In the United States Bankruptcy Court

for the Northern District of Iowa

STEVEN R. BEHR Debtor.	Bankruptcy No. X88-01976D Chapter 7
DANIEL P. ERNST, Trustee Plaintiff EAST DUBUQUE SAVINGS BANK Intervenor vs. SPAHN & ROSE LUMBER CO. Defendant.	Adversary No. X89-0182D

MEMORANDUM OF DECISION AND ORDER

The court has previously ordered Spahn & Rose Lumber Co. (SPAHN & ROSE) to return a preferential transfer to the estate. [(1)] The trustee is presently holding $12,245.44. Intervenor East Dubuque Savings Bank (BANK) has asked the court to impress the funds with constructive trust in its favor. It contends that because of fraud committed by Steven Behr in obtaining the loan from the bank and/or in performing the loan agreement, Behr's bankruptcy estate should not benefit ahead of the bank from the return of the funds.

I.

Steven R. Behr (BEHR) was in the construction business in and around Dubuque, Iowa. Sometime prior to the end of July, 1988, he incorporated his business.[(2)]

Behr's business suffered serious losses through the conversion of assets by his accountant. The embezzlement was apparently discovered in 1988. As a result, Behr began experiencing cash flow problems. He was also having difficulty completing work on a building project for a woman named Edna Blosch. Behr began notifying the bank of his problems in August of 1988. In September, the bank made two loans to Behr totaling $13,000.00. In October, 1988, Behr and Behr's new accountant, Ed Fett (FETT), began working with the bank on a solution to Behr's financial problems. In late October, the bank learned from Behr that he owed $48,800.00 in accounts payable on the Blosch project. Upon completion of the project, Blosch would owe Behr $15,000.00. Behr also owed an additional $15,488.00 to other creditors. Bank continued to obtain information from Behr. By October 24, bank believed that Behr's accounts payable exceeded his receivables by nearly $55,000.00. At that time, Behr's checking account with the bank was overdrawn in the amount of $2,253.00.

On November 2, 1988, bankers Thomas J. Reilly and Daryl Barklow met with Behr; Behr's father, Erv; and Fett. Fett submitted lists of Behr's receivables, payables and work-inprocess as of October

31. As a result of the submitted figures, the bankers believed that Behr had approximately $22,000.00 in net current accounts receivable (those that could be collected immediately) not counting $15,000.00 due on the Blosch job. The bankers also believed it would cost Behr more to complete the Blosch job than was still due. The bankers learned that over the next six months Behr would collect approximately $333,000.00 from work-in-process and on confirmed jobs. Of this, approximately $55,000.00 would be profit. Behr, Fett and the bankers discussed a plan by which bank would lend Behr $42,000.00. The money would be used to pay one-half of all the payables on the Blosch job, to take care of Behr's overdraft at the bank, to permit payment of one week's payroll in the amount of $2,000.00 and to allow an additional $5,000.00 for operating capital. The bank was willing to lend the $42,000.00 but outlined at least ten conditions for the granting of the loan. These conditions included the securing of life and health insurance on Behr, settlement with the Blosch creditors, the maintenance of a positive balance in Behr's checking account with the bank, and several changes in the way Behr did business, especially in the collection of accounts receivable.

Behr was slow to accomplish all of these conditions, and by November 18, 1988, bank had notified Behr that it would not lend him any money. Not only had Behr failed to meet several of the bank's requirements, but Behr's overdraft in his checking account had more than doubled.

Despite Reilly's denial of the loan request, negotiations continued. There were further discussions about Behr's plan to settle with the Blosch creditors. Although a plan was again discussed with the bank, Behr himself had no further discussions with the bank on borrowing additional funds for operating. Behr testified that he was told by others that the bank would lend an additional $10,000.00, but he admits he was not told this by the bank. Bank officer Reilly denies any agreement by the bank to lend Behr more than the amount of one-half the Blosch payables.

Bankruptcy was discussed as an alternative to Behr's obtaining further loans. Behr and his wife told the bankers they wanted to avoid bankruptcy. However, Behr also told the bankers that if he could not get a loan, bankruptcy would be the result. on November 22, 1988, Reilly and Barklow decided to loan Behr enough money to enable him to pay one-half of the Blosch project payables. Behr was to use his income from accounts receivable and work-in-process as working capital. Reilly attempted to call Behr but was unsuccessful in reaching him. He was able to reach Fett and confirmed the decision in a letter to Fett. The letter was not offered into evidence. Fett began compiling the figures on the Blosch payables for the purpose of the bank's finalizing the loan figure. The loan closing took place on November 30, 1988. By that time, it was determined that

Behr owed $65,617.94 to contractors and materialmen on the Blosch project. The bank would thus loan $32,808.97. At the closing, Behr signed the promissory note to the bank on behalf of his corporation. The note described the loan as a "single advance" and stated that, "[n]o additional advances are contemplated under this note." (Exhibit 0.) In the security agreement portion of the note, Behr assigned certain life insurance proceeds to the bank and also granted bank a security interest in inventory, equipment, accounts and general intangibles. Bank also took a security interest in a utility trailer, a Ford pickup, a Lincoln town car, and a Buick Riviera. The loan was guaranteed by Steven Behr and his wife. As security, Behrs granted bank a second mortgage on their homestead. After the documents were signed, bank deposited the $32,808.97 in loan proceeds in Behrs' checking account.

By the closing date, Behr had reached agreement with all the Blosch project creditors. In early November, Fett had sent letters to all of the creditors indicating that bank had committed to loan sufficient funds for Behr to immediately pay onehalf of all the project payables. The balance of the Blosch payables and other accounts payable would be paid from Behr's current cash flow. Creditors were told by Fett that the bank was "asking for complete cooperation from all creditors to proceed

with this arrangement" and that the bank's loan commitment depended upon all creditors agreeing to the plan. (Exhibits F, G, H, I, J and K.) Spahn & Rose was diligent in following up on the settlement; on the same day that the loan proceeds were deposited in Behr's checking account, Spahn & Rose obtained payment of one-half of its claim.

Steven Behr testified that he had believed that the bank was still obligated to loan him an additional $10,000.00. On the day of the loan closing, Fett called Reilly and asked if further monies would be loaned to Behr. Reilly told him "no." Behr, who was in Fett's office at the time of the call, became upset. Bank next received a letter from attorney Doug Henry dated December 6, 1988 which demanded, on behalf of Behr Construction, Inc. and the Behrs, additional advances of $12,000.00 in accordance with Behr's understanding of the loan agreement. Bank did not advance the additional funds.

There was no agreement by bank to lend Behr any more than $32,808.97. Behr may have believed that bank had obligated itself to lend an additional $10,000.00 or $12,000.00. However, bank did not make such a promise. Behr's only evidence was that, on previous occasions, bank had deposited money in his accounts without loan documentation, and that he had expected bank would loan the additional money as part of this transaction. It had been discussed prior to the bank turning down the initial loan request. Behr testified that after initially being denied the loan, other persons, including Fett, had told him that the bank would loan the additional funds. The latter evidence is based on hearsay and is not reliable as to what bank promised to do. The only obligation of the bank was to lend Behr $32,808.97, which it did.

On December 12, 1988, Behrs, their attorney, and Fett met with the bankers and bank's attorney. They discussed Behrs' finances and the possible loan of an additional $10,000.00. The session broke up without agreement, and bank lent no further money.

On December 6, 1988, Behr removed the unused portion of the loan proceeds from bank and deposited it at First National Bank of Dubuque. The unused portion totaled $19,628.22. On December 6, 1988, Fett, on Behr's behalf, began spending the funds. Between December 6 and December 27, 84 checks were written on the account at the First National Bank; approximately $2,000.00 was paid to Behr's wife, $2,000.00 was paid to Fett, $6,500.00 was paid to attorney Tom McCuskey to pay for representation in Behr's bankruptcy case, and other funds were used to pay operating expenses. Behr filed his chapter 11 case on December 22, 1988.

On January 24, 1990, Fett signed an affidavit stating that "[f]rom a review of his records, I believe that Steve Behr was insolvent on November 30, 1988, primarily as a result of embezzlement by Ralph Berg [Behr's former accountant]." (Exhibit Y, unsigned. The signed affidavit was filed with the court in support of the trustee's motion for summary judgment.) Banker Reilly testified that had he been aware of Behr's insolvency, he could not have made the loan. Behr was insolvent on November 30, 1988.

Two primary questions are presented to the court. First, do Behr's actions in obtaining the loan or in spending the proceeds warrant the court's imposing a constructive trust on the funds obtained by Behr from the bank? If so, did Behr's transfer of the funds to Spahn & Rose or the trustee's subsequent recovery of those funds cut off Bank's entitlement to a constructive trust? I conclude that a constructive trust should not be imposed upon the monies which Behr transferred to Spahn & Rose. Even if Behr constructively held the funds in trust for bank, bank's equitable interest in them would not continue once the funds were transferred to Spahn & Rose.

III.

Bank asserts a right to the funds recovered by the trustee under a theory of constructive trust, arguing that Behr fraudulently obtained the loan proceeds and subsequently disbursed them in a manner equally fraudulent.[(3)] Property rights in bankruptcy are determined by state law. Butner v. U.S., 440 U.S. 48, 55, 99 S.Ct. 914, 918, 59 L.Ed.2d 136 (1975). In Iowa, constructive trusts may arise under circumstances of fraud, actual or constructive. Newell v. Tweed, 241 Iowa 90, 40 N.W.2d 20, 24 (1949). Such trusts are imposed by the court, not to effectuate the intentions of the parties, "but because the person holding title to the property would profit by a wrong or would be unjustly enriched if he or she were permitted to keep the property." Cox. v. Waudby, 433 N.W.2d 716, 720 (Iowa 1988). Bank must prove its entitlement to such an equitable remedy by clear and convincing evidence. Copeland v. Voge, 237 Iowa 102, 20 N.W.2d 2, 5 (1945) reh'g. denied (1945). "The elements of fraud [at law] are (1) material misrepresentation, (2) made knowingly (scienter), (3) with intent to induce the plaintiff to act or refrain from acting, (4) upon which the plaintiff justifiably relies, (5) with damages. Beeck v. Kanalis, 302 N.W.2d 90, 94 (Iowa 1981) reh'g. denied (1981). Fraudulent intent is a necessary element in every actionable fraud. Kimmans v. Chandler, 13 Iowa 322 (1862). In equity, relief may be granted even absent proof of scienter or pecuniary damage. First National Bank in Lenox v. Brown, 181 N.W.2d 178, 181 (Iowa 1970).

Bank asserts that Behr obtained the loan by fraud. it contends that Behr knowingly provided false information to the bank in obtaining the loan--that Behr listed accounts receivable as still owing, although they had already been paid; that Behr's representations to it as to his financial status were knowingly false because Behr failed to notify the bank that several of the accounts receivable were disputed by Behr's customers; and that Behr failed to disclose his insolvency.

Although accounts actually owing to Behr were less than he indicated to the bank, the misrepresentation was not material. Banker Reilly testified that the difference between the representations by Behr and the actual amounts due (approximately $3,500.00) would not have been significant in determining whether to make the loan. Reilly was more concerned that Behr would have knowingly misrepresented the figure by any degree. However, in order for a misrepresentation to be actionable, it must be of a material fact which was relied on by the bank. Sinnard v. Roach, 414 N.W.2d 100, 105 (Iowa 1987). According to the evidence, the difference in the amounts represented and those actually owed was not material in the decision to make the loan.

Bank contends also that Behr's failure to tell it that several of the accounts receivable were disputed by the customers was a knowing misrepresentation. There is no evidence the bank asked about or that Behr made any representation as to the quality of the receivables. Moreover, Behr was making legitimate attempts to collect these accounts despite disputes raised by the customers. Based on the evidence, the court can find no fraudulent intent by Behr in failing to tell the bank that some of the accounts receivables were disputed.

Bank claims that Behr defrauded it in obtaining the loan because he failed to disclose his insolvency. Bank points to the affidavit of Fett (Exhibit Y) in which the accountant states that he believed Behr was insolvent on November 30, 1988. Banker Reilly says that had he known that, bank would not have made the loan. Bank has not shown that Behr issued any false statement as to his solvency to obtain the loan. Bank does not claim that any false financial statements were submitted as part of the application or at any other time. In making the loan, the bank relied on information on accounts receivable, work-in-process, and projected income from future projects which had been secured by Behr. It also must have relied on the security which it took for the loan. There was no evidence that the bank inquired as to Behr's solvency. They were aware of his inability to pay debts as they came

due. His increasing overdraft position in his checking account provided notice of his financial problems. Furthermore, Behr had told the bankers that without the loan he faced bankruptcy. Moreover, it cannot be determined from Fett's affidavit whether his belief as to Behr's insolvency was held at the time of the loan application or whether his belief related to the time the affidavit was executed in 1990. Based on the evidence, I cannot find that there was an intentionally false statement of solvency by Behr to the bank, nor can I find that bank relied on balance sheet solvency in making the loan.

Bank also argues that Behr falsely represented to it that he was borrowing the money for the purpose of paying off his creditors on the Blosch project, but that he had no intention of using the money for that purpose. There is no direct evidence that Behr obtained the loan with the intention of not using the money for the expressed purpose. That Behr did not use all of the money to make the agreed payments is not convincing evidence that he obtained the loan by falsely representing what his use of the funds would be. This is especially so because of the evidence of the post-loan disagreement on further advances. That dispute provides explanation for Behr's later actions.

To demonstrate fraud, Bank primarily focuses on Behr's conduct after receiving the loan funds, contending that Behr's failure to distribute the loan proceeds in accordance with the purpose of the loan was fraud in the performance of the loan agreement. After the loan funds were deposited in Behr's account, Fett, on Behr's behalf, distributed the agreed payment to Spahn & Rose. I can find no fraud in this distribution. As to the Spahn & Rose debt, Behr did exactly as he had proposed. Behr, however, made no other distribution to the other creditors with whom he had settled accounts. After the loan money had been made available to him and after Fett had paid Spahn & Rose, Behr and bank disagreed over whether further loan money was due Behr under the loan agreement. Although Behr was incorrect in believing that the Bank had promised to lend more, I do not find that his position was falsely asserted.

Behr's payments to his wife, accountant, lawyer and others may have constituted a breach of contract with the bank, but they did not constitute fraud as to the Spahn & Rose distribution, and they should not have the effect of vitiating a loan agreement which was valid when made. "The mere failure to perform an agreement or to carry out a promise, or the failure to pay a debt, cannot in itself give rise to a constructive trust, since such a breach does not in itself constitute fraud or abuse of confidence, or duty requisite to the existence of a constructive trust. . . ." Security Nat. Bank of Greensboro v. The Educators Mut. Life Ins. Co., 265 N.C. 86, 143 S.E.2d 270, 276 (1965) citing 54 Am.Jur.2d Trusts 221 (1975). Behr's use of more than $19,000.00 of the loan proceeds for purposes not contemplated does not destroy the efficacy of the one payment which he did make in accordance with his asserted purpose for obtaining the loan. Moreover, I do not agree with bank's contention that no authorized payment by Behr can be valid unless all the payments were made. Spahn & Rose was told that all creditors would have to agree to the same settlement, and they did; it was not told that it could not keep its payment if Behr did not pay the rest.

Although, as stated previously at page 9, equity may find fraud without proof of pecuniary damage, I am concerned that the bank has not proven the remaining balance on the loan nor the value of the collateral still securing it. I cannot, therefore, determine the extent of the injury to the bank. If I were to grant the bank's requested remedy without such information, my action could unnecessarily deprive the bankruptcy estate of assets for distribution to unsecured creditors. Bank has not shown it does not have other remedies.

Although unjust enrichment may be the basis for establishing a constructive trust, I do not find that Spahn & Rose was unjustly enriched by receiving payment. It was paid in accordance with the agreement with Behr--receiving a partial payment on an account which was justly owing.

Finally, Bank has argued that a constructive trust should be imposed because Behr spent the loan proceeds in violation of a fiduciary duty owed to it as lender. In Iowa, a constructive trust can arise when a fiduciary acquires or retains property in violation of his fiduciary duty to another. McGaffee v. McGaffee, 244 Iowa 879, 58 N.W.2d 357, 360 (1953). Bank, however, has failed to prove that Behr received the loan proceeds in a fiduciary capacity. "A person is said to receive money in a fiduciary capacity when the money is not his own or for his benefit, but is for the benefit of another person to whom he stands in a relation implying great confidence and trust on the one party and a high degree of good faith on the other." Vertman v. Drayton, 223 Iowa 380, 272 N.W. 438, 439 (1937). Behr was nothing more than a borrower from the bank. He borrowed the money for his benefit, not the bank's. A fiduciary duty does not generally arise from such a relationship. See, Kurth v. Van Horn, 380 N.W.2d 693, 696 (Iowa 1986) rehlq. denied (1986). I conclude that Behr did not stand in a fiduciary relationship to bank as to the subject transactions.

Bank has failed to prove it is entitled to the imposition of a constructive trust on the monies being held by the trustee.

IV.

Even if a constructive trust were appropriate because of Behr's actions, I would not impose it because I find that Spahn& Rose was a good faith purchaser for value without notice of any breach of trust by Behr. "[E]quity will not impress constructive trust upon property that has passed into hands of a good-faith purchaser for value without notice. Such a purchaser is regarded as equal, if not superior, in equity." Frink v. Commercial Bank of Emmetsburg, 195 Iowa 1011, 191 N.W. 513, 519 (1923); Harris v. Warner, 199 Iowa 1000, 203 N.W. 279, 281 (1925). Payment on an existing debt is sufficient as value under such a rule. See Burnett V. Gustafson, 54 Iowa 86, 6 N.W. 132 (1880).

To be a good faith purchaser without notice, Spahn & Rose would have had to have accepted the payment from Fett without notice that the other Blosch creditors had not or would not be paid. There is no evidence of this. The only evidence is that Spahn & Rose picked up its payment in conformance with the agreement it had made. Spahn & Rose had no duty of inquiry to determine at the time it obtained payment whether other creditors on the Blosch project had been paid. I conclude, therefore, that Spahn & Rose was a good faith purchaser without notice of any breach of trust that may be attributed to Behr. Such a status would prevent the imposition of a constructive trust on the loan proceeds which it received.

The trustee is entitled to assert the same status against the claim of bank. The Spahn & Rose payment was returned to the trustee pursuant to a decision of this court under 11 U.S.C. 547, covering preferences, and under 11 U.S.C. 550 permitting the recovery of avoided transfers. Section 551 of the Code preserves for the benefit of the estate any transfers avoided under 547. An avoided transfer so preserved becomes property of the estate under 11 U.S.C. 541(a)(4). I construe these sections to permit the trustee to assert any good faith purchaser defense against the bank which Spahn & Rose could have asserted. If the trustee could not do so, bank would be in a position to recover from the trustee even though it could not have recovered from Spahn & Rose had no bankruptcy occurred. Therefore, even were I to hold that a constructive trust should be imposed on the loan proceeds in Behr's hands, the transferee's status as a good faith purchaser without notice may be asserted by the trustee against bank's claim. Research-Planning, Inc. v. Segal (In re First Capital Mort. Loan Corp.),

917 F.2d 424, 428 (10th Cir. 1990) rehlq. denied (1990). By such an assertion, trustee would defeat bank's claim.

ORDER

Judgment shall enter that the Intervention Complaint of East Dubuque Savings Bank is dismissed.

SO ORDERED ON THIS 4th DAY OF OCTOBER, 1991.

William L. Edmonds
Bankruptcy Judge

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1. Judgment was entered against Spahn & Rose on July 12, 1990. Because of the pending intervention complaint, the court should not have entered judgment. Spahn & Rose appealed. Before the permissibility or outcome of the appeal was determined, trustee and Spahn & Rose settled their dispute. Although the court had ordered the return of $13,180.75, the settlement approved by the court provided for a return of $12,245.44.

2. The fact of incorporation was ignored in the preference action. Behr was treated by Spahn & Rose and the trustee as the transferor of the preferential payment.

3. If the money transferred by Behr to Spahn & Rose were impressed with a constructive trust, the equitable interest in the funds would not be property of the estate and thus could not be the object of a preferential transfer. Begier v. IRS, U.S. 110 S.Ct. 2258, 2262, 110 L.Ed.2d 46 (1990). Such a defense to the preference action was not raised by Spahn & Rose. Bank, in the pre-trial statement, supported the trustee's claim that the transfer to Spahn & Rose was preferential but also claimed that the property rightfully belonged to it. Given the aforementioned Supreme Court ruling, it would appear that Bank has taken inconsistent positions. However, I do not conclude that Bank should be judicially estopped from doing so. The trustee certainly did not rely to his detriment on the Bank's support. He pursued his claim that the property transferred was property of the estate. Although it may be unclear whether judicial estoppel is a valid doctrine in this circuit (see Total Petroleum, Inc. v. Davis, 822 F.2d 734, 737, n.6 (8th Cir. 1987)), even if it were, I would not apply it under these circumstances.