

## Global Finance

# Financing the Middleman: Traps for the Unwary When Financing an Intermediary Business

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Lenders relying on a security interest in the accounts receivable of borrowers need to use caution when financing an intermediary business that could be subject to express or constructive trusts. For example, freight forwarders, logistics companies, payroll processors, back office billing companies, staffing companies and general contractors, may receive funds from their customers for the express purpose of paying specific third parties. Other types of businesses, like real property developers and operators of nursing homes and senior-living facilities, may receive deposits from customers with an obligation to return the deposits under specified circumstances.

If an intermediary business holds accounts receivables or deposits in express or constructive trust, there is a risk that a lender's security interest would not attach to the portion of the accounts receivable or deposit that is destined for the trust beneficiary. Further, even if the lender's security interest did attach, there is a risk that the lender's security interest would be subordinate to the rights of the trust beneficiary.<sup>1</sup>

This report explains the law relating to such express and constructive trusts and offers suggestions on how to protect lenders that finance intermediary businesses that might be subject to an express or constructive trust.

### Who are the trust beneficiaries?

The beneficiary of an express or constructive a trust could be one more of a borrower's customers that have provided the funds,<sup>2</sup> one or more intended recipients of the funds,<sup>3</sup> or a third party, such as the issuer of a surety bond, asserting a right to indemnification following its payment of one or more intended beneficiaries of the trust.<sup>4</sup>

<sup>1</sup> While U.C.C. § 9-201(a) states that, except as otherwise provided, a security interest is effective against *creditors*, it does not purport to make a security agreement effective against third-party *owners* of the collateral. This vulnerability applies not only to legal claims of ownership but also to equitable claims of ownership. Specifically, a claim that the collateral is subject to a constructive trust in favor of a third party can defeat the rights of a putative secured party. See Restatement (Third) of Restitution and Unjust Enrichment ("Restatement") §§ 66, 69 (2011).

<sup>2</sup> See, e.g., *In re Atrium of Racine, Inc.*, 986 N.W.2d 780 (Wis. 2023); *Variety Wholesalers, Inc. v. Salem Logistics Traffic Servs. LLC*, 723 S.E.2d 744 (N.C. 2012); *Lonely Maiden Prods., LLC v. Goldentree Asset Mgmt., LP*, 135 Cal. Rptr. 3d 69 (Cal. Ct. App. 2011); *In re AE Liquidation, Inc.*, 426 B.R. 511 (Bankr. D. Del. 2010); *In re Coupon Clearing Serv., Inc.*, 113 F.3d 1091 (9th Cir. 1997). Some states impose a statutory trust for the benefit of unpaid suppliers and subcontractors on funds that a contractor receives. See, e.g., Mich. Comp. Laws § 570.151; *Perini/Tompkins Joint Venture v. Comerica Bank*, 2014 WL 1028945 (E.D. Mich. 2014).

<sup>3</sup> See, e.g., *In re Union City Contractors, Inc.*, 2010 WL 1226882 (Bankr. N.D.N.Y. 2010); *Parker Motor Freight v Fifth Third Bank*, 116 F.3d 1137 (9th Cir. 1997);

<sup>4</sup> See, e.g., *Travelers Casualty and Surety Co. of America v. Paderta*, 315 F. Supp. 3d 1096 (N.D. Ill. 2018); *Safeco Ins. Co. v. Wheaton Bank and Trust Co.*, 2009 WL 2407740 (N.D. Ill. 2009).

For example, the trust beneficiary of a freight forwarder or logistics company could be the trucking company or carrier that delivers the goods of the customer of the freight forwarder or logistics company.

### How is an express trust created?

An express trust is created by contract. For example, a freight forwarder's contract with a customer might state that all or a specified portion of the amount collected from the customer is to be held in trust by the freight forwarder for payment to the carriers. But not all language that purports to create an express trust will actually create one. If the contract disclaims fiduciary obligations, imposes no requirement to segregate the funds, or contains other terms treating the intermediary as the owner of the funds, a court might disregard the language purporting to create a trust. In other words, the mere inclusion of trust language into a contract that creates what is fundamentally a debtor-creditor relationship is unlikely to create an express trust. Accordingly, lenders and their counsel should review a prospective borrower's contracts for express trust language and do an analysis of the substance of a transaction to determine if a trust is likely to have been created.

### How is a constructive trust imposed?

Under traditional principles of law and equity, a constructive trust can be imposed when the borrower receives funds or other assets for the purpose of or with the expectation that, those funds or assets will be forwarded to another person or entity. The most critical factors are:

- Whether the funds subject to the constructive trust are, or are required to be, segregated by the borrower from other funds or used for a specified purpose. A requirement that funds be segregated or used for a specified purpose favors imposition of a constructive trust.<sup>5</sup>
- Whether the borrower is obligated to pay interest on the funds received. A requirement that the borrower pay interest is a hallmark of a debtor-creditor relationship, and not a fiduciary or trust relationship.<sup>6</sup> However, if the borrower is required merely to remit to a third party whatever earnings the funds generate – for example, to pass along interest that is earned from the funds sitting in a segregated interest bearing deposit account – that might suggest that the third party is the beneficial owner of the funds.
- Whether the borrower is liable for its accounts payable owed to a third party even if the borrower does not collect from its own customers. Such liability implies a debtor-creditor relationship and not a constructive trust.<sup>7</sup>

Unfortunately none of these factors is conclusive. For example, while courts frequently state that the segregation of funds is the most important factor in deciding whether to impose a constructive trust, they might disregard the absence of segregation if the funds are collected from numerous customers and held for numerous intended recipients, such that segregation would be impractical.<sup>8</sup>

<sup>5</sup> See, e.g., *Lonely Maiden Prods.*, 135 Cal. Rptr. 3d 69 (a security interest granted by a payroll processor attached to funds provided to the processor by its clients because even though the processor's contracts with its clients required the processor to pay the clients' employees, the contracts disclaimed an agency relationship and did not require the processor to make the payments out of the funds provided).

<sup>6</sup> See, e.g., *In re Columbia Gas Systems Inc.*, 997 F.2d 1039, 1060 (3d Cir. 1993).

<sup>7</sup> See, e.g., *In re Coupon Clearing Service, Inc.*, 113 F.3d 1091, 1101-02 (9th Cir. 1997) (security interest of a lender to a clearing house attached to the funds received by the clearing house when it redeemed a manufacturer's coupons for retailers; the funds were not held in trust for the retailers because the clearing house was required to make payments to the retailers on a fixed schedule regardless of when it was paid by the manufacturers); *United States v. Lequire*, 672 F.3d 724 (9th Cir. 2012) (defendant's employer did not hold funds received for insurance premiums in trust for insurers because the agreement allowed for commingling, required premium payments to be made regardless whether the employer had collected them, and allowed the employer to collect interest on late premium payments).

<sup>8</sup> See, e.g., *In re Columbia Gas Systems Inc.*, 997 F.2d at 1061.

## What are a lender's legal defenses?

The imposition of a constructive trust does not necessarily prevent a security interest from attaching to the trust res. In general, as long as a secured lender acts without notice of the facts giving rise to the restitution claim, its security interest will attach and defeat the rights of the party seeking a constructive trust to support or enforce a restitution claim.<sup>9</sup>

Unfortunately, for this purpose “notice” means knowledge or having reason to know.<sup>10</sup> This means that the more due diligence the lender or its counsel performs, and the more it understands about the borrower's business and contractual relationships, the more likely the lender's security interest will be defeated by the rights of the trust claimant. In other words, even though the lender might not have notice of a particular trust beneficiary, a lender who was aware of how the borrower does business might be deemed to be on notice of any such claim flowing out of the borrower's regular operations, even if that claim arose after the creation of the security interest.<sup>11</sup> The security interest, if it attached at all, would therefore be subordinate to the constructive trust claim unless the constructive trust claimant knew of and consented to the grant of the security interest.<sup>12</sup>

## What should lenders look for when conducting due diligence?

Beyond conducting a review for express trust language, the segregation of funds, payments of interest to third parties and a borrower's liability for accounts payable, it is important for a lender to be on the lookout for other terms in the borrower's agreements that might permit the diversion of accounts receivable.

For example, if the borrower's agreement with its customers gives the customers the right to pay intended third party recipients directly under specified circumstances, or if the borrower's agreements with intended third party recipients (e.g., trucking companies or carriers) gives them the right to directly bill the borrower's customers, a dispute or default could generate an urgent liquidity problem.

This issue can be particularly acute if the borrower contracts with a third party under a master agreement. For example, if a freight forwarder has a master agreement with a carrier and enters into carriage contracts for multiple customers under the master agreement, a default in paying one carriage contract (perhaps because the borrower's customer did not pay) might entitle the carrier to withhold delivery of goods under other carriage contracts for different customers, and incentivize those customers to pay the carrier directly.

## How can a lender mitigate the risk?

A lender could put language in its loan agreements to restrict the borrower from engaging in activity that would create an express or constructive trust or permit the diversion of accounts receivable, a violation of which would generate an event of default that the lender could act upon. Note that the more language that is added – such as representations and warranties of sole ownership and no valid claims to a constructive trust – the more it may appear that the lender has inquiry notice of the facts giving rise to the trust claimant's rights.

<sup>9</sup> See Restatement (Third) of Restitution and Unjust Enrichment §§ 55, ill. 7, 66, 69. See also *Buffets, Inc. v. Leischow*, 732 F.3d 889 (8th Cir. 2013) (a restaurant company that lost \$3.5 million when a utility bill processor ceased operations had no claim against the processor's banks under the Minnesota version of the Uniform Fiduciaries Act because the bank accounts were titled in the processor's individual name and therefore the banks were not required to inquire whether the processor was breaching an obligation as fiduciary).

<sup>10</sup> See Restatement (Third) of Restitution and Unjust Enrichment § 69(2). See also *Parker Motor Freight*, 116 F.3d at 1142 (referring to “inquiry notice”).

<sup>11</sup> *But see* Restatement (Third) of Restitution and Unjust Enrichment § 69(1) (indicating that “notice” refers to “the facts giving rise to the restitution claim,” suggesting that the claim must be specific to a particular claimant and must precede the lender's interest).

<sup>12</sup> See, e.g., *In re Big Drive Cattle, LLC*, 2015 WL 1509824 (Bankr. D. Neb. 2015) (prepetition payments by a feedlot to the owner of cattle following the feedlot's sale of the cattle were avoidable preferences; the payments were not made from funds held in constructive trust for the owner because the owner, as a member of the feedlot, knew of and consented to the feedlot's grant of a security interest in its deposit accounts and the subsequent deposit of the sale proceeds into those deposit accounts caused the funds to lose the protection they would otherwise have had as bailment proceeds).

A lender may be able to short circuit constructive trust claims by requiring the borrower to include in its agreements with potential trust beneficiaries a waiver of the trust beneficiaries' rights. Because a constructive trust is a creature of equity, there is no reason to think that such right cannot be waived.

For example, to prevent intended payment recipients (e.g., the carriers or trucking companies contracting with a freight forwarder) from asserting a constructive trust claim, a lender could require the borrower to add the following language to its agreements with the carriers or trucking companies:

Nothing in this Agreement gives [ ] any right to, ownership interest in, or claim on [borrower's] rights to payment from any of [borrower's] customers or any payment received by [borrower] from any of [borrower's] customers. [ ] has no right to a constructive trust or lien on any of [borrower's] accounts due or receipts from [borrower's] customers.

Dealing with a potential constructive trust asserted by the borrower's own customers may be more difficult because language inserted into the borrower's contracts with its customers expressly disclaiming a trust might prompt customers or vendors to reconsider doing business with the borrower, or even worse, require that the borrower set up an express trust for the benefit of the customer or vendor. However, it should be possible to reduce the risk that a constructive trust would be created by omitting any requirement to segregate funds, disclaiming fiduciary duties, and expressly authorizing the borrower assign its rights under the contract.

## Conclusion

Lenders relying on a security interest in the accounts receivable or receipts of an intermediary business should conduct due diligence for express or constructive trusts. A lender's security interest may not attach to the portion of the receivables or receipts that is destined for one or more third-parties, and an intermediary borrower's liquidity problem could be amplified if the expected flow of funds is diverted through the actions of one or more customers or third-party payees. Lenders should carefully weigh their options with respect to additional loan agreement representations and warranties and covenants and additional language in a borrower's agreements.



*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

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