Tracing Del. Bankruptcy Court's Unclear Tracing Rules

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An inherent tension exists between the Bankruptcy Code and the common-law doctrine of constructive trust. On the one hand, the Bankruptcy Code provides a broad scheme for ratable distribution among creditors. On the other hand, constructive trust law allows a creditor to recover from outside that scheme — and often in full — while its peers receive cents on the dollar. Yet, unlike an express or "real" trust, a constructive trust is a mere fiction, a remedy that courts invent after the fact to redress cases of unjust enrichment. From a creditor's perspective, constructive trusts are a tantalizing remedy, so it is important for both debtors and creditors to know when this remedy can be imposed.

Unfortunately, the state of the law in the Delaware bankruptcy courts is unclear. Delaware courts tend to allow constructive trusts in bankruptcy (not all courts do), but disagree on an important and often outcome-determinative question: How must a creditor trace the money subject to the constructive trust if that money has been commingled?

Under general trust principles, a trust must relate to specific identifiable property. When that property is money that has been commingled with other money, a problem arises: There is no way to distinguish any given dollar in a bank account from any other given dollar, so how can we tell which dollars are trust dollars? *In re Catholic Diocese of Wilmington*, 432 B.R. 135, 151 (Bankr. D. Del. 2010), dealt with this issue. To alleviate this difficulty, trust law employs a fiction known as the "lowest intermediate balance test," which holds that whenever a trustee withdraws money from a commingled account, the trustee withdraws non-trust-fund dollars first, thereby maintaining as much of the trust fund as possible. But any funds added by the trustee to the account are treated as non-trust funds, so if an account is depleted to $0 and then replenished (as may commonly occur when a bank account is swept to $0 by the debtor's lender), the trust funds are lost and the constructive trust claim is defeated. Many Delaware courts apply this approach to deny trust claims seeking to reach commingled money in accounts whose balances were replenished after having fallen, as in *Catholic Diocese* and *In re Amp'd Mobile*, 377 B.R. 478, 490 (Bankr. D. Del. 2007).

But other published opinions have adopted a little-known approach that appears to allow for much broader tracing, as in *In re Edison Brothers Stores*, 243 B.R. 231 (Bankr. D. Del. 2000), and *In re Lexington Healthcare Group*, 335 B.R. 570 (Bankr. D. Del. 2005). These courts allow tracing whenever a sufficient nexus exists between the depleted trust funds and the funds over which the plaintiff now wants to impose a trust. The idea is that the lowest intermediate balance test is just one of many reasonable ways of identifying trust funds and plaintiffs should be allowed to employ other reasonable methods, too, even when the lowest intermediate balance test would tell us that the funds are untraceable.

While this disagreement among Delaware's bankruptcy judges has been recognized, as in *Catholic Diocese*, it has not yet been resolved, so it is prudent for any practitioner to understand the outer contours of the nexus tracing approach. At first glance, the approach seems incredibly broad. How much of a nexus must there be? From published cases, we know the following:

- At one end of the spectrum, the mere fact that the debtor commingled trust funds with non-trust funds, standing alone, is not enough to create a nexus between the trust funds and the debtors' other cash, as the court held in *Lexington Healthcare*.

- At the other end of the spectrum, where a debtor voluntarily sets aside commingled funds to replace dissipated trust funds, or pays commingled funds directly to the beneficiary as if they were trust funds, then under the nexus approach, the designated funds are treated as trust funds, as in *Edison Brothers*.

- Falling between these two extremes is another example: Where a debtor uses trust funds to pay down a credit facility and there is availability under the credit facility, there is no nexus between the trust funds and the facility, such that a trust could reach funds available under the facility, as the court held in *In re Edison Brothers Stores*, 268 B.R. 409, 414 (Bankr. D. Del. 2001).

Tracing under the nexus approach, therefore, is not the limitless approach that it first seems to be. It requires evidence from which the court can reasonably conclude which particular dollars are trust dollars. If the debtor has somehow identified those dollars, such as by designating them in any way, then a sufficient nexus may exist to treat the designated funds as trust funds, regardless of the lowest intermediate balance test. The nexus approach, therefore, might be better labeled the "reasonable assumption" approach, as it will allow the use of fictions beyond the lowest intermediate balance test to identify trust funds. But the mere fact that money is commingled and spent, without more, should never be enough to allow a constructive trust over a debtor's general assets.

The bottom line is that until a dispute over the proper tracing standard reaches the U.S. Court of Appeals for the Third Circuit, avenues will exist for clever plaintiffs to pursue constructive trust claims on facts that might not have been so promising under the traditional tracing test.

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