United States Bankruptcy Court
Western District of Wisconsin

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In re Smedema Grain, Inc., Debtor
Bankruptcy Case No. MM7-85-01946

United States Bankruptcy Court
W.D. Wisconsin

April 4, 1991

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Robert D. Martin, United States Bankruptcy Judge.

MEMORANDUM DECISION

The material facts are not in dispute. Smedema Grain, Inc., the debtor, was licensed as a grain dealer by the State of Wisconsin Department of Agriculture, Trade and Consumer Protection ("Department") for the year ending August 31, 1985. The debtor was owned and operated by John and Randall Smedema ("Smedemas").

In March of 1985 the Department audited the debtor and determined that the debtor was not able to fulfill its obligations to pay grain producers for the grain that the producers had delivered to the debtor. The Smedemas hired Thomas Ludlow, d/b/a The Ludlow Company, to help work out the debtor's cash flow problems.

On March 20, 1985 the Department received a notice stating that the debtor had paid one of the grain producers for a grain shipment by means of a $45,794.30 check which was returned due to insufficient funds in the debtor's account. The Department thereafter initiated an administrative default proceeding to determine the debtor's liability to grain producers. Several grain producers filed claims for payment in that proceeding. On March 22, 1985 the debtor voluntarily surrendered its grain dealer registration to the Department.

Shortly thereafter, Thomas Ludlow and Randall Smedema met with Department agents to discuss the debtor's default. Randall Smedema agreed to take the money received from the debtor's outstanding sales agreements and to have Ludlow, on behalf of the debtor, hold it in a segregated trust account. The account would eventually be distributed by order of the Department to those producers who filed claims in the Department's default proceeding.

On March 26, 1985 the Department determined that the debtor "has a total of $65,779.48 due to producers for which there are no funds available to pay those producers." Its Summary Special Order entered on that date further provides that:

All monies received by the respondent from the sale of grain it has sold and delivered

shall be deposited in a trust account until such time as the department conducts a proceeding under s. 127.12, Stats., concerning respondent's activities as a grain dealer and the department issues an order directing how the monies are to be disbursed.

On or about June 6, 1985 Ludlow opened a bank account which "all parties understood and acknowledged to be the trust account required by the department (producers' trust account)." Ludlow thereafter deposited into the producers' trust account four checks totalling $31,895.53 received in payment for the sale of grain.

On June 18, 1985, the Department held a hearing in the default proceeding. Although the hearing examiner issued a proposed decision on August 30, 1985, the Department has not issued a final order regarding disbursement of funds in the producers' trust account both because the funds were removed from the trust account and because of the automatic stay which arose upon the filing of the debtor's chapter 11 bankruptcy petition on September 30, 1985.

Immediately prior to the filing of the debtor's petition, and without the Department's consent, Ludlow withdrew $32,068.25 from the producers' trust account. The Smedemas consented to Ludlow's pre-petition payments to the debtor's bankruptcy attorney ($10,000.00), to Ludlow ($7,946.41), and to a third attorney ($585.00), as well as to Ludlow's post-petition payment of an insurance premium ($610.00). The remainder of the funds from the producers' trust account were transferred without the Smedemas' consent by Ludlow to accounts in the name of the Ludlow Company. The Department did not consent to any of these transfers.

On January 30, 1986 the Smedemas each filed a chapter 11 petition. The Department initiated an adversary proceeding against each of the Smedemas, seeking a determination that the removal of the $31,895.53 which had been placed into the producers' trust account resulted in a nondischargeable debt. On October 15, 1986 this court signed a judgment declaring the debt nondischargeable to the extent of $31,895.53 in each debtor's bankruptcy. Subsequently, the Smedemas each converted their cases to chapter 13 and then, no plans having ever been confirmed, converted again to chapter 7. The chapter 7 bankruptcies are now closed.

On June 20, 1986 the Department was successful in having a trustee appointed in the debtor's chapter 11 proceeding. On June 15, 1988 the chapter 11 trustee initiated an adversary proceeding in the debtor's chapter 11 case against Ludlow and the Ludlow Company, seeking return of the funds taken from the producers' trust account.

On July 1, 1988, while the Smedemas' chapter 7 cases were pending, the Department initiated adversary proceedings against the Smedemas, seeking declarations of nondischargeability regarding the funds removed from the producers' trust account. The Smedemas answered the complaint and also filed a third-party complaint against the debtor, the chapter 11 trustee, and Ludlow.

On September 20, 1988 the Department's adversary proceedings were consolidated with that brought by the chapter 11 trustee. On October 11, 1988, the consolidated adversary proceedings were settled. Pursuant to the parties' stipulation, Ludlow paid the chapter 11 trustee $8,000.00 and the Smedemas paid the chapter 11 trustee $11,000.00 (from non-estate funds), thereby fully performing their respective obligations under the settlement. The Department concedes that it cannot trace the source of the money paid to the trustee by Ludlow or the Smedemas to the money taken out of the producers' trust account.

On July 17, 1989 the debtor's chapter 11 proceeding was converted to chapter 7. The chapter 7 trustee received a total of $36,247.48 from the chapter 11 trustee. In addition

to the $19,000.00 in settlement proceeds, this amount includes $15,935.22 received as proceeds from the sale of the debtor's grain warehouse assets. The final balance in the account is currently $31,284.30, but expenses have accrued since the filing of the final account by the chapter 7 trustee.

Only two creditors have pending claims in the chapter 7 bankruptcy. The Department filed a claim in the total amount of $87,052.33, representing an unsecured nonpriority claim in the amount of $31,933.72, a secured claim in the amount of $32,365.62 (allegedly secured by the producers' trust account), and a priority claim in the amount of $22,752.99 (pursuant to 11 USC §§ 507(a)(3) and 507(a)(5)(A)). In addition, Hubbard Leasing has filed an unsecured claim in the amount of $24,274.17.

The Department contends that the $19,000.00 received in settlement of the adversaries should be paid to the Department for disbursement to the grain producers, with the remaining funds paid to the producers under the priority status granted to grain claimants under 11 USC § 507(a)(5)(A), up to $2,000.00 per claimant, with the amounts claimed on the priority basis to be reduced by any pro rata payment made to the grain producer by the Department from the $19,000.00 it hopes to receive.

The chapter 7 trustee, on the other hand, contends that priority status should be granted to grain claimants up to $2,000.00 per producer, with any remaining amount due to each grain producer to be treated as an unsecured claim. The trustee asserts that the Department is not entitled to treatment as a secured creditor with respect to the $19,000.00 received in settlement of the adversary proceedings because the Department cannot trace the funds paid to the chapter 11 trustee to the original producers' trust account.

"The debtor's interest in property is determined by nonbankruptcy law, but the determination of what constitutes section 541 property is a federal question." Koch Refining v Farmers Union Central Exchange, Inc., 831 F2d 1339, 1343 (7th Cir 1987), citing HR Rep No 595, 95th Cong, 1st Sess 367-68 (1977), S Rep No 989, 95th Cong, 2d Sess 82-83 (1978), US Code Cong & Admin News 1978, p 5787. Thus, "[s]tate law determines whether property is an asset of the debtor." Koch, 831 F2d at 1344, citing In re Brass Kettle Restaurant, Inc., 790 F2d 574, 575 (7th Cir 1986). In our case, Wisconsin law controls the initial determination of whether the producers' trust account is an asset of the debtor.

In City of Milwaukee v Fireman Relief Association of the City of Milwaukee, the court stated that "'[a]n express trust is one which comes into being because a person having the power to create it expresses an intent to have the trust arise and goes through the requisite formalities.'" City of Milwaukee v Fireman Relief Association of the City of Milwaukee, 34 Wis 2d 350, 360, 149 NW2d 589 (1966), citing Bogert, Law of Trusts § 8 at 13 (4th ed, 1963). See also In re Lenk, 48 BR 867, 870 (WD Wis 1985), citing In re Pehkonen, 15 BR 577, 581 (Bankr ND Iowa 1981) ("'[i]f the intention is that the money shall be kept or used as a separate fund for the benefit of the payor or a third person, a trust is created.'").

In the present case, the Department ordered that all monies received by the debtor from the sale of grain which it sold and delivered were to be deposited in a trust account until the Department issued a subsequent order directing how the monies in the fund were to be disbursed. Thereafter, Ludlow opened a bank account that "all parties understood and acknowledged to be" the producers' trust account required by the Department. The debtor had the power to create a trust and expressed its intent to create the producers' trust account by going through the formalities of having the trust bank account established. Under Wisconsin law, an express trust was created. In addition to its legal ownership of the trust, the debtor possessed a contingent equitable interest in funds of

the trust to the extent, if any, that the amount of the funds in the account exceeded the amount due to grain producers.

11 USC § 541 creates the bankruptcy estate, including, except as otherwise provided, "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 USC § 541(a)(1). Section 541(a) is qualified by 11 USC § 541(d), which provides:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or 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.(1)

"To the extent that such an [equitable or legal] interest is limited in the hands of the debtor, it is equally limited in the hands of the estate except to the extent that defenses which are personal against the debtor are not effective against the estate." 124 Cong Rec H 11096 (daily ed. Sept. 28, 1978). In United States v Whiting Pools, 462 US 198, 204 n 8 (1983), the Supreme Court stated that "Congress intended to exclude from the bankruptcy estate property of others in which the debtor had some minor interest such as a lien or bare legal title."

A Wisconsin court has determined that "[p]roperty which is held in trust is not property of the estate." In re Lenk, 48 BR 867, 871 (WD Wis 1985).(2) Courts are not, however, in agreement with respect to whether trust funds are property of the estate. See, In re Cedar Rapids Meats, Inc., 121 BR 562, 567 (Bankr ND Iowa 1990), and cases cited therein. In In re Palm Beach Heights Development & Sales Corp., 52 BR 181 (Bankr SD Fla 1985), the court considered a trust account created to assure the completion of road and drainage improvements on some property. Only upon completion of the improvements would the debtor-therein have any interest in the fund. Palm Beach, 52 BR at 183. The court stated:

Any claim, contingency or chose in action against the trust fund is the property of the estate but the fund itself is not. The debtor may not have any part of said fund until such time as the debtor establishes that all prior claims in the fund have been paid and that a residuum remains to which it is entitled.

Palm Beach, 52 BR at 183. Similarly, it has been stated that "[a]n assurance fund, where the debtor has no claim or interest in the fund until all prior claims have been paid in full, is not property of the estate." In re Dolphin Titan International, Inc., 93 BR 508, 512 (Bankr SD Tex 1988) (citations omitted). See also Cedar Rapids Meats, 121 BR at 567. In concluding that the fund in issue was not property of the estate, the Dolphin Titan court noted that to release the fund to the debtor-therein would be to "convert Debtor's contingent right [to the remainder] into a non-contingent right." Dolphin Titan, 93 BR at 512 (citation omitted).

Without question, the debtor in the present case possesses legal title to the producers' trust account. The debtor does not, however, possess an equitable interest in the any funds which may be traced to those originally placed in the account. On March 26, 1985 the Department determined that the debtor owed grain producers the sum of $65,779.48. Subsequently, the sum of $31,895.53, representing payments for the sale of grain, was placed in the producers' trust account. The funds placed in the account thus fell far short of the total amount due to the grain producers. There existed no "excess funds" to which an equitable interest of the debtor could attach. Pursuant to 11 USC § 541(d), the

debtor's legal title to the long-empty producers' trust account is property of the estate, but any funds which may be traced to those originally placed in the account are not.

Immediately prior to the filing of the debtor's bankruptcy petition, Ludlow removed the $31,895.53 which had been placed into the producers' trust account. Subsequent adversary proceedings initiated against Ludlow and the Smedemas on the basis of wrongful removal of funds from the account resulted in a settlement pursuant to which Ludlow paid the chapter 11 trustee $8,000.00 and the Smedemas paid the chapter 11 trustee $11,000.00. The chapter 7 trustee and the debtor dispute whether this $19,000.00 in settlement proceeds may be impressed with a constructive trust.

In In re Adametz the court discussed the law relating to constructive trusts, stating:

To invoke a constructive trust unjust enrichment and some additional factor such as actual or constructive fraud, duress, abuse of a confidential relationship, mistake, commission of a wrong or some from of unconscionable conduct must be found. Wisconsin courts have added a third element; a constructive trust may only be applied to a specific res to which the party has acquired legal title.

In re Adametz, 53 BR 299, 305 (Bankr WD Wis 1985), citing Wilharms v Wilharms, 93 Wis 2d 671, 679, 287 NW2d 779, 783 (1980); Prince v Bryant, 87 Wis 2d 662, 275 NW2d 676 (1979); Gorski v Gorski, 82 Wis 2d 248, 262 NW2d 120 (1978); Meyer v Ludwig, 65 Wis 2d 280, 222 NW2d 679 (1974); In re Raschke, 84-C-635-C (WD Wis, May 15, 1985); Hanson v Valdivia, 51 Wis 2d 466, 476, 187 NW2d 151, 156 (1971). See also First National Bank of Appleton v Nennig, 92 Wis 2d 518, 539, 285 NW2d 614, 625 (1979); Richards v Richards, 58 Wis 2d 290, 296-98 (1973); In re Stiennon, 73 BR 905, 907 (Bankr WD Wis 1987). Moreover,

[i]t is not necessary that the person against whom the constructive trust is to be imposed be a wrongdoer or know of the wrongdoing initially. If the elements for imposing a constructive trust have been satisfied, and the holder of the legal title is not a bona fide purchaser, a constructive trust may be imposed.

Wilharms, 93 Wis 2d at 679, citing Richards, 58 Wis 2d at 298-99; Prince, 87 Wis 2d at 668; and Meyer, 65 Wis 2d at 289.

Unjust enrichment "arises when one party receives a benefit, the retention of which would be unjust as against the other." Richards, 58 Wis 2d at 296-97 (citations omitted). In the instant case, those who received the funds originally placed in the producers' trust account received benefits the retention of which would be unjust to the grain producers for whose protection the Department ordered the creation of the account.

Furthermore, "a wrong or some form of unconscionable conduct" has occurred in this case. Without the knowledge or consent of the Department, the Smedemas, as officers of the debtor, authorized Ludlow to remove $19,141.41 from the producers' trust account. Ludlow thereafter removed the remainder of the funds from the producers' trust account, also without the knowledge or consent of the Department. Thus, both the debtor (through the Smedemas) and Ludlow engaged in wrongful conduct.

The third element required to find a constructive trust, the existence of a specific res to which the debtor has acquired legal title, appears in the form of the $19,000.00 in settlement proceeds contained in the bankruptcy trustee's account. The parties dispute, however, whether the Department can trace the funds in the producers' trust account to the settlement proceeds.

Specifically, the trustee contends that "[i]n order for a trust to be imposed on the funds

within the control of the trustee, the department must show that it can trace the funds in the hands of the trustee back to the specific funds which were initially placed into the account created for the grain producers." The Department concedes that it cannot trace the source of the monies paid by Ludlow and the Smedemas to the money removed from the producers' trust account. The trustee therefore concludes that due to the Department's inability to trace the funds, "any claim to the funds on hand as the proceeds of an express trust obviously fail." The Department contends, however, that "[t]here is no requirement under the law that the funds which went back into the chapter 11 trustee's account have to be traced to the exact same funds that were removed from the producers' trust account." It asserts that tracing need only be shown "to the extent necessary to prove that the funds went into a trust account, then were paid out of the trust account, and were repaid in way of restitution."

In Bergier v Internal Revenue Service the United States Supreme Court addressed whether payments of trust fund taxes were transfers of "property of the debtor." In doing so, it stated: "In the absence of any suggestion in the Bankruptcy Code about what tracing rules to apply, we are relegated to the legislative history. The courts are directed to apply 'reasonable assumptions' to govern the tracing of funds . . ." Bergier v Internal Revenue Service, __ US __, 110 SCt 2258, 2267 (1990).

"It is beyond peradventure that, as a general rule, any party seeking to impress a trust upon funds for the purposes of exemption from a bankrupt estate must identify the trust fund in its original or substituted form." First Federal of Michigan v Barrow, 878 F2d 912, 915 (6th Cir 1989) (citations omitted). "'It is necessary to identify trust . . . funds . . . in order to follow and enforce the trust against the same; otherwise the beneficiary has only . . . the right of a general creditor.'" In re Telemark Management Co., Inc., 54 BR 29, 31 (Bankr WD Wis 1985), citing 76 Am Jur 2d Trusts § 252 (1975). See also King, 4 Collier on Bankruptcy ¶ 541.13 at 541-79 (1990) ("If the trust fund or property cannot be identified in its original or substituted form, the cestui becomes merely a general creditor of the estate.") Thus it is possible that property which does not initially qualify as property of the estate may be transformed into property of the estate by virtue of the trust beneficiary's inability to identify it in its substituted form.

In Truelsch v Miller, 186 Wis 239, 202 NW 352 (1925), an employee embezzled funds from his employer and allegedly used the funds to pay the premiums on four life insurance policies, one of which named the employee's wife as beneficiary of the policies. The wife was unaware of this conduct of her husband. Upon the employee/husband's death, the employer sought to impress the insurance proceeds in the widow/beneficiary's hands with a constructive trust.

The widow contended that the employer could not prove that the embezzled money went into the policies, and that because the funds could not be traced, the equitable right of the cestui que trust to follow and reclaim the trust fund failed. Truelsch, 186 Wis at 257. The Wisconsin Supreme Court rejected the widow's argument, stating:

It would be a signal failure of justice if one who has become a constructive trustee by reason of wrongfully receiving or securing the property of another could escape the consequences of his acts by changing the form of the property thus acquired. Hence, as between him and the cestui que trust, the latter may pursue the funds into the new investment and charge that investment with the trust. He may also assert and enforce the same right against third parties to whom the property has been transferred with knowledge of the trust or who have paid no consideration for it, provided the identity of the trust has been established.

Truelsch, 186 Wis at 252.

With regard to identification of the trust, the court stated that "'it may be stated generally that the burden of identifying the trust property in a satisfactory manner to the required extent rests on the party seeking to establish the trust.'" Truelsch, 186 Wis at 259 (citation omitted). It is not necessary to prove the tracing of the funds "beyond a reasonable doubt." Truelsch, 186 Wis at 259.

The court resolved that "it was competent for the appellant [the employer] to prove by circumstantial evidence that the funds were embezzled and that these funds were used in paying the premiums." Truelsch, 186 Wis at 260. The court stated that "[w]hatever may have been the former rule, it is not now the law that one cannot follow money in equity because it has no earmarks." Truelsch, 186 Wis at 260 (citation omitted). The court concluded that because the proof established that two-thirds of the premiums on the policy had been paid for from money embezzled by the employee/husband, two-thirds of the proceeds from the policy were impressed with a trust in favor of the employer. Truelsch has recently been cited as standing for the proposition that a "constructive trust [may be] imposed on [a] fund created by [the] diversion of resources designated for the benefit of another even though specific monies cannot be traced." Parge v Parge, 159 Wis 2d 175, 182-83, 464 NW2d 217 (App 1990) (Fine, J, dissenting).

Unlike Truelsch, the instant case involves not life insurance proceeds but settlement proceeds. No Wisconsin cases appear to have considered tracing requirements as they pertain to settlement proceeds; however, at least two other courts have done so. In In re Preston, 76 BR 654 (Bankr CD Ill 1987), the debtors used false mechanics lien affidavits to obtain $181,250.00 in payments from construction contracts. Immediately upon the debtors' deposit of this sum in their general bank account in Brimfield Bank, the Bank withdrew $165,000.00 to repay outstanding loans. Of this amount, $21,000.00 was kept by Brimfield Bank and the remaining $144,000.00 was given to Yates City Bank as repayment for a participating loan.

After the debtors filed under chapter 7, the trustee initiated a preference action against Brimfield Bank for the return of the $165,000.00. The case was settled for $106,000.00. Brimfield Bank paid the $106,000.00 from its "loan loss reserve" account, an account funded from the profits of the Brimfield Bank. When the trustee applied for approval of the settlement, subcontractors with valid mechanics liens claimed that the $106,000.00 was impressed with a constructive trust in their favor. The project owner also claimed a constructive trust on the $106,000.00.

The trustee contended that the $106,000.00 could not be traced to the settlement proceeds because "(1) the $106,000.00 received from the Brimfield Bank came from the Bank's loan reserve account which consisted of commingled proceeds from various profitable loans and ventures of the Brimfield Bank, and (2) there was no tracing of funds back from the Yates City Bank." Preston, 76 BR at 657. The court rejected the trustee's contentions, stating:

This Court does not believe the source of the funds for the settlement destroyed the ability to trace. . . . [T]he cestui does not have to trace and identify funds as his original dollars or necessarily as any dollars, but is entitled to recover if he can trace his funds through and into any form into which his funds may have been converted. It is clear that the Brimfield Bank received the $165,000.00 and it is not required that the Bank repay the $106,000.00 with the same funds that it received initially. The fact that it repaid $106,000.00 from a loan loss reserve account which was created from various profitable loans and ventures of the Bank is no reason to deny the ability to trace. . . . Likewise, the fact that $144,000.00 was paid to the Yates City Bank does not affect the ability to trace. For all intents and purposes the Brimfield Bank was the creditor, received the payment, and disgorged the preference.

Preston, 76 BR at 657-58 (emphasis supplied). The court held that the $106,000.00 could be traced. Similarly, in the instant case, Ludlow and the Smedemas received the funds of the producers' trust account, and disgorged them, to the extent of $19,000.00, by way of their settlement contributions.(3)

Although the Preston court determined that the $106,000.00 at issue therein could be traced, it further reasoned that:

If a mechanic's lien claimant cannot directly recover from a bona fide transferee, he should not be able to indirectly recover by claiming the proceeds of the trustee's successful preference action. To permit him to do so would be to place him in a superior position to other unsecured creditors who have claims against the bankruptcy estate.

Preston, 76 BR at 659-60. The court thus determined that a constructive trust could not be imposed upon a bona fide transferee such that "if the Brimfield Bank falls into that category, the Trustee would subrogate to the rights of the Brimfield Bank pursuant to section 551 of the Code." Id., 76 BR at 656.

11 USC § 551 provides:

Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.

(emphasis supplied). Thus, under Section 551, if the property recovered is not property of the estate, it is not preserved for the benefit of the estate. The Preston court does not explain how a trust beneficiary's inability to recover from a bona fide transferee property which was not previously property of the estate transforms that same property, when recovered from the transferee by the trustee, into property of the estate. The court instead ignores its own statement that "the Bankruptcy Code does not authorize a trustee to distribute other people's property among the debtor's creditors." Preston, 76 BR at 656 (citation omitted).

On rehearing en banc in In re First Capital Mortgage Loan Corp., the Tenth Circuit Court of Appeals, faced with a like fact situation, vacated the panel's earlier decision, reaching a conclusion similar to that reached by the Preston court. In re First Capital Mortgage Loan Corp., 917 F2d 424 (10th Cir 1990). In First Capital, the debtor-bank removed funds contained in an escrow account, and improperly used them to pay debts owed by it to a bona fide purchaser. After the debtor's bankruptcy petition was filed, the trustee recovered a portion of transfers made to the bona fide purchaser in settlement of a preference action against the purchaser.

The court determined that the settlement proceeds were property of the debtor's bankruptcy estate, citing 11 USC § 551 and stating:

Had the debtor not been involuntarily placed into bankruptcy, and had the trustee not decided to initiate the preference proceedings, neither Research-Planning [the party who had deposited funds into the escrow account] nor the debtor would have any claim against First Security. As a bona fide purchaser for value, First Security owned the funds. When the trustee recovered them from First Security, it was subrogated to the interests of the transferee, that is, of First Security.

First Capital, 917 F2d at 428 (citations omitted; emphasis in original). In response to the majority's opinion, Judge Seth wrote a dissenting opinion in which he recapitulated the position he had taken in the panel's earlier decision.

In In re First Capital Mortgage Loan Corp., 872 F2d 335 (10th Cir 1989), Judge Seth stated that the trial court had "assumed that there was a metamorphosis as the funds were transferred depending on who had possession." First Capital, 872 F2d at 337. Judge Seth rejected this notion, stating:

[T]he basic rights of the plaintiff [Research-Planning] did not change. First Security's status as a bona fide purchaser did not divest the plaintiff of ownership of the funds. Instead, it merely shielded First Security from any claim for the funds that the plaintiff might have asserted. First Security's status as a bona fide purchaser is irrelevant now that it no longer possesses the funds.

First Capital, 872 F2d at 337.

Judge Seth concluded that the trustee "held the funds not as part of the estate but for the benefit of plaintiff." First Capital, 872 F2d at 337. In so concluding, he reasoned:

The procedure in settling the preference suits did not change the ownership of the funds--only who had possession of them. They did not become part of the debtor's estate just because the trustee obtained possession. He has possession of property not part of the debtor's estate. He established the source of the funds--the debtor's escrow agreement. The trustee was able to identify the several transfers and payments and to so obtain possession of the funds. He may have obtained possession in his capacity as trustee, but again, this did not make the funds any more part of the debtor's estate than they were when in the original escrow.

First Capital, 872 F2d at 336-37. Analyzing Judge Seth's conclusions under Section 551, the trustee's recovery was not preserved for the benefit of the estate because the property recovered by the trustee was not property of the estate.

In his later dissent, Judge Seth stated:

[T]he bare fact that suit was filed and that the funds were paid cannot be enough in these circumstances to launder the trust out of the funds in the hands of the Trustee in Bankruptcy. This is all that the majority would require, but this cannot be enough. The defendant Trustee in Bankruptcy should not be allowed to convert known trust funds originally in the possession of the bankrupt into part of the bankruptcy estate contrary to established doctrines for the protection of trust funds . . .

First Capital, 917 F2d at 430. The law applicable to trusts indeed reinforces Judge Seth's conclusions.

As has previously been noted, in Truelsch the Wisconsin Supreme Court stated that the cestui que trust may impress property held by "third parties to whom the property has been transferred with knowledge of the trust or who have paid no consideration for it" with a constructive trust, provided that the identity of the trust has been established. Truelsch, 186 Wis at 252. In both Preston and First Capital, the plaintiffs identified the trusts at issue therein, but were precluded from impressing those trusts against the bankruptcy trustees despite the fact that the bankruptcy trustees had knowledge of the trusts, and did not pay any consideration for the funds recovered, having received them in settlement of preference actions. It was not necessary that the trustees have been wrongdoers in order for constructive trusts to be imposed. Wilharms, 93 Wis 2d at 678. Under Truelsch, the trust beneficiaries in Preston and First Capital should have been able to recover the settlement proceeds from the bankruptcy trustees.

Unlike the good faith purchasers involved in Preston and First Capital, in the instant case both the debtor (through the Smedemas) and Ludlow had knowledge of the

producers' trust account. Neither qualifies as a bona fide purchaser for value and without notice. But for the filing of the debtor's bankruptcy petition, the Department would have been able to seek recovery from both Ludlow and the Smedemas. Furthermore, although the trustee is guilty of no wrongdoing, he had knowledge of the producers' trust account and he paid no consideration for the settlement funds. Under Truelsch, the Department, as the trust beneficiary, may impress with a constructive trust those funds which can be traced to funds originally placed in the producer's trust account.

It has already been established that unjust enrichment and wrongful conduct are present in the instant case. If the Department can trace the funds originally placed in the producers' trust account to the settlement proceeds (the "specific res"), those proceeds may be impressed with a constructive trust in favor of the Department. The Department has identified, in their substituted form, the funds removed from the producers' trust account. That form has taken the shape of $19,000.00 in settlement proceeds received by the chapter 11 trustee from Ludlow and the Smedemas. The Department may impress the trustee's bankruptcy trust account with a constructive trust in the amount of $19,000.00 provided it can identify the $19,000.00 within the account. See Adametz, 53 BR at 299; Wilharms, 93 Wis 2d at 678; Truelsch, 186 Wis at 252.(4)

The fact that $15,935.22 in proceeds received from the sale of the debtor's grain warehouse assets, in addition to the $19,000.00 in settlement proceeds, was placed into the bankruptcy trust account does not defeat the Department's ability to trace the funds from the producers' trust account to the bankruptcy trust account. It has been stated that:

The situation frequently occurs where trust funds have been traced into a general bank account of the debtor. The following general principles have been applied. The bankruptcy court will follow the trust fund and decree restitution where the amount of the deposit has at all times since the intermingling of the funds equaled or exceeded the amount of the trust fund.

King, 4 Collier on Bankruptcy ¶ 541.13 at 541-79 (1990). The bankruptcy trust account currently contains $31,284.30. There is no evidence that amount in the bankruptcy trust account has at any time since the deposit of the settlement proceeds dropped below the amount of $19,000.00. Under such circumstances, the Department is entitled to restitution of the $19,000.00 in settlement funds.

END NOTES:

1. 11 USC §§ 541(a)(1) and (2) provide:

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

(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.

(2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is--

(A) under the sole, equal, or joint management and control of the debtor; or

(B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.

2. See also, In re All-Way Services, Inc., 73 BR 556, 564 n 21 (Bankr ED Wis 1987) ("The trust fund exception creates a situation where the funds in the payroll account are an asset of the debtor pursuant to state law, but are not property of the estate pursuant to bankruptcy law.").

3. Funds were transferred from the producers' trust account to various entities. The Smedemas, as officers of the debtor, consented to the removal of $10,000 to pay the debtor's bankruptcy attorney, $7,946.41 to pay Ludlow, $585.00 to pay a third attorney, and $610.00 to pay an insurance premium. Although the Smedemas did not directly receive any of the funds (either personally or on behalf of the debtor), they (and thus the debtor, their principal) both consented to, and were benefitted by, the transfers. Because the Smedemas consented to the transfers, the situation is no different than if Ludlow had directly paid the Smedemas $19,141.41, and the Smedemas had conveyed that sum to third parties. The Smedemas may therefore be treated as constructive transferees of the $19,141.41 in trust account funds received by the above entities. Furthermore, in addition to the $7,946.41 received with the Smedemas' consent, Ludlow received the remainder of the funds in the producers' trust account (approximately $ 13,000.00) by transferring the balance into accounts in the name of the Ludlow Company.

4. This court specifically rejects the proposition that recovery by the chapter 11 trustee of the settlement funds automatically transforms those funds into property of the estate. See Pomeroy, 3 Equity Jurisprudence § 1048 n (e) at 2387 (Bancroft-Whitney, 4th ed 1918), stating:

If the beneficiary can show that the trustee's estate, as it came into the hands of his assignee, trustee in bankruptcy, receiver, executor, or administrator, was actually increased by the whole or a definite portion of the misappropriated trust fund, justice demands that he and not the other creditors should have the benefit of the increase. The creditors have no right to make a profit by their debtor's breach of trust.

(citations omitted).