutes, including in Wisconsin, provide that creditors of a settlor cannot reach the assets of a special needs trust).

III. Issues in Creation of a Trust as a Fraudulent or Voidable Transfer

Notwithstanding that a debtor's interest in a trust may be protected by an enforceable spendthrift clause, such as in a DAPT or valid testamentary trust or QPRT, trust creation and asset transfers into trusts are still subject to attack as basic fraudulent transfers.

One avenue of attack for trustees is through the Bankruptcy Code. Under § 548, "Fraudulent transfers and obligations," a transfer of assets into a trust may still be attacked as an actually or constructively fraudulent transfer, subject to the same elements and proofs as any other asset transfer. *E.g., Menotte v. Champalanne (In re Champalanne),* 425 B.R. 707,713 (Bankr. S.D. Fla. 2010)(transfer into family trust subject to attack as actually fraudulent transfer); *Rigby v. Mastro (In re Mastro)*, 465 B.R. 576 (Bankr. W.D. Wash. 2011)(pre-petition transfer of residential real properties from revocable trust into newly created self-settled irrevocable trust was avoided as an actually fraudulent transfer made with intent to hinder, delay or defraud creditors); *cf. Waldron v. Huber (In re Huber)*, 493 B.R. 798 (Bankr. W.D. Wash. 2013). The basic reachback period under

§ 548(a)(1) is only two years.

Another avenue of attack on the transfer of assets into a trust is through applicable state fraudulent transfer or conveyance law. *Id*. Under § 544(b), "Trustee as lien creditor and as successor to certain creditor and purchasers," the applicable state law of fraudulent transfers or conveyances may be imported into the Bankruptcy Code, as long as the trustee can identify a creditor that could have avoided the transfer. 11 U.S.C § 544(b)(1)("the trustee may avoid any transfer of an interest of the debtor in property...that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title..."). Oftentimes the advantage for a trustee in asserting state law under § 544(b) is a longer reachback period than just the two years in § 548.

The general principle that transfers into a trust may be attacked as fraudulent is equally applicable to DAPTS, both inside and outside of bankruptcy. State DAPT statutes, however, often limit creditor remedies with respect to DAPTs and provide specific and more limited reachback periods for transfers into DAPTS than for other types of transfers. Likewise, the burden of proof for creditor's attacks may be heightened. For example, under the new Michigan APT statute, the limitations period for attacking transfers into a valid APT is significantly limited, to one year in certain circumstances and two years in others, with a clear and convincing standard of proof.

As a result of the burgeoning number of DAPT jurisdictions (five such statutes at that time), and perhaps the perceived inequity of cracking down on average little guy consumer debtors while allowing monied debtors to shelter their stuff from the reach of creditors, Congress added § 548(e) to the Bankruptcy Code in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. 11 U.S.C. § 548(e). The two most significant aspects of § 548(e)(1), as follows, are that it applies to actually fraudulent transfers to a "settled-settled trust *or similar device*" (emphasis added) and it provides a lengthened reachback period of ten years before the date of filing the petition:

> In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if —
> (A) such transfer was made to a self-settled trust or similar device;
> (B) such transfer was by the debtor;
> (C) the debtor is a beneficiary of such trust or similar device; and
> (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

Congress did not define either "self-settled trust" or "similar device." Absent statutory definitions, the meaning of these terms is open to interpretation and shaping through litigation, with not much having occurred so far. Indeed a trustee may have an opening into the longer reachback period by arguing that certain arrangements or legal entities that are not exactly trusts amount to a "similar device" under § 548(e)(1). Thus far, however, courts have generally adopted narrow constructions of the term.

In *Quality Meat Products, LLC v. Porco, Inc. (In re Porco, Inc.*), 447 B.R. 590 (Bankr. S.D. Ill. 2011), an unsecured judgment creditor in a corporate debtor's Chapter 7 case attacked a transfer made some five years before commencement of the bankruptcy case to an LLC and argued that the LLC was a "similar device" under § 548(e)(1)(A) in that a constructive or resulting trust was created by the transfer. Narrowly construing the term "similar device" and relying largely on the legislative history, the court decided that § 548(e) requires a form of express trust for an arrangement to amount to a "similar device."

In *Smith v. Pollack (In re Pollack)*, Case No. 13-11508--BAH, 2016 Bankr. LEXIS 190, *14-*15, 2016 WL 270012, *5 (Bankr. N.H. Jan. 20, 2016), in *dicta*, the bankruptcy court stated that a transferee revocable trust did not qualify as a "self-settled trust or similar device" because it "is not an irrevocable trust or a spendthrift trust. It does not contain any provisions that would restrict the trustee's ability to make distributions or that would protect the trust assets from claims of creditors." Thus, even where a form of express trust is involved as the transferee, at least the New Hampshire bankruptcy court would find that not just any old form of trust will amount to a "similar device."

The bankruptcy court in *Castellano* construed the "similar device" language more expansively. The arrangement at issue was a brokerage account established by the trustee from assets from debtor's mother's testamentary trust after her death and after debtor advised him of her financial problems and impending bankruptcy. The account was titled the "Faith F. Campbell Spendthrift Trust f/b/o Linda Castellano," although it lacked the formal requisites of an express trust. The court decided that the account was nevertheless a "similar device" subjecting the transfer of funds into it to avoidance under § 548(e) and so recommended to the district court. *Castellano*, 514 B.R. at 562. While the district court ultimately rejected the report and recommendation and held that § 548(e)(1) did not apply, it did not do so on the basis that the brokerage account did not qualify as a "similar device."

IV. Resulting Trusts in Bankruptcy

The foregoing discussion largely assumes various forms of express trusts. The intersection of trust law and bankruptcy often also involves implied trusts, one form of which is the "resulting trust." Resulting trusts in various jurisdictions share the common feature that they are remedial in nature and arise by operation of law to effect the intentions of the parties. Resulting trust arguments often seem to involve interests in motor vehicles and financial accounts.

A good general working definition of a resulting trust is the definition under Illinois law cited by the bankruptcy court in *In re Porco, Inc.*, 447 B.R. at 596: "[u]nder Illinois law, resulting trusts arise by operation of law and are generally created where an express trust fails, or where an express trust terminates prior to the exhaustion of the trust estate, or where one person pays for property and another takes title. *Midwest Decks, Inc. v. Butler & Baretz Acquisitions, Inc.*, 272 Ill.App.3d 370, 649 N.E.2d 511, 519, 208 Ill.Dec. 455 (1995); *see Matter of Engel's Estate*, 87 Ill.App.3d 273, 408 N.E.2d 1134, 42 Ill.Dec. 425 (Ill.App. 3 Dist. 1980) (resulting trust arose where son holds funds given to him by his mother in his bank account); *Carlson v. Carlson*, 74 Ill.App.3d 673, 393 N.E.2d 643, 30 Ill.Dec. 607 (Ill.App. 1 Dist. 1979) (resulting trust where wife puts home in husband's name to avoid creditors)."

Similarly, "[u]nder New York law, a resulting trust arises '(1) where an express trust fails in whole or in part; (2) where an express trust is fully performed without exhausting the trust estate; (3) where property is purchased and the purchase price is paid by one person and at his direction the vendor conveys the property to another person.'... A resulting trust 'can be established only by clear, unequivocal and convincing evidence, especially when parol evidence is relied upon.'" *Jacobs v. Matrix Capital Bank (In re AppOnline.com, Inc)*, 315 B.R. 259, 275-76 (Bankr. E.D.N.Y. 2004).

Notwithstanding its remedial purpose, the determining factor in imposing a resulting trust is still the intent of the parties. *E.g. Sender v. Buchana (In re Hedged-Invs. Assocs, Inc.)*, 163 B.R. 841, 851 (Bankr. D. Colo. 1994)("'A resulting trust carries into effect the intentions of the parties..."). And generally, the standard of proof is by clear and convincing evidence. *Rollins v. Neilson (In re Cedar Funding, Inc)*, 408 B.R. 299, 315 (Bankr. N.D. Cal. 2009).

The concept of the resulting trust can be used by a variety of bankruptcy case actors, both offensively and defensively. While sometimes successful, resulting trust arguments more often than not exude the aura of a desperate last gasp destined to fail.

A trustee may argue that the beneficial interest in property in the possession of or titled to a third party is really the debtor's and thus property of the estate because it is subject to a resulting trust in favor of the debtor. *Bash v. Cunningham (In re Cunningham)*, Case No. 06-14882, 2008 Bankr. LEXIS 4125, 2008 WL 2746023 (Bankr. N.D. Ohio July 11, 2008)(Chapter 7 trustee successfully argued that there was a purchase money resulting trust in favor of the debtor impressed on real estate bought with debtor's money but titled in his son's name); *see Sacramento Real Estate Corp. v. First Chicago Bank (In re Sacramento Real Estate Corp.)*, 201 B.R. 225 (Bankr. N.D. Ill. 1996)(court entered a declaration that a refund received from a government entity belonged to the bankruptcy estate and directed the turnover of such funds to a debtor-in-possession account, noting that the bank had held the refund as trustee of a resulting trust for the benefit of debtor).

On the other hand, a debtor may be the one arguing that she has a beneficial interest in property not titled in her name through a resulting trust, such as for the purpose of claiming an exemption, *In re Frankel*, 508 B.R. 527 (Bankr. D. Mass. 2014)(court rejected argument that debtor wife had a beneficial interest via a resulting trust in a car titled in debtor husband's name), or for the purpose of claiming a violation of the automatic stay by a creditor, *Smith v. Prokos (In re Smith)*, Case No. 15-60272, 2016 Bankr. LEXIS 2418, 2016 WL 3619799 (Bankr. N.D. Ohio June 28, 2016)(no beneficial interest in debtor where car titled in creditor's name and no intent to the contrary shown).

A debtor or third party may defensively argue the opposite where property is titled in debtor's name: namely that debtor does not hold the beneficial interest in property, which is subject to a resulting trust in favor of a beneficiary who does as the parties intended. 11 U.S.C. § 1141(d); *e.g. In re Phillips,* 41 B.R. 143 (Bankr. N.D. Ohio 1984)(court decided that debtors held insurance policies subject to a resulting trust in favor of a third party beneficiary and they were not property of the estate); *Gold v. Demeter (In re Demeter)*, 539 B.R. 760 (Bankr. E.D. Mich. Oct. 20, 2015)(where evidence showed that funds in joint account did not come from debtor or her property, presumption under Michigan law that joint account holders each owned a one-half interest rebutted); *Barber v. Unionbank (In re Johnson)*, 232 B.R. 735 (Bankr. C.D. Ill. 1999)(resulting trust defense against trustee turnover action for account and certificate of deposit held by debtor's brother allowed to proceed); *In re Caddarette*, 362 B.R. 829 (Bankr., N.D. Ohio 2006)(trust argument rejected as not viable under Ohio motor vehicle title act with respect to a car titled in debtor's name); *Gold v. Harper (In re Ambrose-Burbank)*, 563 B.R. 820 (Bankr. E.D. Mich. Jan. 25, 2017)(same under Michigan motor vehicle title act)*; see In Butler v. Case (In re Case's Estate)*, 161 Ohio St.

288, 118 N.E.2d 836 (1954), syllabus (paragraph three)(Supreme Court of Ohio held that by reason of Ohio motor vehicle title statute a resulting trust with respect to a motor vehicle cannot be created in Ohio). *But cf. Bavely v. Powell (In re Baskett)*, 219 B.R. 754, 761-62 (B.A.P. 6th Cir. 1998)(court held that an Ohio oral express trust, distinguished from a resulting trust, for a beneficiary other than the debtor, can prevent ownership interest in a vehicle from being included in the property of the debtor's estate, even though the vehicle was titled in only the debtor's name).

Creditors and third parties may also use resulting trust arguments defensively (usually unsuccessfully) in response to trustee avoidance actions, either as preferential or fraudulent transfers, arguing that that the property at issue is impressed with a resulting trust in favor of the transferee such that the challenged transfer is not avoidable. *E.g. Askenaizer v. May (In re Jewett)*, 2007 Bankr. LEXIS 1526, 2007 WL 1288740 (Bankr. D.N.H. May 2, 2007)(debtor acquired title to the property at a foreclosure sale for the benefit of the transferee (former son-in-law) but held it for him in a resulting trust until the deed transfer, because but at all times the parties intended the property for use by the transferee, the transferee remained in continuous possession, using the property as his home, and the transferee eventually took over sole financial responsibility for the property); *In re AppOnline.com, Inc*, 315 B.R. at 275-76; *Mason v. Clark (In re Book)*, Case No. 11-62686, 2013 Bankr. LEXIS 3303 (Bankr. N.D. Ohio Aug. 1, 2013)(defense attempted unsuccessfully in constructive fraudulent transfer action and preference action); *Yoder v. T.E.L. Leasing (In re Suburban Motor Freight)*, 124 B.R. 984 (Bankr. S.D. Ohio 1990)(in fraudulent transfer action, no evidence of resulting trust imposed on $2.1 million transferred by debtor to defendant pre-petition).

Similarly, third parties may use a resulting trust argument offensively in seeking to recover property in a debtor's custody and control as the third party's beneficial property. *Secure Leverage Group, Inc. v. Bodenstein (In re Peregrine Fin. Group, Inc.)*, Case No. 12 B 27488, 2014 Bankr. LEXIS 2328, 2014 WL 2197945 (Bankr. N.D. Ill. May 27, 2014)(customer funds transferred to debtor for the purposes of trading were property of the debtor's bankruptcy estate, since the funds were not segregated, the debtor was presumed to own the funds in its possession, the customer agreements did not provide for retention of ownership of the funds by the customers and thus no resulting trust existed); *In re O'Malley*, 252 B.R. 451 (Bankr. N.D. Ill. 1999)(under liberal pleading requirements, the court found sufficient facts stating a cause of action for a resulting trust against the bankruptcy estate).

V. Constructive Trusts in Bankruptcy

Resulting trusts and constructive trusts are both equitable remedies. *Richardson v. Huntington Nat'l Bank (In re CyberCo Holdings, Inc.)*, 382 B.R. 118 (Bankr. W.D. Mich. 2008)(Michigan law recognizes unjust enrichment and constructive trust as two separate remedies, each designed to eliminate injustice no matter how it may have occurred). They float within the sphere of trust law in that, properly raised, they address specific identifiable property as in the nature of the *res* of an express trust. *Id.* at 129 (Michigan case law unequivocally limits the imposition of a constructive trust to only those instances where the defendant is in possession or control of either the subject property itself or proceeds traceable to that property). Whereas the purpose of a resulting trust is to effectuate the actual intentions of the parties, a constructive trust is instead "utilized to prevent fraud and unjust enrichment." *Rodgers v. Pahoundis*, 178 Ohio App.3d 229, 2008 Ohio 4468, 897 N.E.2d 680 Ohio App. 2008). The basis of the constructive trust is not the intentions and agreement of the parties, but "the unjust enrichment which would result if the person having the property were permitted to retain it." *Id.* (citing *Bilovocki v. Marimberga,* 62 Ohio App.2d 169, 171-72, 405 N.E.2d 337 (Ohio App. 8th Dist. 1979)). And "[b]y imposing a constructive trust, a court orders a person who owns the legal title to the property to hold or use the property for the benefit of another or to convey the property to another to avoid unjust enrichment." *Id*. (citation omitted).

Some jurisdictions treat a constructive trust as a distinct cause of action, *In re Gen. Coffee Corp*., 828 F.2d 699, 701 (11th Cir. 1987)(constructive trust upheld in bankruptcy case, rejecting theory that the constructive trust did not arise until the bankruptcy court decreed it), sometimes codified, and not just an equitable remedy. *See CyberCo Holdings, Inc.*, 382 B.R. at 129 n.10 (recognizing that a trustee might sometimes inherit a claim for imposition of a constructive trust from a debtor as property of the estate under § 541(a)(1)).

A good general working definition of a constructive trust is the definition under Ohio law cited by the appellate court in *Belfance v. Bushey (In re Bushey)*, 210 B.R. 95, 104 (B.A.P. 6th Cir. 1997) (quoting *Union Sav. & Loan Ass'n v. McDonough*, 101 Ohio App. 3d 273, 655 N.E.2d 426, 428 (Ohio Ct. App. 1995)).

> A constructive trust is a trust created by operation of law against the holder of a legal right to property which that person should not, in equity and good conscience, hold or enjoy; it is a relationship associated with property subjecting the title holder to an equitable duty to convey it to another because otherwise the title holder would be

unjustly enriched.

This definition is similar to and representative of the definition of constructive trusts in other cases from other jurisdictions.

The ways in which the various actors in a bankruptcy case might use a constructive argument are similar to the use of resulting trust arguments. Indeed constructive trust arguments are often made in tandem with resulting trust arguments, *see Bushey*, 210 B.R. at 104, as constructive trust arguments are also often asserted as the last desperate gasp of equity. As one commentator has aptly noted, "[j]ust as 'patriotism is the last refuge of a scoundrel,' a 'constructive trust' is the last cry of the unsecured creditor seeking a priority when none is due. As a result, most bankruptcy courts are tired of hearing of the term..." William Rothschild, "How to Treat Constructive Trust Claims in Bankruptcy," 35-11 ABIJ 24 (November 2016).

The primary concern articulated in bankruptcy constructive trust jurisprudence, including by the Sixth Circuit Court of Appeals, is that the priority and ratable distribution principles of bankruptcy will be upset by imposition of a constructive trust in favor of a credtior. *Poss v. Morris (In re Morris)*, 260 F.3d 654, 666 (6th Cir. 2001) (citing *XL/Datacomp, Inc. v. Wilson (In re Omegas Grp., Inc*.), 16 F.3d 1443, 1451 (6th Cir. 1994)). The Sixth Circuit has thus emphasized that § 541(d) does not authorize bankruptcy courts to recognize a constructive trust based on a creditor's claim of entitlement to one. Rather, section 541(d) only operates to the extent that state law has impressed property with a constructive trust prior to its entry into bankruptcy. In *XL/Datacomp, Inc. v. Wilson (In re Omegas Group, Inc.)*, 16 F.3d 1443, 1451 (6th Cir. 1994), the Sixth Circuit held that "a creditor's *claim* of entitlement to a constructive trust is not an 'equitable interest' in the debtor's estate existing prepetition, excluded from the estate under § 541(d)." (Emphasis added).

The facts of *Omega*s were typical in that the creditor transferred property to the debtor in the ordinary course of business, allegedly due to the fraud of the debtor, and the creditor argued its entitlement to imposition of a constructive trust in bankruptcy court when no state court proceedings had occurred prior to the filing of the bankruptcy petition and state law did not provide a clear answer to whether the circumstances warranted such a remedy. While stressing that the bankruptcy policy of ratable distribution among creditors conflicts with the constructive trust remedy and counsels its sparing use, *id.* at 1451 (quoting *The Oxford Organisation, Ltd. v. Peterson (In re Stotler & Co.)*, 144 B.R. 385, 388 (N.D. Ill. 1992)), the Sixth Circuit still acknowledged that in certain limited circumstances not present in *Omegas* recognition of a constructive trust would be appropriate. In later cases, such circumstances included when property in bankruptcy was not subject to distribution to creditors and so did not implicate the rationale of ratable distribution, *McCafferty v. McCafferty (In re McCafferty)*, 96 F.3d 192, 196-97 (6th Cir. 1996) (quoting Begier v. IRS, 496 U.S. 53, 58, 110 L. Ed. 2d 46, 110 S. Ct. 2258 (1990)), and when creditors who had initiated proceedings in state court pre-petition had the automatic stay lifted to pursue their action such that *Omegas* "does not bar the enforcement of such a judgment by the bankruptcy court." *Kitchen v. Boyd (In re Newpower)*, 233 F.3d 922, 936 (6th Cir. 2000). In *Poss v. Morris*, the Sixth Circuit ultimately expansively interpreted and deferred to the type of state court judgment that could be construed as having created a pre-petition constructive trust in favor of the creditor-defendant and ultimately effectively asserted as a defense to a trustee's avoidance action.

In the case *Clark v. Mason*, Case No. 1:13 CV 2422, 2014 U.S. Dist. LEXIS 45793, 2014 WL 12546666 (N.D. Ohio Apr. 2, 2014), a district court on appeal explained the Sixth Circuit's emphasis on constructive trusts as dependent upon pre-petition entitlement:

> Defendant-Appellant maintains that Debtor held only bare legal title to the property when it was transferred because Defendant-Appellant previously paid for Debtor's interest. This transfer, she argues, gives rise to an equitable interest in the property in her favor. She therefore seeks the imposition of a constructive trust over the property titled to her daughter, which the Bankruptcy Court rightfully declined to do. Defendant-Appellant points out that a bankruptcy estate succeeds only to the property interest held by Debtor, no more and no less. Consequently, if a debtor holds only bare legal title, and not the equitable interest, only the legal interest comes into the estate. See 11 U.S.C. § 541(d). Be that as it may, Defendant-Appellant's broader point fails in the absence of a pre-petition action establishing or recognizing an equitable interest in her favor. Ohio law "does not recognize a stand-alone claim for [a] constructive trust[,] instead it is a remedy that can only be imposed ... where there is some ground upon which equity will grant relief." See *Gaymar Ind., Inc., v. FirstMerit Bank, N.A.,* 311 Fed.Appx. 814 (6th Cir. 2009) (internal citations omitted). Defendant-Appellant contends that she is entitled to a remedy even though she has never pursued a claim. That contention is wholly unsupported by cited case law.
>
> Defendant-Appellant also references constructive trusts that arise by operation of law as compared to those that arise by judicial fiat. Her reference rests on a total misunderstanding of the relevant legal landscape. As the Bankruptcy Court correctly recognized below, there is no statutory basis for a constructive trust — it is created as a remedy by a court. A court need not declare that a constructive trust has been created. Indeed, the fact remains that judicial action established or recognized the

> legal and equitable interests. *See Hines v. Hines (In re Hines)*, 193 Fed.Appx. 391, 395 (6th Cir. 2006).
>
> While it is certainly true that constructive trusts may arise by operation of law to prevent unjust enrichment, it is also the case that such trusts only arise where there is a sufficient basis in law. *Id.* Defendant-Appellant's argument completely glosses over this critical point. In *Poss v. Morris (In re Morris)*, 260 F.3d 654 (6th Cir. 2001), the Sixth Circuit noted in dicta that 11 U.S.C. § 541(d) "does not authorize bankruptcy courts to recognize a constructive trust based on a creditor's claim of entitlement to one ... rather, [the section of the statute] only operates to the extent that state law has impressed property with a constructive trust prior to its entry into bankruptcy. *Id.* at 666; *see also XL/Datacomp, Inc. v. Wilson (In re Omegas Grp*., *Inc*.), 16 F.3d 1443 (6th Cir. 1994).
>
> In the case at bar, no court action had been taken to legally establish an equitable interest held by Defendant-Appellant. There was no court division of property to rely on, for instance. Defendant-Appellant did not pursue a claim seeking a constructive trust remedy, nor did she hold a cognizable beneficial interest in the property. As a consequence, the Bankruptcy Court correctly declined to recognize a constructive trust here.

The policy concerns underpinning constructive trusts in bankruptcy and the fine distinctions imposed on raising constructive arguments, as in the Sixth Circuit, counsel parties in interest to raise such arguments with respect to the particular property at issue, *Cyberco Holdings, Inc*., 382 B.R. at 128 (constructive trust is available as a remedy only if there is property that the defendant is able to return, as distinct from just another breach of contract claim seeking fungible money), early and often in state court actions before the need to do so might ultimately arise in the cauldron of bankruptcy.

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May 8, 2017.