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Feature

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Copyright © 2005 by American Bankruptcy Institute; **Irve J. Goldman*****54 CAN YOU FREEZE ASSETS IN A FRAUDULENT CONVEYANCE ACTION AFTER GRUPO MEXICANO?**

In *Grupo Mexicano de Desarrollo v. Alliance Bond Fund Inc.*,¹ the U.S. Supreme Court held that in a contract action for money damages where no equitable relief is sought and no interest in the defendant's assets is claimed, a district court lacks authority to issue a preliminary injunction freezing a defendant's assets before a judgment is entered.² Since *Grupo Mexicano*, however, most courts have not found it to be a legal impediment to granting an asset-freeze injunction in cases where the plaintiff's underlying action makes a claim to assets in a defendant's possession or seeks equitable relief, such as the imposition of a constructive trust.³

The Ninth Circuit's Decision in *Focus Media*

Recently, in *Rubin v. Pringle (In re Focus Media Inc.)*,⁴ the U.S. Court of Appeals for the Ninth Circuit held that *Grupo Mexicano* did not preclude a bankruptcy court from issuing a prejudgment asset-freezing injunction in an adversary proceeding for the recovery of fraudulent transfers under 11 U.S.C. §548 and state law and for turnover under 11 U.S.C. §542.⁵ The reasoning of the Ninth Circuit in upholding the injunction was that because the underlying causes of action were equitable in nature⁶ and involved bankruptcy and fraudulent conveyances, *Grupo Mexicano* did not bar the grant of a preliminary injunction freezing assets.⁷ It is submitted that the Ninth Circuit's reasoning in *Focus Media* is subject to debate.

In reaching its conclusion, the Ninth Circuit interpreted *Grupo Mexicano* as permitting prejudgment asset-freeze injunctions in all actions involving bankruptcy and fraudulent conveyance.⁸ In support of this interpretation, the Ninth Circuit referred to language in the Supreme Court's opinion stating that when debtors try "to avoid paying their debts," such as by transferring their property, or seek "to favor some creditors over others,"⁹ "[t]he law of fraudulent conveyance and bankruptcy was developed to prevent such conduct; an equitable power to restrict a debtor's use of his unencumbered property before judgment was not."¹⁰

In the context of the *Grupo Mexicano* case, however,¹¹ it seems clear that in describing the laws of fraudulent conveyance and bankruptcy as designed to prevent transfers of assets or preferential payments, the Supreme Court was not laying down a rule that prejudgment asset-freeze injunctions are permitted in all such cases, but was simply observing that fraudulent-conveyance actions are the remedy for recovering assets transferred prejudgment and that bankruptcy is available to be filed, involuntarily, if a creditor believes preferential transfers have been made. This alternate interpretation is corroborated by the court's discussion of [Rule 18\(b\) of the Federal Rules of Civil Procedure](#), which provides:

(b) **Joinder of Remedies; Fraudulent Conveyances.** Whenever a claim is one heretofore cognizable only after another claim has been prosecuted to a conclusion, the two claims may be joined in a single action, but the court shall grant relief in that action only in accordance with the relative substantive rights of the parties. In particular,

a plaintiff may state a claim for money and a claim to have set aside a conveyance fraudulent as to that plaintiff, without first having obtain[ed] a judgment establishing the claim for money.

Fed. R. Civ. P. 18(b).

In commenting on [Rule 18\(b\)](#), the Supreme Court remarked “that it says nothing about preliminary relief,”¹² and in a footnote stated as follows:

Several states have adopted the Uniform Fraudulent Conveyance Act (or its successor Uniform Fraudulent Conveyance Act), which has been interpreted as conferring on a nonjudgment creditor the right to bring a fraudulent conveyance claim [*citing authority.*] Insofar as [Rule 18\(b\)](#) applies to such an action, the state statute eliminating the need for a judgment may have altered the common-law rule that a general creditor has no interest in his debtor's property. *Because this case does not involve a claim of fraudulent conveyance, we express no opinion on the point.*¹³

Thus, the Supreme Court expressly declined to rule that a prejudgment asset-freeze injunction was an available remedy in a fraudulent-conveyance action.¹⁴

Is a Fraudulent-conveyance Action Legal or Equitable?

To characterize a fraudulent-conveyance action as equitable is also of doubtful validity. In *Granfinanciera v. Nordberg*,¹⁵ the U.S. Supreme Court ruled that a fraudulent-conveyance action under 11 U.S.C. §548, which sought the recovery of \$1.7 million that was transferred within one year of a bankruptcy filing, was a legal, not equitable, claim, because it sought the recovery *55 of a fixed sum of money without a claim for accounting or other equitable relief.¹⁶ While in the course of its opinion the Supreme Court suggested that under English common law, a fraudulent-conveyance action seeking the recovery of real estate invoked the equitable process,¹⁷ it later observed that this conclusion was in tension with its decision in *Whitehead v. Shattuck*,¹⁸ which it quoted as stating that “where an action is simply for the recovery of specific real or personal property, or for the recovery of a money judgment, the action is one at law. An action for the recovery of real property, including damages for withholding it, has always been of that class.”¹⁹ Thus, based on the teachings of the *Granfinanciera* decision, one would be hard-pressed to denominate a fraudulent-conveyance action as equitable in nature, particularly if all it seeks is the recovery of money.²⁰

The Availability of a Constructive Trust

All is not lost for proponents of the prejudgment asset-freeze injunction, however, because a constructive trust, which is recognized as an equitable remedy, is a widely accepted form of relief in many fraudulent-conveyance cases, particularly those involving real estate or specific assets.²¹ In cases where a constructive trust in money is asserted and the money is commingled with other funds, however, a constructive trust is more difficult to establish because of the requirement that the money be traced.²² Nonetheless, cases in which a constructive trust is asserted have been held to be outside the prohibition in *Grupo Mexicano* against prejudgment asset-freeze injunctions.²³

Particular Bankruptcy Considerations

In *Grupo Mexicano*, the Supreme Court distinguished its decision in *U.S. v. First National City Bank*,²⁴ which authorized the freezing of a taxpayer's bank account pending the determination of a tax collection *79 action²⁵ on the basis that in *First National City Bank*, there was a provision in the Internal Revenue Code that authorized district courts “to grant injunctions necessary or appropriate for the enforcement of the Internal Revenue laws.”²⁶ The language of that statutory provision, 26 U.S.C. §7402(a), is strikingly similar to the language of 11 U.S.C. §105(a), which states that bankruptcy courts “may issue any order that is necessary or appropriate to carry out the provisions of this title.”²⁷

Section 105(a) of the Bankruptcy Code has been held to be a basis for issuing a prejudgment asset-freeze injunction in an adversary proceeding in bankruptcy court.²⁸ In so holding, the Second Circuit in *Feit & Drexler* specifically analogized §105(a) to the statutory provision relied upon by the Supreme Court in *First National City Bank* in upholding the freezing of assets *pende lite*. Since *Grupo Mexicano* was decided, at least one bankruptcy decision has held that based on 11 U.S.C. §105(a), bankruptcy courts have the power to issue prejudgment asset-freeze injunctions in adversary proceedings.²⁹ Thus, it appears the result in the *Focus Media* case may have been correct, but for the wrong reasons.

Conclusion

The Supreme Court in *Grupo Mexicano* confirmed the power of a federal court to issue a prejudgment asset-freeze injunction where the underlying action asserts a claim to assets in the defendant's possession or seeks equitable relief. Since a fraudulent-conveyance action to recover money or personal property was held by the Supreme Court in *Granfinanciera* to be a legal, not equitable, claim, a prejudgment asset-freeze injunction may not be available in that type of case. Nonetheless, for fraudulent-conveyance actions in bankruptcy court, such injunctions would appear to be properly based on 11 U.S.C. §105(a), which authorizes the bankruptcy court to issue any order that is necessary or appropriate to carry out the provisions of the Code.

Footnotes

- 1 *Grupo Mexicano de Desarrollo v. Alliance Bond Fund Inc.*, 527 U.S. 308, 119 S.Ct. 1961, 144 L.Ed.2d 319 (1999).
- 2 *Grupo Mexicano*, 527 U.S. at 333, 119 S.Ct. at 1975 (district court “had no authority to issue a preliminary injunction preventing petitioners from disposing of their assets pending adjudication of respondents' contract claim for money damages”). Earlier in its opinion, the Supreme Court emphasized that as a general rule, a creditor has no right to interfere with the assets of its debtor absent an interest on those assets, which is typically acquired, in the case of real estate, when a money judgment is obtained, and in the case of personal property, when an execution is served. See *Grupo Mexicano*, 527 U.S. at n. 6 and accompanying text. The Court also distinguished the case of *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 61 S.Ct. 229, 85 L.Ed. 189 (1990), on the basis that in *Deckert*, the plaintiff, which sought and was granted a preliminary injunction freezing assets, also sought, in its underlying action, “the equitable remedies of rescission of the contracts and restitution of the consideration paid.” *Grupo Mexicano*, 527 U.S. at 325.
- 3 See *CSC Holdings Inc. v. Redisi*, 309 F.3d 988, 996 (7th Cir. 2002). (*Grupo Mexicano* did not apply where complaint sought an accounting and the imposition of a constructive trust); *U.S. v. Oncology Associates PC*, 198 F.3d 489, 496-97 (4th Cir. 1999), (*Grupo Mexicano* does not apply when plaintiff makes a “cognizable claim to specific assets of the defendant or seeks a remedy involving those assets,” such as a claim under the “equitable doctrine of unjust enrichment” or a request for the imposition of a constructive trust); *Motorola Credit Corp. v. Uzan*, 202 F.Supp.2d 239, 250 (S.D.N.Y. 2002) (preliminary injunction requiring transfer of stock to registry of court in aid of a constructive trust, where stock was also pledged as collateral for loan to plaintiffs, was not prohibited by *Grupo Mexicano*); *Quantum Corporate Funding Ltd. v. Assist You Home Health Care Services of Virginia LLC*, 144 F.Supp.2d 241, 249-50 (S.D.N.Y. 2001) (granting preliminary injunction to freeze assets in which plaintiff had a security interest and where there was a strong nexus between collateral—receivables—and claims for money damages, notwithstanding *Grupo Mexicano*); *Wisnatzki v. Nathel v. H.P. Island-Wide Inc.*, No. 00 Civ. 8051 (JSM). 2000 WL 1610790, at *2 (S.D.N.Y. Oct. 27, 2000) (preliminary injunction freezing assets permitted where assets were claimed to be the proceeds of a statutory trust under Perishable Agriculture Commodities Act).

- 4 *Rubin v. Pringle (In re Focus Media Inc.)*, 387 F.3d 1077 (9th Cir. 2004).
- 5 *Id.* at 1080. The causes of action were based on the transfer by Focus Media, the debtor, of \$20 million to its sole shareholder, Rubin, within one prior to an involuntary bankruptcy filing, and its granting of millions of dollars in unpaid loans to Rubin in 1999 and 2000. *Id.*
- 6 The Ninth Circuit noted that the chapter 7 trustee also pleaded a cause of action for a constructive trust. *Id.* at 1085, which was not mentioned when it initially described the causes of action brought by the trustee. *See Id.* at 1080.
- 7 *Id.* at 1084.
- 8 *Rubin v. Pringle (In re Focus Media Inc.)*, 387 F.3d 1077, 1084 (9th Cir. 2004) (“the court specifically excepted from this rule instances of bankruptcy and fraudulent conveyance.”)
- 9 *Rubin v. Pringle (In re Focus Media Inc.)*, 387 F.3d 1072, 1084 (9th Cir. 2004).
- 10 *Id.* (quoting *Grupo Mexicano de Desarrollo SA v. Alliance Bond Fund Inc.*, 527 U.S. 308, 322, 119 S.Ct. 1961, 1970, 144 L.Ed.2d 319 (1999)).
- 11 In *Grupo Mexicano*, the justification claimed for the pre-judgment asset-freeze injunction was that defendant “was dissipating its most significant asset...and was preferring its Mexican creditors” by earmarking certain assets for them. *Grupo Mexicano*, 527 U.S. at 312.
- 12 *Grupo Mexicano*, 527 U.S. 308, 324, 119 S.Ct. 1961, 1970, 144 L.Ed.2d 319 (1999).
- 13 *Grupo Mexicano*, 527 U.S. at 324, n. 7, 2, 119 S.Ct. at 1970 n. 7 (emphasis added).
- 14 At least one court has held that a district court may order a preliminary injunction preventing a corporation owned by a judgment debtor from transferring any assets or funds to the judgment debtor or his offshore trust pending resolution of the judgment creditor's underlying fraudulent transfer action. *See Nastro v. D'Onofrio*, 263 F.Supp.2d 446, 459-461 (D. Conn. 2003). The creditor in *D'Onofrio* did, however, hold a money judgment.
- 15 *Granfinanciera v. Nordberg*, 492 U.S. 33, 109 S.Ct. 2782, 106 L.Ed.2d 26 (1989).
- 16 *Id.* at 46-48, 2793. The issue in *Granfinanciera* was whether the defendant was entitled to a jury trial on a fraudulent-conveyance action to recover an allegedly fraudulent monetary transfer. *Id.* at 37, 2787. For that purpose, the Supreme Court set out to determine whether the cause of action was legal or equitable. *Id.* at 40-47, 2790-2793.
- 17 *Id.* at 44, 2791.
- 18 *Whitehead v. Shattuck*, 138 U.S. 146, 11 S.Ct. 276, 34 L.Ed. 873 (1891).
- 19 *Granfinanciera*, 429 U.S. at 46 n.5, 109 S.Ct. at 2792 n.5 (quoting *Whitehead v. Shattuck*, 138 U.S. 146, 151, 11 S.Ct. 276, 277, 34 L.Ed. 873 (1891)). *But, see Resolution Trust Corp. v. Pasquariello (In re Pasquariello)*, 16 F.3d 525, 530-31 (3d Cir. 1994) (fraudulent-conveyance action for recovery of real estate is equitable, notwithstanding *Granfinanciera*).
- 20 The other cause of action asserted by the bankruptcy trustee in *Focus Media* was for turnover under 11 U.S.C. §542. While obviously equitable in nature, it is equally clear that a turnover action cannot be sustained if what is sought to be turned over is also claimed to be the subject of a fraudulent transfer. Under 11 U.S.C. §542, turnover must be of “property of the estate.” 11 U.S.C. §542(a). Property that is fraudulently transferred, however, is not property of the estate. *See FDIC v. Hirsch (In re Colonial Realty Co.)*, 980 F.2d 125, 131 (2d Cir. 1992).
- 21 *See Luker v. Reeves (In re Reeves)*, 65 F.3d 670, 672 (8th Cir. 1995); *Resolution Trust Corp. v. Pasquariello (In re Pasquariello)*, 16 F.3d 525, 531 (3d Cir. 1994); *Belfance v. Bushey (In re Bushey)*, 210 B.R. 95, 105 (6th Cir. BAP 1997); *Bohm v. Dolata (In re Dolata)*, 306 B.R. 97, 145 (Bankr. W.D. Pa. 2004).
- 22 *Kupetz v. United States (In re California Trade Technical Schools Inc.)*, 923 F.2d 641, 647 (9th Cir. 1991) (“[t]he imposition of a constructive trust upon the assets of the debtor is subject to the tracing requirement under bankruptcy law”); *Daly v. Radulesco (In re Carrozella & Richardson)*, 247 R.R. 595, 601-02 (2d Cir. BAP 2000 (party seeking to establish constructive trust in money

that was commingled must trace funds in which constructive trust is asserted); *Amedisys v. JP Morgan Chase Bank (In re National Century Financial Enterprises Inc.)*, 310 B.R. 580, 599 (Bankr. S.D. Ohio 2004) (funds alleged to be held in a constructive trust, when commingled with other unidentifiable funds, had to be traced in order for constructive trust claims to succeed); *Orchards v. Linsey (In re Linsey)*, 296 B.R. 582, 586 (Bankr. D. Mass. 2003) (“[i]n the case of commingling...the claimant bears the further burden of tracing the alleged trust property ‘specifically and directly’ back to the illegal transfers giving rise to the trust”). The tracing requirement is, however, made easier by the “lowest intermediate balance” rule. This rule has been described as allowing trust beneficiaries to assume that trust funds are withdrawn last from a commingled account. Once trust money is removed, however, it is not replenished by subsequent deposits. Therefore, the lowest intermediate balance in a commingled account represents trust funds that have never been dissipated and that are reasonably identifiable. *In re Columbia Gas Systems Inc.*, 997 F.2d 1039, 1063 (3d Cir. 1993).

23 *See supra* p. 1. n. 3. While a constructive trust in money alleged to have been fraudulently transferred is an available remedy, courts should take care to ensure that it is not claimed simply to fit within an exception to the *Grupo Mexicano* rule, for the prejudgment asset-freeze injunction has been described as “the nuclear weapon of the law.” *Grupo Mexicano de Desarrollo SA v. Alliance Bond Fund Inc.*, 527 U.S. 308, 329, 119 S.Ct. 1961, 1973, 144 L.Ed.2d 319 (1999).

24 *United States v. First National City Bank*, 379 U.S. 378, 85 S.Ct. 528, 13 L.Ed.2d 365 (1965).

25 *Id.* at 384, 531-32.

26 *Grupo Mexicano*, 527 U.S. at 325-26, 119 S.Ct. at 1971.

27 11 U.S.C. §105(a).

28 *Green v. Drexler (In re Feis & Drexler Inc.)*, 760 F.2d 406, 414 (2d Cir. 1985).

29 *Adelphia Communications Corp. v. Rigas (In re Adelphia Communications Corp.)*, No. 02-Civ, 8495 GBD.02-41729 REG, 2003 WL 21297258, at *4 (S.D.N.Y. June 4, 2003) (bankruptcy court may issue a prejudgment asset freeze injunction under 11 U.S.C. §105(a)).

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