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UPDATE
Business Reorganizations and Bankruptcy

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Constructive Trusts in Bankruptcy Court: Not Dead Just Yet

The Seventh Circuit Court of Appeals in Chicago recently made a decision that may be of interest to lenders, suppliers, and preference defendants. It held that goods supplied to a business that sold those goods to a customer were held by the seller as a bailee and that the supplier may be entitled to a constructive trust on the proceeds received by the seller. This is despite the fact that the seller commingled the proceeds and filed a bankruptcy petition. The supplier made no UCC filings.

The decision, *In re Mississippi Valley Livestock, Inc.*, Case No. 13-1377 (7th Cir. March 12, 2014), involved the supply and sale of cattle. J&R Cattle supplied cattle to Mississippi Valley, with the intention of Mississippi Valley selling the cattle, along with other cattle it had, to Swift. After selling the cattle it had received from J&R to Swift, Mississippi Valley delayed payment to J&R. Ultimately, Mississippi Valley paid J&R but did so within the 90-day preference period prior to Mississippi Valley's bankruptcy filing. The bankruptcy trustee sued J&R to recover the money that Mississippi Valley paid J&R.

J&R defended the preference action in part by asserting that the cattle it supplied were in Mississippi Valley's possession as a bailment. The Bankruptcy Court held that the cattle were held in bailment but, nonetheless, entered judgment for the trustee. The District Court affirmed. In reversing and remanding, the Seventh Circuit did not discuss the record below in detail. In particular, there is no discussion about the particular facts that established that the transaction was a bailment, rather than a conditional sale or consignment, or even an express trust. Evidently, no UCC filings were made by J&R in connection with its delivery of the cattle to Mississippi Valley. There is no discussion of any of the potentially applicable UCC provisions, either from Article 2 (Sales) or Article 9 (Secured Transactions).

The Court of Appeals did not stop with its conclusion that a bailment had been established. It went on to explain that imposing a constructive trust in favor of J&R and against the bankruptcy estate might be in order. In doing so, it took issue with the Sixth Circuit's proclamation in *In re Omegas Group, Inc*., 16 F.3d 1443, 1451 (6th Cir. 1994) that constructive trusts are "anathema to the equities of bankruptcy," severely limiting their application. Instead, the Court felt that *Omegas* drew too sharp a distinction between constructive trusts and other trusts and that ordinary equitable standards would correctly sort out the rights of the parties and the estate. The Court remanded the case for further development of these issues.

Property rights are state law rights that can be complicated, and predicting how a court will view them can be elusive. This has been particularly true in the area of bailments, consignments, and other supply arrangements. Suppliers often take refuge in applicable provisions of the UCC and utilize the filing procedures to make their rights publicly known. The 2001 amendments to Article 9, in particular, drove behavior in this direction. In general, bankruptcy courts have trended away from applying constructive trusts because of the widespread view that it is in derogation of the rights of general unsecured creditors. That trend may meet substantial headwinds in the wake of the Seventh Circuit's decision in *Mississippi Valley*.

Typically, lenders carefully scrutinize the sources of their borrower's inventory and any unusual supply arrangements deviating from straightforward purchase transactions. Such arrangements jeopardize their ability to realize the value of all of the borrower's inventory. *Mississippi Valley* may motivate lenders to increase that scrutiny and consider further the risk of losing a portion of the value of their collateral to purported bailors. In addition, lenders may want to consider the potential imposition of constructive trusts on a subset of the collateral to protect the rights of suppliers who have not filed UCC statements or have otherwise openly publicized their ownership of inventory in the possession of the borrower.

For more information, please contact one of the authors of this update, listed below, or any other member of Robinson & Cole's Business Reorganizations and Bankruptcy Practice Group.

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