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Column

Last in Line

***10 CONSTRUCTIVE TRUST ON REAL ESTATE HITS PAYDIRT IN THE SIXTH CIRCUIT**

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The constructive trust is a fiction: an equitable remedy imposed against one who commits fraud (or some other bad act) in order to prevent unjust enrichment. Although the idea of imposing a constructive trust might sound good to the unsecured creditor, constructive trusts are inimical to the Bankruptcy Code's priority scheme because they result in some creditors receiving special treatment as they effectively move from "last in line" to "first in line." The impact of a constructive trust on any bankruptcy case is governed by 11 U.S.C. §541(d), which has the effect of excluding from a bankruptcy estate assets held in constructive trust by the debtor in favor of another, because under §541(d), property is part of the debtor's estate *only* to the extent of the legal title, but not to the extent of the equitable interest that the debtor does not own. The efforts of unsecured creditors to squeeze themselves into the parameters of 11 U.S.C. §541(d) are legendary:

... each of those unsecured creditors would rush into the bankruptcy court to argue that debtor's dealings with it were more egregious than his dealings with the others and the debtor's bad conduct justified special treatment, *i.e.*, the imposition of a constructive trust by the bankruptcy court ...

Kitchen v. Boyd, 233 F. 3d. 922, 936 (6th Cir. 2000).

In its 1994 decision in In re Omegas Group, 16 F. 3d 1443, 1448-1453 (6th Cir. 1994), the Sixth Circuit held that 11 U.S.C. §541(d) will not operate to exclude from the bankruptcy estate property that is subject to a constructive trust *unless* the constructive trust is declared by a court in a pre-petition court proceeding. Omegas is often cited as the cornerstone of the Sixth Circuit's concerted effort to quash unsecured creditors' attempts to convince a bankruptcy judge that he or she should impose a constructive trust that enables them to effectively make an end run around bankruptcy's priority scheme. In cases since Omegas, the Sixth Circuit has clarified its position to allow a constructive trust under certain rather limited circumstances. For example, in In re McCafferty, 96 F. 3d 192 (6th Cir. 1996), the court recognized that the imposition of a constructive trust in favor of the debtor's ex-wife was appropriate because, in that case, the property subject to the constructive trust was exempt from distribution to creditors.

In re Morris, 260 F.3d 654 (6th Cir., Aug. 13, 2001), is a real estate dispute in which the Sixth Circuit appears to have relaxed its "ban" on constructive trusts once again in order to reach the right result. The opinion of the court—written by Judge Batchelder, who authored the court's opinion in Omegas—demonstrates that the court was willing to overcome procedural and substantive obstacles in order to impose a constructive trust on the disputed parcel of real estate.

The facts of the case are somewhat complicated. Apparently, Marilyn Morris and John Poss started out as friends. Morris was in the tool manufacturing business and wanted to buy a parcel of land so that she could relocate her business. Unable to get a conventional mortgage, she persuaded Poss to lend her \$17,500 to buy the 17.5-acre parcel. Morris took the title to the land and did not grant Poss a mortgage but, instead, she signed a cognovit note payable over 15 years. Next, Morris convinced Poss

to lend her \$149,750 to enable her to build a new building (consisting of a plant on the first floor and her apartment on the second floor) on the 17.5 acres of land. Once again, Poss did not take a mortgage in exchange for the financing he provided, but instead, Morris and Poss entered into an odd transaction: Morris entered into a 15-year lease with Poss for the 2.5 acres of land on which the building was situated, and in exchange, Poss built Morris's building on the land and then leased the building to Morris for 15 years with a payment structure that would amortize the repayment of Poss's \$149,750 loan, plus interest. The net result was that Morris owned the land on which the building was located and leased it to Poss for 15 years, and Poss owned the building and leased it to Morris for 15 years. Neither Morris nor Poss made regular payments to one another as set forth in their respective leases.

Without telling Poss, and before Morris and Poss signed the documentation for their odd reciprocal lease arrangement, Morris obtained a \$40,000 loan from Huntington Bank and gave the bank a security interest in her business assets, plus a mortgage on the entire 17.5 acre parcel. When Morris fell behind in her payments to Poss on the \$17,500 note, Poss did not initially seek to collect but, instead, offered to postpone payments under the note for one year. However, once Poss learned of the Huntington Bank mortgage, his friendship with Morris evaporated and he sued her on the cognovit note. That case was assigned to Ohio state court Judge Yost. Ultimately, Poss got a judgment for approximately \$17,000, which Morris did not pay, so Poss started a foreclosure action to collect his judgment on the note.

Morris also fell behind on her lease payments for the building, so in 1989, Poss sued her for rent. This rent lawsuit was consolidated with Poss's foreclosure action, and ultimately Poss got a \$152,000 judgment against Morris. Once again, Poss found it difficult to enforce his judgment against Morris, so the parties tried to negotiate a settlement. In 1993, however, settlement negotiations deteriorated, so Poss filed a third lawsuit against Morris—a forcible entry and detainer lawsuit alleging that her continued possession of the building was unlawful.

In July 1993, Morris and Poss entered into a settlement agreement in the forcible-entry and detainer lawsuit. Pursuant to the settlement, Morris was relieved from the judgment against her in exchange for which she was to convey a particular seven-acre parcel of land to Poss within 60 days and vacate the building by Jan. 1, 1994. In September 1993, Judge Yost entered a judgment that adopted the settlement agreement *and incorporated it by reference in his order*.

On the very same day, as Judge Yost entered his order incorporating the settlement, the settlement unraveled. Morris moved for relief from the court's order, and Poss moved for its enforcement. Judge Yost denied Morris's motion, and in April 1994, required Morris to immediately comply with her obligations under the settlement, failing which Poss could resort to all of his remedies at law or in equity. Morris appealed, but the Ohio Court of Appeals affirmed Judge Yost. When Poss learned of this in July 1995, he obtained an *ex parte* *28 order directing the county recorder to convey the seven-acre parcel described in the settlement agreement to himself. As soon as Morris learned about this *ex parte* order, she appealed it. Poss, however, returned to Judge Yost, claiming that Morris failed to comply with the settlement, and after an evidentiary hearing, Judge Yost agreed with Poss and ordered the sheriff to seize the building. Morris appealed once again, then filed chapter 13 on Sept. 8, 1995—less than 90 days after Poss obtained the *ex parte* order directing the county recorder to convey the parcel to him.

Morris's chapter 13 bankruptcy petition listed Poss as a secured creditor in the amount of \$150,000. Her chapter 13 plan indicated that she lived in the apartment above the plant in the building.

Amazingly, after all this litigation, Poss failed to file a proof of claim in Morris's chapter 13 case. As soon as the claims bar date expired, Morris amended her chapter 13 plan to provide that distributions under the plan would only be made to creditors who had timely filed a proof of claim. Poss objected to this plan, but the court overruled his objection because he had not filed a proof of claim. The court also held that Poss's objections to the amended plan did not give him an “informal proof of claim.” Poss appealed the bankruptcy court's decision to the Bankruptcy Appellate Panel for the Sixth Circuit, which dismissed it as premature.

Meanwhile, before Poss's objection to Morris's chapter 13 plan had been overruled, Morris filed a two-count adversary proceeding against Poss. Count One sought to avoid the July 1995 *ex parte* order that effectively transferred the seven-acre parcel to Poss. Count Two claimed that Poss's alleged lien impaired her \$5,000 homestead exemption under state and federal law.

Amidst these machinations in the bankruptcy court, the appeals were being decided in the Ohio state court because the bankruptcy court granted relief from the automatic stay for their pursuit. Indeed, immediately after Poss's objections to Morris's chapter 13 plan were overruled, the Ohio Court of Appeals held that Poss was never entitled to the *ex parte* order that effectively conveyed the seven-acre parcel to himself; that matter was remanded to Judge Yost for further proceedings. In its ruling, the Ohio Court of Appeals held that Judge Yost had the power to evict Morris and her business from the building based on her breach of her own promise in the settlement agreement to vacate the building, but that the nature of a forcible entry and detainer action prohibited Judge Yost from determining who held legal title to the seven-acre parcel. Thus, upon the remand of the case to Judge Yost, Poss obtained relief from the automatic stay in order to have Judge Yost determine his ownership interest in the seven-acre parcel of real estate.

In April 1997, Judge Yost issued his decision on the title to the disputed seven-acre parcel. He found that the settlement agreement created an enforceable contract for the conveyance of the property from Morris to Poss, but then ruled that Poss had failed to complete either an execution on his judgment lien against the parcel, or a conveyance of the parcel to him, before Morris filed for bankruptcy. Consequently, Judge Yost concluded that legal title to the seven-acre parcel remained with Morris when she filed her chapter 13 petition. However, based on Morris's failure to abide by the terms of her own promises in the settlement agreement, Judge Yost held that Poss was entitled to pursue appropriate enforcement proceedings in Ohio state court, including an application for an order transferring legal title from Morris to himself. Until the entry of such an order, however, Morris had legal title and ownership of the seven-acre parcel.

*29 After Judge Yost found that she retained legal title to the seven-acre parcel, Morris moved for a summary judgment in her adversary proceeding against Poss. Incredibly, Poss failed to timely respond to Morris's summary judgment motion—even after receiving an extension of time to do so. Based on the record before it—which apparently included Judge Yost's April 1997 ruling—the bankruptcy court granted summary judgment in favor of Morris and held that (1) she had legal title to the seven-acre parcel and (2) the alleged conveyance to Poss pursuant to the wrongfully obtained *ex parte* order was simply a nullity. The bankruptcy court also held that *even if* Poss had properly attempted to enforce the conveyance, the conveyance itself would have occurred within the 90-day preference period and therefore would have been avoidable pursuant to 11 U.S.C. §547.

On appeal, the district court permitted Poss to raise new issues so long as they were issues of law and required no factual development. After considering Poss's appeal on its merits, the district court affirmed the bankruptcy court.

In its opinion (dated Aug. 13, 2001), the Sixth Circuit Court of Appeals *reversed* and held that the bankruptcy court erred in failing to recognize that, at the moment Morris signed the settlement agreement that contained her promise to convey the seven-acre parcel to Poss, Morris undertook an *equitable duty* to convey that parcel to him. Consequently, as a matter of Ohio law, the disputed seven-acre parcel became impressed with a constructive trust *automatically* and without the need for any court order or decree. The Sixth Circuit court also held that the constructive trust did not constitute an avoidable preference because the constructive trust arose when Morris signed the settlement agreement *years* before filing her chapter 13 petition—and hence beyond the preference period. Thus, the Sixth Circuit Court of Appeals reversed both the bankruptcy court and the district court and remanded the matter to the bankruptcy court for proceedings consistent with the appellate opinion.

Morris is somewhat surprising for several reasons. First, the reversal was a procedural long shot in light of Poss's failure to respond to the summary judgment motion filed against him in the adversary proceeding. Nevertheless, the court held that Poss's failure to respond was *not* a jurisdictional bar to its adjudication of issues raised for the first time on appeal. Instead, the court found that its consideration of Poss's appeal was simply a departure from the general rule that appellate courts will not consider issues raised for the first time on appeal. The court noted that deviations from this general rule are permitted where,

as in this case, the issue is presented with sufficient clarity and completeness that its resolution will not require further factual development, and adjudication of the appeal will promote the finality of litigation.¹

Substantively, *Morris* is an important departure from the court's clear attempt to discourage unsecured creditors from claiming that the debtor's bad acts require the bankruptcy court to impose a constructive trust. *Morris* is consistent with *Omeegas, supra*, to the extent that both cases hold that a constructive trust imposed pre-petition will operate to exclude the property from the debtor's estate pursuant to 11 U.S.C. §541(d). *Morris* is also somewhat inconsistent with *Omeegas* because *Omeegas* required that the pre-petition constructive trust be declared by a court in a pre-petition proceeding, while *Morris* (like *McCafferty, supra*) did not require a formal pre-petition judicial *33 decision declaring the existence of the constructive trust. Instead, in *Morris*, the Sixth Circuit honored a constructive trust, which it determined that Ohio law *automatically* impressed upon the seven-acre parcel when *Morris* signed the settlement agreement *years* before the debtor filed her bankruptcy petition. *Morris* also answers, in the affirmative, the question of whether a bankruptcy court may give effect to a state court judgment obtained post-petition in an action commenced pre-petition, but notes that state law governs the effective date of such a judgment.

The fact that the court overlooked the procedural obstacles inherent in ruling for *Poss* evidences its willingness to relax its aversion to constructive trusts where necessary to achieve justice, especially if the constructive trust is to be imposed upon real property because disputes regarding real property trigger equitable remedies in many states due to the uniqueness of the land and the inherent inadequacy of any legal remedy. Undoubtedly, however, zealous unsecured creditors are likely to view *Morris* as a “carte blanche” to argue that the “debtor's bad acts” and the equities of their particular situations warrant imposition of a constructive trust in their favor. The unfortunate language in the conclusion of the court's opinion, to the effect that a constructive trust cannot be avoided as a preference, will likely spur on these zealous unsecured creditors even though the opinion itself clarifies that the court's holding on the preference issue was due to its ruling that the constructive trust arose *years* before *Morris*'s bankruptcy, and therefore beyond the preference period.

In the final analysis, *Morris* represents the court's sincere and diligent attempt to reach the right result. After all, *Morris* broke *her own promise* to convey the seven-acre parcel pursuant to a settlement agreement, which became a court order. She then engaged in “hard-ball” tactics in her bankruptcy case. In its zeal to do the right thing, the Sixth Circuit was willing to overlook procedural obstacles, and even relax its aversion to the imposition of constructive trusts based on the debtor's “bad acts.” Although *Morris* might have been *Poss*'s friend before the case began, the Sixth Circuit Court of Appeals was his best friend when it ended.

Footnotes

¹ The court was so concerned that its ruling would be construed as excusing the failure of counsel to respond to summary judgment motions that its opinion includes a reminder that the lower courts could impose appropriate sanctions on *Poss*'s attorney for failing to respond to *Morris*'s summary judgment motion in the adversary proceeding.

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