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Imposing a Constructive Trust in Bankruptcy Cases: Federal Common Law Triumphs!

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When creditors are left holding the bag after providing valuable goods or services to a company that files for bankruptcy relief, they often feel misused and that an injustice has occurred. After all, they are legitimately owed money for their work or their product, and the debtor has in effect been unjustly enriched because it received something for nothing. Unsecured creditors do not have recourse to collateral, and typically have to wait in line to receive cents on the dollar.

The feeling of injustice can be especially acute in a subcontractor scenario when the debtor used the subcontractor's work to fulfill its own obligations under its primary customer contract. The customer then pays in full for what was provided, and instead of passing along the subcontractor's rightful share of the payment, the debtor keeps the payment and the subcontractor is left with only a bankruptcy claim. In those cases where a subcontractor provides construction services, the subcontractor will often have the right to assert statutory mechanic's liens or artisan's liens to protect itself (and in those cases, it is critical for the subcontractor to consult with counsel to ensure that all of the requirements for obtaining those liens are met). However, in other cases, a statutory lien might not be available.

In [*In re Suniva, Inc.*, 2018 Bankr. LEXIS 761 \(Bankr. D. Del. March 16, 2018\)](#), the Bankruptcy Court for the District of Delaware considered just such a case. The debtor had contracts with the United States Department of Energy, and subcontracted out a portion of the research and analysis that was necessary for the project. The subcontractor who performed the research was left unpaid for its services, despite the debtor having provided the research to the DOE and having received millions of dollars in compensation from the DOE that was supposed to be shared with the subcontractor. Instead, during the bankruptcy, the Debtor entered into a proposed cash collateral stipulation with its lenders and the official committee of unsecured creditors that, if approved, would have resulted in certain secured lenders receiving payments from, among other funds, the funds that were received from the DOE. The subcontractor objected.

The Court rejected arguments that the funds the debtor received from the DOE were earmarked for subcontractor or that the debtor was simply intended to be a pass through entity to facilitate the payment of the subcontractor's portion of the funds. The Court found that those arguments were not supported by the terms of the contract. The Court also noted that a constructive trust would not have been permitted under the state law governing the contract because there had been no fraud or other misconduct on the part of the debtor. However, because this case involved the DOE and a federal research project, the Court believed it was appropriate to apply federal common law as set forth in the Third Circuit's decision in *In re Columbia Gas Systems, Inc.*, 997 F.2d 1039 (3rd Cir. 1993).

The Court read the *Columbia Gas* case to allow a bankruptcy court to impose a constructive trust "even when one would not be imposed under applicable non-bankruptcy law." The Court felt that such a result was also supported by the legislative policy underlying section 541(d) of the Bankruptcy Code. Accordingly, the Court imposed a constructive trust on a portion of the funds at issue and found that those funds were never included in property of the estate and that the subcontractor was entitled to payment.

The facts of this case are relatively narrow, as they involve government contracts by the DOE for a federal

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research program. The Court might not have concluded that federal common law governed if private parties had been involved. However, the lesson for subcontractors is that there can be value in being creative and advancing arguments like the ones asserted here. One should not just assume that one is unsecured and without recourse. Perhaps the circumstances of the particular case present alternative arguments like earmarking or constructive trust that may prove successful.

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